

quarterly predictions

#37, fourth quarter 2006

In this issue, the International Centre for Policy Studies presents an estimate of the political and economic situation in Ukraine for 2006, government policy, and factors that will influence these in the medium term. Forecasts for 2007–2008 are updated and a forecast for 2009 introduced.

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MAJOR INDICATORS

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Indicator							estimate	forecast		
Economic activity										
GDP, billions UAH	170.1	204.2	225.8	267.3	345.1	424.7	525.5	610.5	726.5	867.6
Real GDP, <i>apc</i> *	5.9	9.2	5.2	9.6	12.1	2.6	6.8	5.5	5.0	5.5
Real industrial output, <i>apc</i>	13.2	14.2	7.0	15.8	12.5	3.1	5.5	3.0	4.0	4.5
Real agricultural output, <i>apc</i>	9.8	10.2	1.2	-11.0	19.7	-0.1	0.0	6.0	3.0	3.0
Gross investment, % GDP	19.7	21.8	20.2	22.0	22.5	22.0	22.9	23.4	24.0	24.7
Real gross fixed investment, <i>apc</i>	12.4	6.2	3.4	22.5	20.5	-0.3	11.0	12.0	13.0	8.0
Real total consumption, <i>apc</i>	2.0	9.3	5.0	10.0	10.0	12.8	14.0	10.8	10.8	10.9
Net FDI, millions USD ⁽¹⁾	594	769	688	1,411	1,711	7,533	4,500	3,500	4,000	4,500
Real disposable household income, <i>apc</i>	11.1	10.0	18.0	9.1	19.6	20.1	16.5	11.0	12.0	14.0
Real retail trade, <i>apc</i>	8.1	13.7	15.0	20.5	21.9	23.0	23.0	13.0	13.0	15.0
Prices										
Consumer price index, <i>apc</i>	25.8	6.1	-0.6	8.2	12.3	10.3	12.5	9.0	8.0	6.0
Producer price index, <i>apc</i>	20.9	0.9	5.7	11.1	24.1	9.5	14.5	10.5	9.0	7.5
Labor market										
Population, millions	49.3	48.9	48.5	48.0	47.6	47.3	46.9	46.6	46.3	46.1
Average monthly real wages, <i>apc</i>	-0.9	19.3	18.2	15.2	23.8	20.3	19.0	13.0	13.0	14.0
Unemployment rate, % (ILO methodology)	11.7	11.0	10.2	9.1	8.6	7.2	6.7	6.4	6.2	6.1
Foreign economic activity										
Exports of goods&services, <i>apc</i>	14.4	8.0	10.7	24.0	42.6	7.5	12.7	6.9	7.8	9.3
Imports of goods&services, <i>apc</i>	17.8	14.1	5.0	28.7	31.3	20.4	21.7	14.1	11.9	10.2
Current account balance, % GDP	4.7	3.7	7.5	5.8	10.6	3.1	-1.1	-4.4	-6.2	-6.2
Budget										
Revenues, % GDP (consolidated) ⁽²⁾	27.0	25.7	27.7	28.2	26.5	31.6	33.7	33.4	31.4	31.4
Balance, % GDP ⁽²⁾	-0.8	-1.5	0.7	-0.2	-3.2	-1.8	-2.9	-2.7	-2.0	-3.0
Financial indicators										
Monetary base, <i>apc</i>	39	37	34	30	34	54	12	22	20	18
M3, <i>apc</i>	45	42	42	47	32	54	36	23	24	20
NBU gold/forex reserves, millions USD ⁽³⁾	1,725	3,341	4,445	6,958	9,526	19,391	21,221	20,017	20,617	20,617
Official exchange rate, UAH/USD (average annual)	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.12	5.44	5.50
Loan interest, % <i>pa</i> (average annual) ⁽⁴⁾	40	32	25	20	18	16	15	13	12	11
Global economy										
Global GDP, <i>apc</i>	4.9	2.6	3.1	4.1	5.3	4.9	5.0	4.2	4.5	4.0
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	6.1	2.6	4.0	4.7	5.7	4.9	5.5	4.3	4.2	3.8

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU;
⁽²⁾ using IMF methodology;
⁽³⁾ according to balance of payments 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

A look at 2006

Ukraine's economy grew 6.8% in 2006

The shocking rise in the price of imported gas¹ had no dramatic impact on Ukraine's economy in 2006. Real GDP grew 6.8%, according to ICPS analysts.²

The main factor driving Ukraine's economic upswing was renewed growth in investment. After contracting 0.3% in 2005, gross accumulation of fixed assets grew 11% in 2006, according to ICPS analysts. This, in turn, was spurred by renewed capital investment on the part of the state and growing need in the private sector to expand production capacities to satisfy domestic consumer demand, which has been growing rapidly (see **BUSINESS**).

The balance of trade became negative...

World prices for Ukraine's main export commodities, metals, were better for the Ukrainian economy in 2006 than they had been in the previous year. Exports increased 11%, compared to only 4.8% in 2005. However, imports grew twice as fast in 2006 because of rising energy prices, high consumer demand, and growing demand for capital. As a result, Ukraine's balance of trade slipped into the red for the first time since 1998, to –US \$3.2bn or 3.1% of GDP (see **FOREIGN TRADE**).

...but did not lead to a devaluation of the hryvnia

This negative balance does not constitute a threat to the stability of the hryvnia or of the economy as a whole. Over the years of a positive trade balance, the National Bank of Ukraine accumulated enough hard currency reserves to maintain a stable exchange rate over a relatively long time. As the inflow of foreign capital grew during 2006, NBU reserves increased 9.3%, to US \$21.2bn. Thus, the hryvnia-dollar exchange rate remained unchanged at UAH 5.05/USD (see **MONETARY POLICY**).

Private consumption grew at a rapid pace in 2006. ICPS economists estimate that household spending increased 17% in real terms. In contrast to the previous period, when consumption was spurred by the growth in incomes among the poorest layers of the population as social benefits went up, 2006 saw consumption grow as middle-income Ukrainians began to spend more. Economic growth ensured a steep rise in salaries³ (see **HOUSEHOLDS**).

Despite much higher gas prices, manufacturing continued to expand

Despite the sharp increase in gas prices, industrial output picked up pace in 2006, growing 5.5% according to ICPS estimates. The highest growth could be seen in metallurgy (8.5%) and heavy machinery (12%). After falling steeply in 2005, trade grew a healthy 14.5% in 2006 as wholesale operations picked up. High demand for real property has led to rapid growth in construction at 7% (see **BUSINESS**).

Inflation has accelerated to 12.5%

The main factor driving prices was an across-the-board increase in regulated rates for utilities. ICPS economists say the Consumer Price Index (CPI) grew 12.5% over the year. Steep growth in disposable incomes and high expectations of inflation among consumers also stimulated price growth. The Producer Price Index (PPI) grew 14.5% over 2006. Manufacturing prices and prices for the distribution of power, gas and water grew the most, as did the cost of extracting fuels (see **PRICES**).

¹ In 2006, the price of imported gas nearly doubled, to US \$95/1,000 cu m. Over 70% of gas consumed in Ukraine is imported.

² In 2005, GDP grew 2.6%.

³ ICPS economists say that real wages grew 19% in 2006.

This faster-than-anticipated economic growth supported Budget revenues so that they covered all planned expenditures. The share of GDP redistributed through the Consolidated Budget reached a record-high 33.7% in 2006. The deficit, according to ICPS estimates, will be 2.8% of GDP for 2006 (see **PUBLIC FINANCE**).

Forecast

Policy environment

The current political system is unable to ensure policies that would stimulate Ukraine's economy to a qualitative breakthrough during the forecast period. ICPS economists base this assessment on their evaluation of the political system:

- **WEAK PUBLIC INSTITUTIONS.** They do not guarantee political honesty and transparency or economic competitiveness in the country. Politicians are able to continually change the rules of the game, at the cost of consistency and systematicness in state policy. Weak institutions also allow politicians to interfere in economic processes and to regulate markets using administrative means. This encourages corruption, preserves an unappealing business climate and creates barriers to entry on domestic markets.
- **A GOVERNMENT MACHINE UNABLE TO ACT STRATEGICALLY.** State decisions are mostly made in the interests of specific political forces. Typically, they are very narrowly focused and short-term in orientation, in response to either some crisis or the powerful lobbying of specific business circles. As a result, economic policy is reactive rather than proactive. The restructuring of the economy is largely happening under pressure from external shocks and is more the outcome of management decisions on the part of business itself, without the strategic support of the state, which should really be instituting reforms itself and direct the changes.
- **NO SYSTEM FOR REACHING COMPROMISES HAS BEEN WORKED OUT.** In a situation where the President and Government belong to different political forces, there is a need to reach compromise in order to make state decisions. On one hand, such a system can lead to better quality policy. On the other, there is a risk of a number of negative consequences. First, this need to agree every single decision reduces the efficiency and responsiveness of the state machine. Second, as the last few months have shown, in order to more quickly reach a compromise, the two sides have started to break up major policy decisions, such as the Budget, into smaller components. This kind of fragmentation of state policy will lead to a loss of systemicness and, thence, strategic effectiveness. Third, there is a problem in that the procedure for reaching these compromises is new to Ukraine's political system and time is needed to work out both formal and informal rules for interacting.

ICPS analysts say that the political situation will evolve without any radical changes to the political system over 2007–2009 (see **POLITICS**). Nor will there be any major positive changes in those areas that critically affect the economy: the judiciary, tax policy or combating corruption. The state will continue to merely respond to ongoing economic changes, without stimulating the development of the country's most promising economic sectors.

Economic trends

ICPS economists expect Ukraine's economy to develop moderately over the forecast period. GDP will grow 5.5% in 2007, 5% in 2008, and 5.5% in 2009.

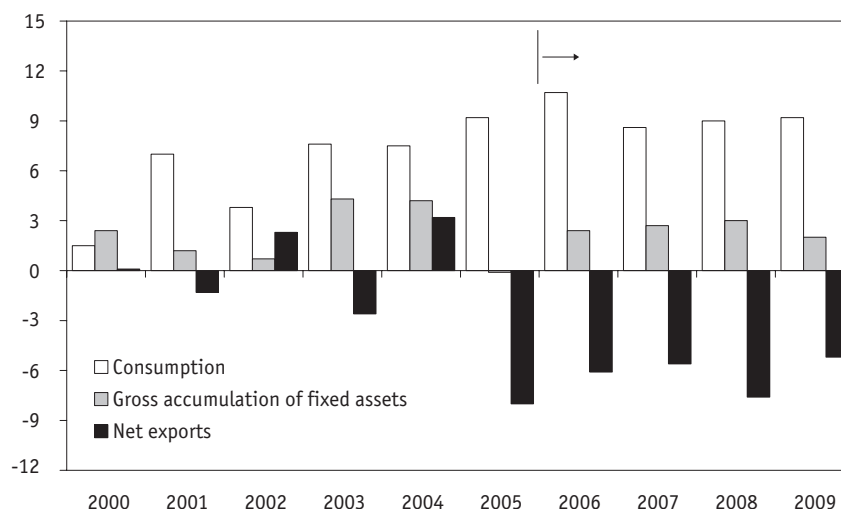
Current economic policy is not going to encourage an economic breakthrough

The state is not about to help promising sectors develop

<i>GDP, % real annual change</i>	
2004	12.1
2005	2.6
2006	6.8
2007	5.5
2008	5.0
2009	5.5

Throughout this period, private consumption will grow more slowly than in 2006 as household incomes slow their growth and individuals begin to save more. In 2007, private consumption will grow 10% in real terms and 11% in 2008. In 2009, consumption will pick up pace as disposable incomes take another leap, to 13%, as social spending increases in the run-up to the Presidential election (see **HOUSEHOLDS**).

Figure 1. Contribution of components to real GDP growth, pp



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

Investments will continue to grow strongly

Over 2007–2008, investment will accelerate to 12% and 13%. ICPS analysts say that investment will mostly go into those sectors oriented on domestic consumer markets and on domestic producers who are looking to update worn-out, energy-intensive equipment and technology. In 2009, investment will slow down to 8% as the state investment component shrinks (see **BUSINESS**).

The trade deficit will grow throughout the forecast period and by the end of 2009 will reach nearly US \$12bn. Imports will continue to grow faster than exports. World prices for traditional export commodities will be less favorable. Imports will satisfy the economy’s demand for investment as well as continuing high consumer demand (see **FOREIGN TRADE**).

Inflation will subside

Inflation will subside throughout the forecast period. Consumer prices will grow more slowly as disposable incomes slow down, imports continue to be price stable, and the supply of consumer goods expands. In 2007–2009, the CPI will grow 9%, 8% and 6%. Stabilization and even a touch of price deflation on steel markets will slow the growth of producer prices. In 2007, these will grow relatively high because of the increased price of imported gas. The PPI will grow 10.5%, 9% and 7.5% over 2007–2009 (see **PRICES**).

The increase in gas prices as of 1 January 2007 to US \$130/1,000 cu m will have a negative impact on the chemicals industry, the fuel and energy complex, and the residential services sector. This will cause industrial output to slow down. In 2007, industrial growth will reach only 3%. Real growth in household incomes will lead to high demand for machinery and food products. Industrial output will then pick up, growing 4% in 2008 and 4.5% in 2009 (see **BUSINESS**).

With a sharp upswing in livestock breeding, farm output will grow 6% in 2007. Slower growth in field crops will hold back overall growth in the agricultural sector. Over 2008–2009, agricultural output will grow 3% per year.

ICPS analysts say that in 2007 the National Bank of Ukraine will begin a gradual devaluation of the hryvnia because of the relatively low inflows of foreign capital. These will not help cover the deficit on the current account balance. By the end of 2007, the hryvnia will be at UAH 5.30/USD, while in 2008 and 2009 it will drop to UAH 5.50/USD.

ICPS economists expect that the share of GDP redistributed through the Budget will grow smaller in 2007–2009. In 2009, it should be down to 31.4%. At the same time, the Consolidated Budget deficit will grow to 3.0% in 2009 as social spending is expanded in the run-up to the Presidential election.

The main risks to the ICPS forecast are:

- a rise in the price of imported gas above the US \$130/1,000 cu m mark in 2008–2009;
- sudden changes in world prices for metals and chemicals;
- reduced tax receipts in the Budget as the result of major tax breaks and/or an increase in shadow operations involving investment projects in SEZs and TPDs;
- a higher-than-forecast devaluation of the hryvnia.

Highlights of quarterly predictions #37

- *rebuilding and reviving political institutions*
- *an assessment of the 2007 Budget*
- *forecast for social reforms*
- *the impact of introducing grain export restrictions*
- *outside influences on investment inflows*
- *should gas be replaced by coal in the energy sector?*
- *foreign capital on the Russian market*
- *various evaluations of the hryvnia*
- *rate-setting policy in the residential services sector*

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