

quarterly predictions

#38, first quarter 2007

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

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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	441.5	535.9	651.6	765.8	880.2
Real GDP, <i>apc</i> *	5.9	9.2	5.2	9.6	12.1	2.7	7.1	6.5	5.5	6.5
Real industrial output, <i>apc</i>	13.2	14.2	7.0	15.8	12.5	3.1	6.2	5.0	4.5	5.0
Real agricultural output, <i>apc</i>	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	6.0	3.0	3.0
Gross investment, % GDP	19.7	19.7	19.2	20.6	22.6	22.0	23.6	25.5	27.0	27.8
Real gross fixed investment, <i>apc</i>	12.3	6.0	3.4	22.5	20.5	3.9	14.7	18.0	14.0	10.0
Real total consumption, <i>apc</i>	2.0	9.3	5.0	10.0	9.7	15.7	11.2	11.0	10.5	12.4
Net FDI, millions USD ⁽¹⁾	594	769	688	1,411	1,711	7,533	5,336	5,500	5,700	6,000
Real disposable household income, <i>apc</i>	11.1	10.0	18.0	9.1	19.6	23.9	16.1	13.0	12.5	15.5
Real retail trade, <i>apc</i>	8.1	13.7	15.0	20.5	21.9	23.4	25.3	18.0	13.5	15.0
Prices										
Consumer price index, <i>apc</i>	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	9.5	8.0	6.0
Producer price index, <i>apc</i>	20.9	0.9	5.7	11.1	24.1	9.5	14.1	11.5	9.0	7.5
Labor market										
Population, millions ⁽²⁾	49.4	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	18.3	14.0	14.0	16.0
Unemployment rate, % (ILO methodology)	11.6	10.9	9.6	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	13.2	8.4	10.2	12.0
Imports of goods&services, <i>apc</i>	17.8	14.1	5.0	28.7	31.3	20.4	22.0	15.5	13.4	11.2
Current account balance, % GDP	4.7	3.7	7.5	5.8	10.7	2.9	-1.5	-4.4	-5.6	-5.4
Budget										
Revenues, % GDP (consolidated) ⁽³⁾	27.0	25.7	27.7	28.2	26.5	30.4	32.5	33.5	33.3	34.3
Balance, % GDP ⁽³⁾	-0.8	-1.5	0.7	-0.2	-3.2	-1.8	-0.7	-2.6	-1.4	-1.6
Financial indicators										
Monetary base, <i>apc</i>	39	37	34	30	34	54	18	22	20	18
M3, <i>apc</i>	45	42	42	47	32	54	35	23	24	20
NBU gold/forex reserves, millions USD ⁽⁴⁾	1,725	3,341	4,445	6,958	9,526	19,391	22,358	23,467	21,767	21,767
Official exchange rate, UAH/USD (average annual)	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.12	5.30
Loan interest, % <i>pa</i> (average annual) ⁽⁵⁾	40	32	25	20	18	16	15	13	13	12
Global economy										
Global GDP, <i>apc</i>	4.9	2.6	3.1	4.1	5.3	4.9	5.4	4.3	4.8	4.2
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	5.6	4.4	4.3	4.0

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU
⁽²⁾ at the start of the year
⁽³⁾ using IMF methodology
⁽⁴⁾ according to balance of payments methodology
⁽⁵⁾ commercial bank loans, UAH

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

OVERVIEW

<i>GDP, % real annual change</i>	
2004	12.1
2005	2.7
2006	7.1
2007	6.5
2008	5.5
2009	6.5

Ukraine's economy will grow at a moderate pace. ICPS economists expect real GDP to grow 6.5% in 2007, 5.5% in 2008 and 6.5% in 2009.

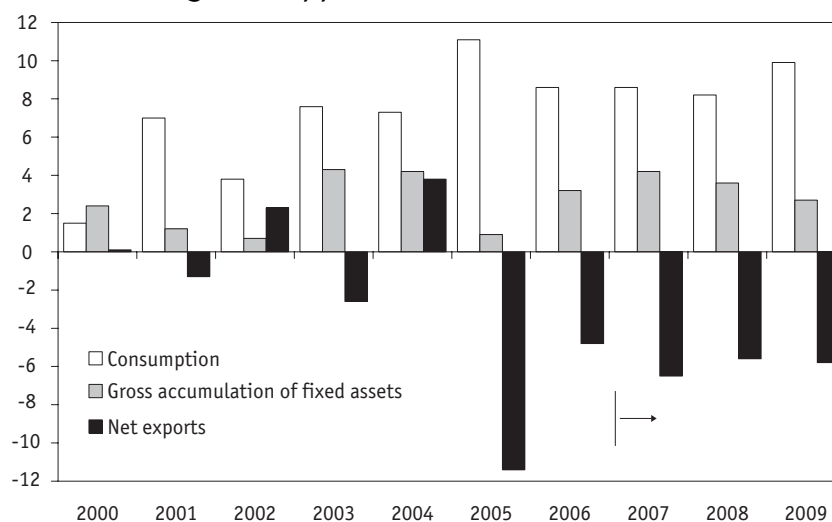
According to ICPS analysts, the Government will not implement any large-scale economic reforms during the forecast period. The failure to complete political reform and the lack of consensus on the country's political system will lead to a situation where political competition will be focused primarily around the issues related to the political structure and powers of various institutions. Meanwhile, economic policy will remain in the background.

The Government will try to resolve current problems and implement initiatives that were prepared but not completed in previous years. It will also invest actively, but inefficiently, as the Government has neither clear-cut priorities regarding the distribution of public funds nor a vision of its own role in the economy.

Despite the Government's announced intentions to reduce the tax burden, the share of GDP re-distributed through the Budget will remain higher. ICPS economists expect Consolidated Budget revenues to constitute 33.5% of GDP in 2007, 33.3% of GDP in 2008 and 34.3% of GDP in 2009 (see **PUBLIC FINANCE**).

The lengthy period between elections will make it possible to increase the share of capital spending in the State Budget. However, in 2009, the Budget's orientation towards capital investment will lessen as the 2009 presidential election approaches and presidential hopefuls begin to focus more on social spending.

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



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

Consumption will be the main factor driving GDP growth...

As in the previous years, consumption will be the main driver of growth. The propensity to consume will continue to be high throughout the forecast period. As in 2006, private consumption will be encouraged by bank loans to private individuals, in addition to growing wages and social benefits.

Still, ICPS economists expect consumption to slow down over 2007–2008, as personal incomes grow more slowly. Specifically, ICPS economists expect social benefits to remain nearly flat in real terms over this period. The ICPS forecast is for household consumption to grow 13% in 2007 and 12% in 2008 in real

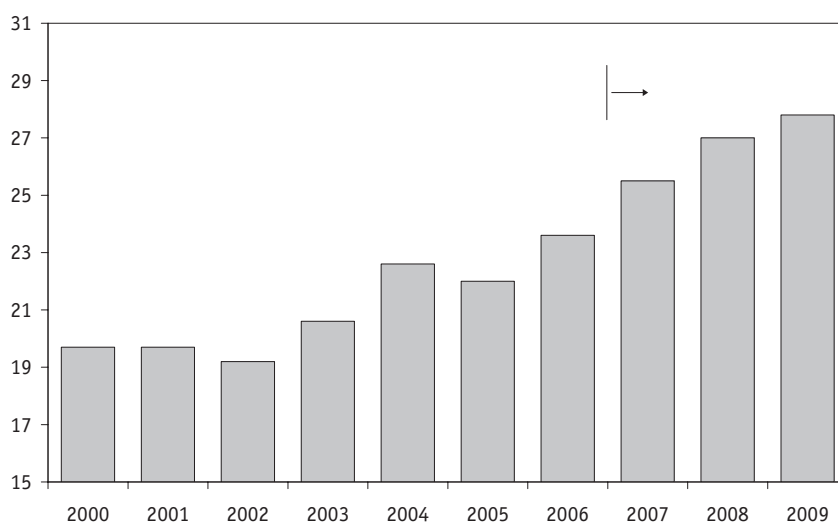
terms. In 2009, private consumption will accelerate to 14% as social outlays grow in advance of the presidential election (see **HOUSEHOLDS** and **PUBLIC FINANCE**).

Rapid growth of consumption will stimulate growth in consumer-oriented sectors of the domestic economy. The need to expand production capacities in sectors oriented on the consumer market will continue to be one of main drivers of investment. Now that it has been operating successfully for some years, the financial sector has been actively expanding and overall risks in the economy have gone down, business will have easier access to credit.

...resulting in lively growth in consumer-oriented sectors

The investment component of GDP will grow steadily. ICPS economists expect gross accumulation of fixed assets to grow 18% in 2007, 14% in 2008 and 10% in 2009. Slower growth over the period will be the result of a gradual saturation of the economy with capital investment. This saturation will largely be the result of lack of reform that might provide new investment opportunities, such as the formation of a full-fledged land market and such public-private partnership mechanisms as concessions.

Figure 2. Gross investment, % of GDP



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

During the forecast period, the contribution of foreign trade to GDP will be negative and the trade deficit will grow. ICPS economists expect exports to accelerate gradually, from 8% in 2007, to 10% in 2008 and 12% in 2009. This increase in exports will be driven by the situation on external metal and chemical markets. Over 2008–2009, the conditions for foreign trade should improve as Ukraine accedes to the WTO (see **FOREIGN TRADE**).

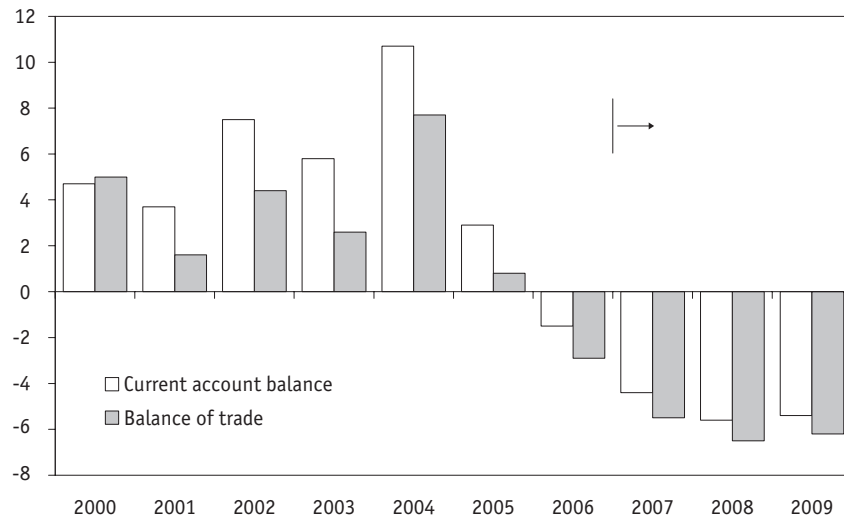
The trade deficit will grow

Imports will grow 15% in 2007, 13% in 2008 and 11% in 2009. Imports of investment goods will remain high. Accession to the WTO will not have a major impact on volumes of imported goods, as liberalization in this area largely took place over 2005–2006.

Despite a deteriorating trade balance, the NBU has enough gold and foreign currency reserves to support the hryvnia exchange rate at current levels. These reserves continue to grow with the inflow of FDI and the active accumulation of public and private foreign debt. ICPS economists expect the central bank to allow a slight depreciation of the hryvnia only in 2008 and to support the exchange rate at a new level, UAH 5.30/USD, in 2009 (see **MONETARY POLICY**).

The NBU will slightly loosen the hryvnia exchange rate in 2008

Figure 3. Foreign trade indicators as % of GDP



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

Ukraine's industry will grow at a moderate pace, with output growing 5% in 2007, 4.5% in 2008 and 5% in 2009. "Traditional" industrial sectors, such as metals and chemicals, will lose their price-related competitive edge as world prices for these commodities stop growing in 2007 and energy becomes more expensive. Over the forecast period, these industries will not complete the restructuring that they need in order to gain a new competitive advantage, that is, a quality improvement in the range of products. This means that these sectors will grow slowly. High demand for capital in Ukraine and in CIS countries will spur rapid expansion in machine-building (see **BUSINESS**).

Inflation will gradually subside to 6% in 2009

ICPS economists expect the rate of inflation to subside throughout the forecast period. Slower growth of producer prices and stable prices in regulated sectors should lead to slower growth in the CPI over 2008–2009, with consumer prices growing 9.5% in 2007, 8% in 2008 and 6% in 2009 (see **PRICES**).

The risks to the ICPS forecast are:

- an exacerbation of political competition to the point where investors and consumers have to change their plans and their behavior;
- serious fluctuations in world prices for steel and chemical products;
- price rises in imported gas to above US \$130 per 1,000 cu m over 2008–2009;
- a transition to targeting inflation over the forecast period;
- price controls on competitive markets;
- shrinking tax revenues because of exemptions or benefits and/or a revival of shadow operations among investment projects in SEZs and TPDs.

*Highlights of **quarterly predictions** #38*

- *predictions regarding pre-term Verkhovna Rada elections and possible outcomes;*
- *the growing risks of managing the Budget on an ad hoc basis;*
- *possible employer reaction to a consolidated social contribution;*
- *ICPS comments on the Cabinet's concept for reforming the tax system;*
- *factors driving rapid growth in construction;*
- *the state of the farm sector;*
- *the prospects of a deep Free Trade Area between Ukraine and the EU;*
- *factors restricting economic growth in the US;*
- *why Ukraine's economy is being dollarized.*

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