

# *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		
<b>Economic activity</b>										
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 <sup>(1)</sup>	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
<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	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
<b>Foreign economic activity</b>										
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
<b>Budget</b>										
Revenues, % GDP (consolidated) <sup>(2)</sup>	24.7	26.2	26.9	27.4	28.5	26.5	32.0	28.5	29.0	29.0
Balance, % GDP <sup>(2)</sup>	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-1.9	-2.5	-2.0	-3.0
<b>Financial indicators</b>										
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) <sup>(3)</sup>	53	40	32	25	20	18	16	14	9.5	9
<b>Global economy</b>										
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: <sup>(1)</sup> according to the NBU;

<sup>(2)</sup> calculation using IMF methodology;

<sup>(3)</sup> commercial bank loans, UAH

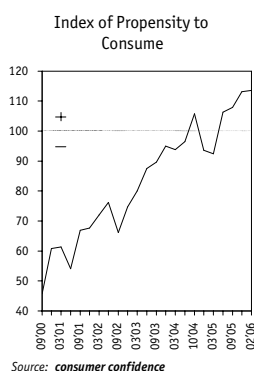
Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by **quarterly predictions**

# 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.<sup>1</sup> Rising domestic demand will be driven by three factors:



- **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.<sup>2</sup> 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**).

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

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

<sup>1</sup> 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.

<sup>2</sup> 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;

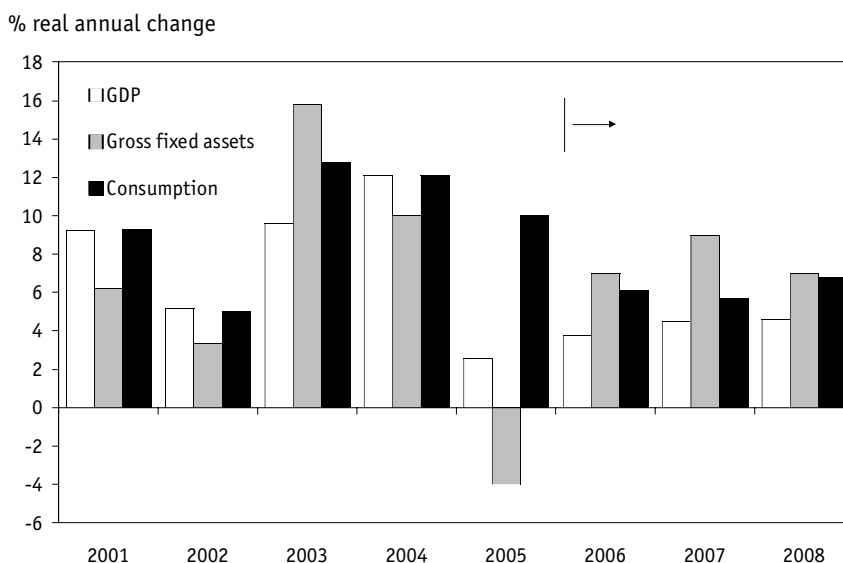
- **WORSENING TRADE RELATIONS WITH RUSSIA.** ICPS economists say that in any possible outcome for the political situation in Ukraine, Ukrainian–Russian relations will remain difficult (see **POLITICAL ENVIRONMENT**). There has been a growing trend towards import substitution in Russia lately, and towards 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 country<sup>3</sup> (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***

<sup>3</sup> 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,<sup>4</sup> 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.

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<sup>4</sup> 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*

# POLITICAL ENVIRONMENT

On the eve of the Verkhovna Rada elections, the Government definitively lost the support of the legislature. The formation of a coalition within the VR, economic reforms and the completion of political reforms were all postponed until after the elections. ICPS analysts say that both the Government and the new Verkhovna Rada coalition will be too weak to proceed with reforms in 2006. The elections will not result in any significant changes in Ukraine's foreign policy

## Political competition

### *Current trends*

In Q1'06, the Government definitively lost the support of the Verkhovna Rada. During the last months before the elections, the legislature turned into a platform for electioneering for the majority of National Deputies. The decision of Speaker Lytvyn's National Bloc also oppose the Government and the coming into force of Constitutional reforms led to a Verkhovna Rada vote of non-confidence in the Yekhanurov Government.<sup>5</sup>

Ignoring the Government's clear position, the Verkhovna Rada then voted to raise social spending in the State Budget (see **PUBLIC FINANCE**), blocked the Government's privatization plans, and criticized the Government vociferously on most policy issues—the gas agreements, residential services reform and so on—on the eve of elections.

Without the support of the Rada, the Government will be hard put to institute the necessary reforms. Over Q1'06, the Cabinet has focused on laying the groundwork for this purpose: developing the relevant concepts and determining priorities. For instance, concept for reforming the judiciary branch and energy strategy have been published, first-line measures to reform the residential services sector have been announced. Active steps to lobby these reforms, which all need legislative support, have been postponed.

Moreover, with an election campaign going on, the Government has singularly failed to establish an effective position on current issues and to defend this position against the attacks of the opposition. A good example is the project to build spent nuclear fuel storage facilities. The Government failed to effectively present this decision to fend off criticism from the opposition, which effectively put a brake on implementation.

The coming into force of Constitutional reform on 1 January 2006 spurred a new conflict between its supporters in the Verkhovna Rada and opponents in the executive branch. Currently, neither side has enough ammunition to resolve the issue in its favor. Supporters interpreted negative statements by

***The battle over political reform has also been postponed***

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<sup>5</sup> On 10 January 2006, the Verkhovna Rada voted 250 in favor of dismissing the Yekhanurov Government. The Government rejected the vote, stating that the legislature had not followed the procedure for dismissing a Government. Instead of a motion by 150 deputies for a vote of no confidence in the Government, the Verkhovna Rada acted on a resolution submitted by only two deputies. With the Constitutional Court still unformed, neither side can prove its case. Moreover, under to the 2004 Constitutional changes, the new procedure for appointing a Government comes into force only after a new Verkhovna Rada is elected. Thus, the Yekhanurov Government continues to fulfill its duties, although its status remains unclear.

President Yushchenko about this reform as a desire to win back lost powers. Thus they reacted negatively to his proposals for tweaking these reforms: to adopt a new text of the Constitution through a national referendum or to turn the entire reform package over to the Constitutional Court for review.

Over Q1'06, supporters of the reform blocked the procedure for forming the country's Constitutional Court and the swearing-in of already-selected judges to the Court. This, coupled with the domination of deputies in favor of this political reform in the legislature, forced the president to postpone further debate on the Constitution until after the election.

At the moment, political reform is incomplete and will not ensure the stable functioning of the government system. The legislature still has not adopted bills on the Verkhovna Rada and, the Cabinet of Ministers. The mechanism for adopting a new Constitution by national vote as proposed by the president has not been approved, either. The current law on referenda is outdated and parts of it are in conflict with the Constitution.

Negotiations to establish a Verkhovna Rada coalition prior to the elections went nowhere. The much-anticipated "Orange coalition" failed to materialize and the idea of an "orange + white-and-blue" coalition remained in the realm of hypothesis. Over Q1'06, competition between the Nasha Ukraina National Union and the Bloc of Yulia Tymoshenko for second place in the elections and primacy in the Orange coalition grew hotter, actually reducing their overall ratings compared to the Party of the Regions. Both Orange forces declared that a coalition with Regions was tantamount to treachery. Therefore, during the election campaign, they have not been looking at PR as a coalition partner.

### *Forecast*

According to ICPS analysts, these political reforms are unlikely to be revisited immediately after the elections, either. Except for Nasha Ukraina, the current version of this reform will benefit the majority of parties likely to pass the 3% barrier, as it will provide the factions and the Verkhovna Rada with more powers and opportunities to influence the executive branch. Also, all variations of a coalition will inevitably include both parties supporting these reforms and parties opposed to it. To prevent the coalition from breaking up, President Yushchenko is likely to avoid aggravating the situation by revising these reforms through a referendum.

ICPS analysts expect the process of forming a stable Verkhovna Rada coalition after the elections to be a complicated process. Any coalition is likely to be situational and weak. The Government will also continue to be weak. ICPS analysts base this forecast on three factors:

- **LACK OF CONSENSUS ON POLITICAL REFORM.** The president is not likely to call for a referendum on a new version of the Constitution, but he will not support the current version of the Basic Law. Nasha Ukraina deputies are unlikely to vote for the bills on the Verkhovna Rada, the Cabinet of Ministers and so on that would enshrine the current version of the Constitution. This means the basis for a coalition to operate will remain unregulated for some time.
- **FIERCE COMPETITION AMONG POTENTIAL PARTNERS IN A COALITION.** Talks about setting up a coalition even before the election demonstrated the incompatibility of the aims of the most likely partners. The Nasha Ukraina National Union is not prepared to satisfy Yulia Tymoshenko's demands for key posts, among which are the premiership for herself. Sharp criticism of

***The Constitution as it stands will not ensure a stable Government and coalition***

***Coalition talks went nowhere***

***Constitutional reforms are unlikely to be revised after the elections, either***

***The eventual VR coalition will be weak***

the Party of the Regions by the BYT and the Nasha Ukraina make negotiations with this party hard to imagine.

- **LACK OF MECHANISMS FOR AGREEING A COMMON AGENDA.** Potential participants in a coalition have different ideas about policies that need to be implemented by the new Government. Even if the coalition were set up and the positions demanded by each participant were satisfied, the matter of a Government program would continue to be unresolved. Without developing a program that can be shared by all participants in a coalition, any Government will not be able to work effectively. It would suffer even more than the current one from internal opposition and situational votes on its bills in the Verkhovna Rada.

***Reforms are unlikely to be implemented in 2006***

ICPS analysts say that economic reforms are unlikely to be implemented during 2006. Without stable support in the Verkhovna Rada, the Government will be unable to push through serious reforms. To institute reforms, the Verkhovna Rada needs to adopt a slew of changes to legislation, particularly to the State Budget Law to allocate the necessary funding for reforms. But the Verkhovna Rada is not very likely to agree to cut social spending after having increased it just before the elections.

***The president will be able to push through only foreign and security policy decisions***

We expect only sporadic progress in key government policy areas, and that in those spheres that continue to be the direct responsibility of the president under the amended Constitution: foreign policy and security. The president has more powers in these areas—specifically the power to delegate to related ministers and heads of central executive bodies—and, thus, will have more control over them. Such decisions are likely to be the result of horse-trading and incidental agreements within the coalition.

ICPS analysts see several positive risks to their forecast: 1) consensus between the government and the opposition regarding the political reform and the passing of the majority of constitution-related laws that regulate relations among the Verkhovna Rada, Government and Presidency; 2) the implementation of mechanisms for political consultation on the agenda of the future coalition and the president's willingness to reject the role of absolute leader in this coalition. Such steps could lead to greater political stability, the formation of a system of rules for political competition, and greater responsibility among the participants in a Rada coalition for their actions.

***One risk to the ICPS forecast is the dissolution of the Rada***

A negative risk to the ICPS forecast is the break up of the coalition and the dissolution of the legislature. The option of dissolving the Verkhovna Rada is a lever the president and Nasha Ukraina can use negotiating a coalition. Also, if the ratings of one participant in the coalition grow significantly, this may provide that force with incentive to break up the coalition and work towards a re-run of the Verkhovna Rada elections.

## **Foreign policy**

### *Current trends*

In Q1'06, Ukraine achieved more in foreign policy than in domestic issues. As the Verkhovna Rada is less responsible for foreign policy, the impact of the election campaign on foreign policy has been limited. The only exception is Ukrainian–Russian relations, which deteriorated because of Russia's determination to strengthen its influence over the internal situation in Ukraine.

In Q1'06, confrontation between Ukraine and Russia continued. Unresolved issues include the deployment and eventual withdrawal of the Black Sea Fleet,

and common borders, particularly in the Azov Sea. The Kremlin is not willing to resolve these issues, preferring to keep them at a simmer as a means for pressuring Ukraine down the line. Meanwhile, Russia is waiting for a possible change in the political scene in Ukraine to resolve these issues in its own favor. Among others, it is Russia that is delaying the launch of the Yushchenko–Putin Commission, which was expected to tackle the majority of these bilateral issues. The problem of gas supply and trade wars became the latest episode in the political confrontation between Ukraine and Russia. Russia is using these issues to destabilize the political situation in Ukraine.

***Relations with Russia remain complicated***

The EU has shown Ukraine that it wants to continue cooperating, regardless of the outcome of the Verkhovna Rada elections. During Q1'06, the European Parliament first invited the leaders of the two largest opposition factions, Yulia Tymoshenko and Viktor Yanukovich, to address European MPs. Later, it also invited representatives of the Socialist Party. The EU also supported the Ukrainian Government regarding its “dismissal” by the Verkhovna Rada and supports it in implementing the Ukraine–EU Action Plan. Because of the gas conflict between Ukraine and Russia, energy has become one of the priority sectors for cooperation with the EU.

***The EU is ready to work with both the government and the opposition***

The US also supported the Ukrainian government in the confrontation between the legislative and executive branches and regarding the “dismissal” of the Government. In February 2006, the US granted Ukraine a market economy status. In early March 2006, US and Ukraine signed the bilateral protocol on mutual access to markets of goods and services that is needed for Ukraine’s accession to the WTO (see **FOREIGN TRADE**).

Ukraine has a real chance to join NATO in 2008. In January 2006, NATO Secretary General Jaap de Hoop Scheffer mentioned Ukraine among the countries that might join the next expansion of the Alliance in 2008. Ukraine’s accession to NATO will largely depend on the results of the VR election and the Government’s capacity to implement reforms.

### ***Forecast***

According to ICPS, the Verkhovna Rada elections will not seriously affect Ukraine’s foreign policy trajectory. Relations with Russia will remain complicated as Russia tries to preserve its influence on the situation in Ukraine. Russia is unlikely to change gears and will probably continue to impose its integration-related economic projects on Ukraine, along with threats of economic “sticks.”

***Ukraine’s foreign policy will not change radically after the elections***

Ukraine will continue to implement the Ukraine–EU Action Plan and will progress towards WTO accession. However, the pace and quality of work in this direction, especially the implementation of the Ukraine–EU Action Plan, could worsen through the weakness of the Verkhovna Rada coalition and the Government, which will make Ukraine more vulnerable to Russian influence.

# BUSINESS

Rising gas prices will put pressure on the country to undertake a large-scale modernization of its traditional industrial sectors. This additional need for investment will be financed through foreign borrowings. Gross fixed investment will grow 7% in 2006, 9% in 2007 and 7% in 2008. 2005 was a record year in terms of foreign direct investment (FDI) because the sales of VAT KryvorizhStal and Aval Bank. The acquisition of domestic commercial banks will be the main factor determining FDI growth in 2006. Growing corporate needs for investments and an improved business environment as a result of accession to the WTO should foster FDI flows over 2007–2008

## Fixed capital investment

### *Investment demand*

***Demand for investment will grow as energy prices rise***

Rising prices for energy resources will be the main factor pushing growth in demand for investment capital in 2006. The need to upgrade production facilities and switch to energy-efficient technologies will make itself felt primarily in the chemical and metal industries, energy, building materials and glass, sugar refining, and baking.

**Table 1. Energy intensity of industrial sectors**

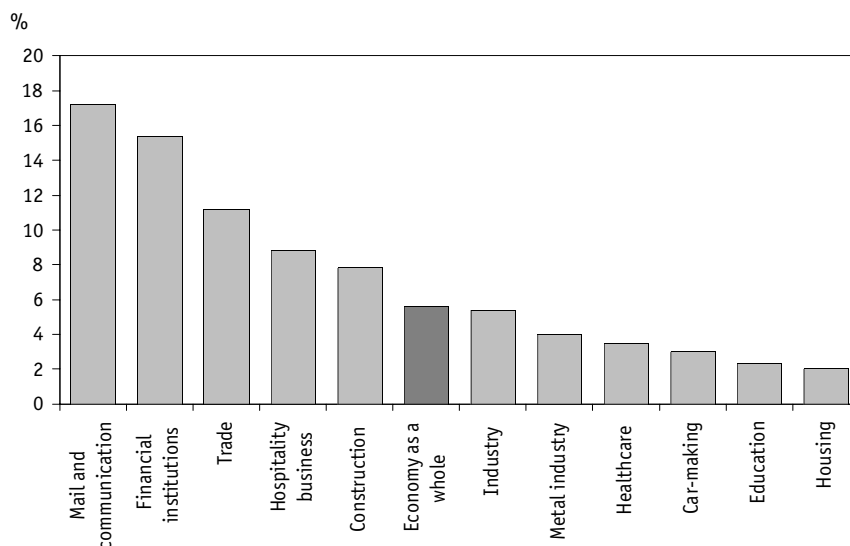
Sector cluster	Description
High energy intensity	
<ul style="list-style-type: none"> <li>• Coke production and oil refining</li> <li>• Power generation and distribution</li> <li>• Chemicals</li> <li>• Building materials and glass</li> <li>• Primary metal processing</li> <li>• Pulp and paper</li> </ul>	<p>These energy-intensive sectors mostly convert raw materials into finished goods primarily by chemical rather than physical means. Heat is essential to their operation, mostly provided by steam. Natural gas, its by-products and waste fuels are the largest sources of energy for this group.</p>
High value-added and low energy intensity	
<ul style="list-style-type: none"> <li>• Secondary metal processing</li> <li>• Industrial machinery and equipment</li> <li>• Electronic and other electrical equipment</li> <li>• Transport equipment</li> <li>• Instruments and related products</li> </ul>	<p>Production is largely done by physical means (cutting, molding, assembling) with the help of electric equipment and heat treating, drying and bonding. Natural gas is the principal source of energy.</p>
Low value-added and low energy intensity	
<ul style="list-style-type: none"> <li>• Tobacco products</li> <li>• Textiles</li> <li>• Garment making</li> <li>• Timber and wood products</li> <li>• Furniture and accessories</li> <li>• Printing</li> <li>• Rubber and plastic products</li> <li>• Leather making</li> </ul>	<p>Mostly uses electrical equipment.</p>
<p>Sources: Derzhkomstat, "Measuring Energy Efficiency in the US Economy: A Beginning," 1995, DOE/EIA-0555 (95)/2</p>	

Until 2006, low energy prices offered little incentive for Ukraine's energy-intensive industries to rapidly upgrade their technology, as they were able to product inexpensive goods using their old production facilities. The preferen-

tial treatment that the Government offered certain industrial sectors<sup>6</sup> only strengthened this tendency. As a result, the introduction of new production facilities was low relative to the total value of fixed assets, while the replacement of depreciated plant was not enough to improve the overall state of fixed assets.<sup>7</sup> What is worse, rapidly growing demand on world markets spurred some companies to restart outdated and hazardous equipment.<sup>8</sup>

**Low gas prices offered little reason to improve production facilities**

**Figure 2. Fixed assets replacement ratio, 2004**



Source: Derzhkomstat

Production capacities in sectors oriented on the consumer market are in a better state. These sectors have had almost no preferential treatment and low energy prices were not overly important because of their low energy intensity. Moreover, strong competition with imports forces these enterprises to work to keep their competitive edge sharp. This is also helped by the openness of consumer-oriented sectors to FDI. The Government tended to place considerable restrictions on the presence of foreign investors in “strategic” industrial sectors until 2005.<sup>9</sup>

**Consumer-oriented sectors use modern technologies**

Price hikes for gas will not be a shock for consumer-oriented sectors. However, their need for new capital will also grow as personal incomes rise while the supply of consumer goods and, even more so, services remains undeveloped. As in 2005, demand for new capital in food processing, housing construction and services, such as retail trade, personal services, recreation and entertainment, healthcare, and education, will be high in 2006.

<sup>6</sup> Coal industry, tank manufacturing, car-making and shipbuilding.

<sup>7</sup> Because of the low rate at which depreciated plant was being replaced, the level of depreciated assets rose over 2000–2004, even though the expansion of fixed assets was gradually growing. Depreciation amounted to 49.3% in 2004, against 43.7% in 2000. In 2004, this indicator for industry was 58.3%: 68.8% in metals, 67.6% in non-fuel extraction, 64.1% in chemicals and petrochemicals, 62.0% in utilities (power, gas and water), and 59.9% in machine-building. As of late 2004, more than 6% of the plant still being used by enterprises was fully depreciated.

<sup>8</sup> See Steel Sector Development. World Bank, 2004, p. 94.

<sup>9</sup> One example of how foreign investors were restricted is the conditions attached to the tender for KryvorizhStal, Ukraine’s steel giant, in the original 2004 sale.

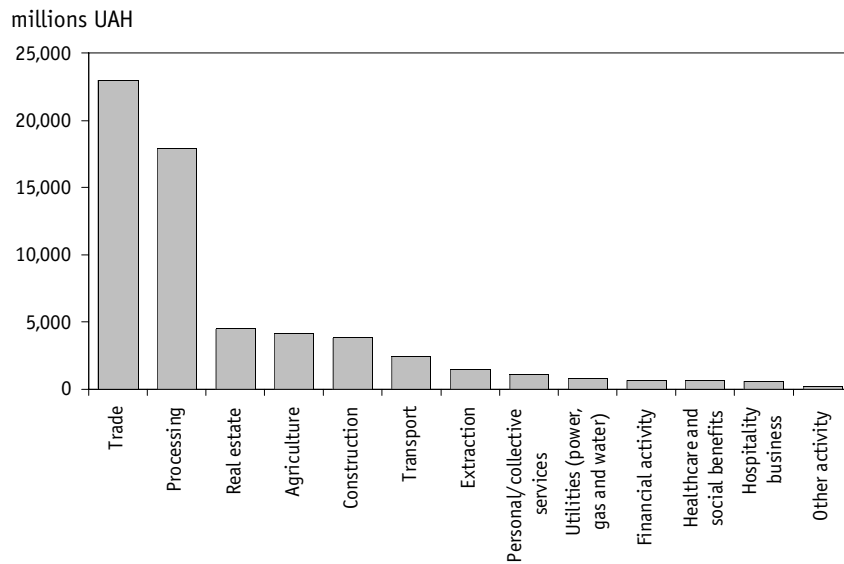
**Energy-intensive enterprises will push up the volume of debt**

### Capital on loan

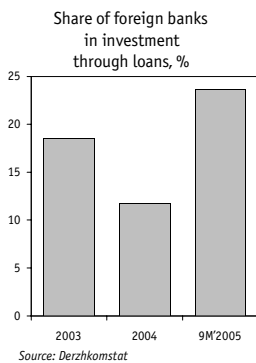
During the forecast period, credit will be the main source of capital to finance growing domestic demand for investment. The reinvestment of profits in energy-intensive sectors will not be enough to pay for urgent large-scale production upgrades. The demand for capital among large energy, metal and chemical companies will be satisfied mainly by borrowing on the external lending market, which has the capacity to provide inexpensive, large, long-term credits. This will increase the share of international borrowings in overall debt.

During the forecast period, the domestic capital market will partly satisfy demand for capital in consumer-oriented sectors, where the size of the credits needed is smaller and lending terms shorter. In recent years, Ukrainian banks that financed corporate investment activity preferred projects yielding a rapid return on investment in consumer-oriented sectors.

**Figure 3. Long-term bank loans issued to business entities as of late December 2005<sup>10</sup>**



Source: NBU



Conditions for bank lending in Ukraine will improve in 2006 due to the mass entry of foreign banks on the Ukrainian market (see **MONETARY POLICY**). Access to credits will improve the most for SMEs, as banks aim at expanding their customer base and diversifying their risk. Currently, loans to large corporate customers account for the lion's share of assets. Better access to loans will contribute not only to a quantitative increase in investment, but also to a qualitatively better structuring of the economy as new production is developed and consumer demand is satisfied more fully.

**The cyclical nature of energy-intensive sectors will make them more interested in making IPOs**

### Initial public offerings (IPOs)

An alternative way to attract capital is to make an initial public offering (IPO). The advantage of IPOs is that there is no obligation to repay the principal and interest on a debt. This is especially important for enterprises whose products undergo demand cycles, such as in the metal and chemical industries. In these sectors, the ratio between joint stock and debt capital is, as a rule, higher than in sectors that do not depend on cyclical fluctuations in demand, because they

<sup>10</sup> 23.6% of long-term personal and commercial loans were issued for investment purposes.

are at greater risk of losing liquidity in the face of a fixed debt repayment schedule.

Except for the obvious loss of control over a portion of their assets, one major drawback of the IPO option for Ukrainian companies is having to bring their accounting in line with international standards and to disclose their reporting. In addition, the IPO procedure requires a certain period of time, at least six months.<sup>11</sup> While there will be the odd IPO among Ukrainian companies in 2006, widespread IPOs will not appear on the market until at least 2007.

### *Forecast*

Given high domestic demand for capital, the ICPS forecast is for gross fixed investment to grow at a rapid pace during the forecast period, climbing 7% in 2006, 9% in 2007 and slipping back to 7% in 2008.

Investment will grow at a more sluggish pace if the Government attempts to soften price shocks for all or even individual industrial sectors through tax breaks or subsidies, as energy resources become more expensive. This kind of policy will dampen the necessary modernization of production facilities. A deeper political crisis (see **POLITICAL ENVIRONMENT**) could damage investment growth by increasing the level of uncertainty on the Ukrainian market.

## **Foreign direct investment**

2005 was a record-high year in terms of FDI flows.<sup>12</sup> The main contributor to FDI growth was the German-registered company Mittal Steel Germany that purchased VAT KryvorizhStal from the state for US \$4.8bn. Thanks to this purchase, Germany became the main investor in the Ukrainian economy, outperforming Cyprus, whose investment is traditionally returned capital belonging to Ukrainian residents. The third investor country by accumulated FDI is Austria, one of whose banks purchased Ukraine's Aval Bank for US \$1bn.

According to the ICPS forecast, annual FDI will be US \$6bn in 2006, US \$3bn in 2007 and US \$2.7bn in 2008. Purchases of Ukrainian banks by foreign banks will contribute the most to FDI growth in 2006. The widespread presence of foreign banking capital will also have a positive impact on Ukraine's investment image, which will foster additional FDI flows over 2006–2008.

During the forecast period, the country's openness to FDI will grow. Companies will be interested in investment and the Government in maximizing privatization revenues. This will provide incentive for holding transparent tenders and not restricting the participation of non-residents. The need to cover the Budget deficit will make privatization revenues the second most important source of FDI in 2006.

Ukraine's accession to the WTO, which ICPS economists expect in 2006, will improve the business environment by enhancing transparency and predictability. The positive impact of WTO membership on FDI flows will be felt starting from 2007.

### *Cumulative FDI inflows, as of 1 Jan. 2006, billions USD*

<i>Germany</i>	<i>5.5</i>
<i>Cyprus</i>	<i>1.6</i>
<i>Austria</i>	<i>1.4</i>
<i>US</i>	<i>1.4</i>
<i>UK</i>	<i>1.2</i>

### *Membership in the WTO will stimulate FDI flows to Ukraine over 2007–2008*

<sup>11</sup> As a rule, local IPO processes takes less time. The preparation is quicker because of softer regulatory requirements and the capital-raising process is also faster. However, far less money can be raised this way.

<sup>12</sup> According to Derzhkomstat, Ukraine received FDI worth US \$7.3bn in 2005.

Still, two issues might get in the way of FDI flows to Ukraine:

- by continuing to offer tax breaks to specific business entities, the Government fails to establish a level playing field on the market;
- the political environment deteriorates. The political crisis deepens and the Government begins to broadly manage the economy on an *ad hoc* basis.

## Industrial output

Industrial output grew 3.1% in 2005. Industrial output grew at a more sluggish pace as investment activity slowed down and prices for key Ukrainian export commodities declined.

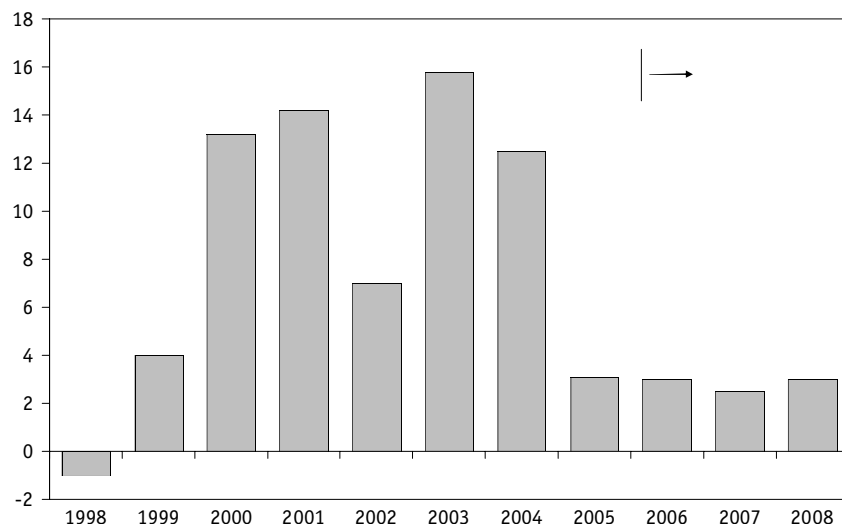
**Uncertain gas prices  
make investment  
planning more  
complicated**

During the forecast period, industrial gas rates will continue to be uncertain. The price for imported gas might change as a result of the Verkhovna Rada elections or increases in the price for Turkmen gas. ICPS economists say the Government will not be able to guarantee the promised price ceiling of US \$110 per 1,000 cu m during the next five years.<sup>13</sup> Because of this uncertainty, business will find it more difficult to develop and implement investment plans.

In February 2006, the Government made public its plans to provide incentives for economizing on gas with the help of penalties.<sup>14</sup> ICPS economists say that this kind of approach is economically irrational. Higher gas prices are a better incentive for energy-saving than penalties on consumption. Setting energy-consumption norms will only encourage bribery or suboptimal consumption volumes.

**Figure 4. Industrial output**

annual % change



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

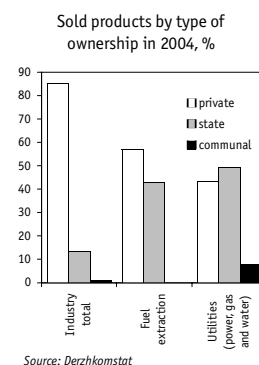
<sup>13</sup> In 2006, gas for industrial consumers will be US \$110 per 1,000 cu m or US \$135–145 per 1,000 cu m, if transportation and VAT are included. A Government resolution provides for preserving a ceiling of US \$110 per 1,000 cu m until 31 December 2010. See the *Interfax–Ukraine* newswire of 8 February 2006.

<sup>14</sup> The Government was talking about introducing a penalty the equivalent of US \$220 per 1,000 cu m of consumption above a certain limit.

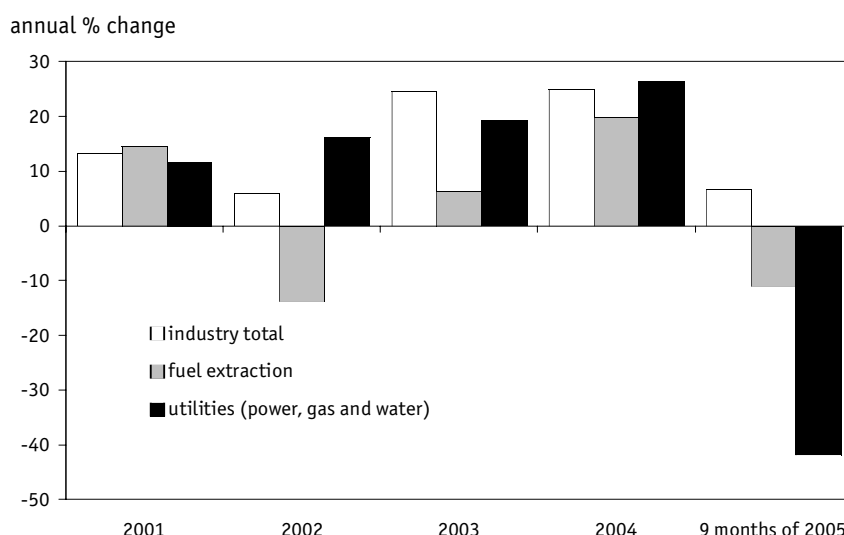
ICPS economists have cut their forecast for industrial output for 2006 to 3% and for 2007 to 2.5%. Industrial output will grow 3% in 2008. The ICPS forecast has been downgraded due to three factors:

- price rises for gas for industrial consumers;
- the squeezing out of food, machinery and metal products from the Russian market (see **FOREIGN TRADE**);
- the withdrawal of a share of fixed assets from active operation through investment projects in the energy-intensive metal and chemical industries. In some instances, unprofitable enterprises or units may be closed down.

Growing prices for energy resources and expected structural changes in the country's energy balance will require the government to adjust its policies. Because of the long-term investment cycle, the slow investment growth in the fuel and energy complex over 2001–2005 means that companies will be unable to rapidly increase fuel extraction and energy output, or to significantly improve their efficiency during the forecast period. Further restrictions on the access of private capital in the energy sector and the burdening of companies with social commitments will worsen their financial standing.<sup>15</sup>



**Figure 5. Fixed capital investment**



Source: Derzhkomstat

During the forecast period, energy-saving technologies will be introduced at a relatively slow pace. Over January–February 2006, gas consumption shrank primarily because of a reduction in both output and the quality of products and services. Low quality energy inputs will make the introduction of new technologies more difficult.<sup>16</sup>

<sup>15</sup> Specifically, the Government refused to raise gas and electricity rates for residential consumers in Q1'06. Because electricity rates are cross-subsidized for residential users, costs for industrial users are growing. Meanwhile, state subsidies for residential rates are also growing at a rapid pace. This caused the share of subsidies in wholesale electricity prices to rise from 9.2% in 2001 to 14.5% in 2004, when subsidies totaled UAH 2.8bn.

<sup>16</sup> The high sulfur content of Ukrainian coal prevents the introduction of coal-dust injection technology in the metal industries, while the high concentration of admixtures in Ukrainian iron-ore makes it hard to use power smelting.

# PRICES

In 2005, consumer and producer price inflation slowed down. ICPS economists expect inflation to pick up again in 2006 as gas prices rise and controlled prices go up as well. In 2006, the CPI will grow 12.5%. ICPS economists say prices for animal products will not drop as a result of trade wars with Russia. The CPI and the PPI will grow 7% in 2007, 6% and 6.5% in 2008

## Consumer prices

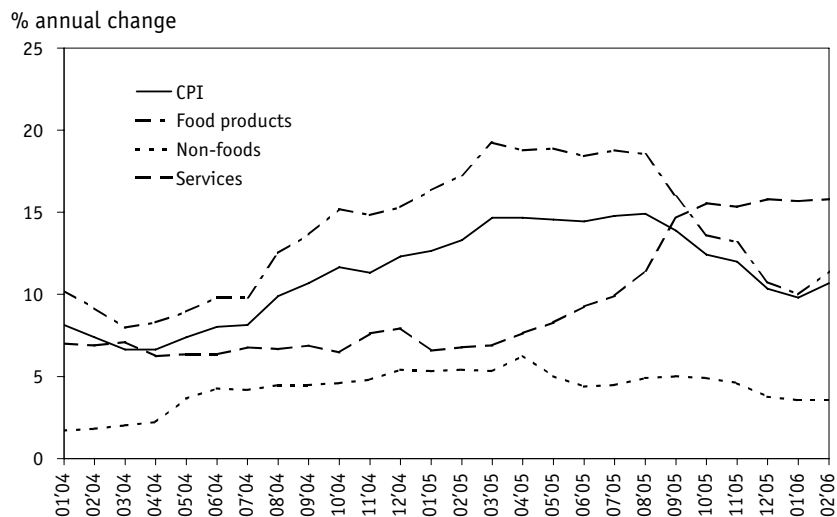
### Current trends

At the beginning of the year, the Consumer Price Index continued to slow down year-on-year. For the first time since August 2004, the Index slipped below 10%, to 9.8%. The main components influencing CPI trends over January–February 2006 were prices for food products and services. Prices for non-foods were stable, given the large share of imported goods in this group, whose prices remained unchanged because of the stable hryvnia.

#### Growth of CPI components, February 2006 vs December 2005, %

<b>Food products</b>	<b>4.2</b>
<b>Non-foods</b>	<b>0.2</b>
<b>Services</b>	<b>1.5</b>

Figure 6. Change in the Consumer Price Index and its components



Source: Derzhkomstat; calculations by *quarterly predictions*

#### Price indices for selected food products, February 2006 vs December 2005, %

<b>Vegetables</b>	<b>37.1</b>
<b>Potato</b>	<b>30.9</b>
<b>Sugar</b>	<b>27.9</b>
<b>Fruits</b>	<b>9.5</b>
<b>Milk</b>	<b>2.3</b>
<b>Meat</b>	<b>-0.3</b>

Over January–February 2006, food prices grew at a faster pace than over January–February 2005. Prices grew fastest for vegetables, potato and fruit. According to ICPS economists, prices for these goods grew because of seasonal factors, as well as severe frosts that prevented stable supplies of this produce from private holdings and retailers.

Over January–February 2006, meat prices remained flat, whereas prices for milk and dairy products climbed. Still, ICPS economists say prices for meat and dairy products are unlikely to shrink because of Russia's ban on animal products from Ukraine (see **FOREIGN TRADE**). Except for cheese, exports of animal products to Russia are relatively minor compared to the size of the domestic market.<sup>17</sup> Moreover, Ukrainian producers are disinclined to lower

<sup>17</sup> According to ICPS estimates, only 3% of Ukrainian meat output and 14% of Ukrainian dairy output are exported to Russia.

prices for these products and are waiting for a rapid settlement of the conflict. The Government plans to introduce minimum purchasing prices for some types of dairy products in order to prevent price drops.<sup>18</sup> However, ICPS economists say such steps will have no impact on the market because of the low likelihood that the Government will implement this decision.

In February 2006, sugar prices grew significantly—25.5%. To stabilize them, the Government began intervening on the domestic market by using sugar from the Farming Fund and DerzhReserv, the state reserve. It also introduced export licenses.<sup>19</sup> However, these measures are unlikely to be effective because of the limited capacities of DerzhReserv and the growing cost of producing sugar now that gas prices have gone up.

According to the ICPS forecast, prices for bread, baked goods and pasta will grow in 2006 due to expectations of a poor grain crop (see **AGRICULTURE**). Another factor behind price rises for bread and baked goods will be the end of the election, which will make it possible for local governments to finally introduce long-postponed price hikes for these goods.

The increase in price for imported gas that took place in January 2006 has not affected food prices yet. ICPS economists expect gas price hikes to make themselves felt in Q2'06. At the same time, a significant slowdown in the growth of personal incomes in 2006 (see **HOUSEHOLDS**) should keep food prices in check.

### *Forecast for the CPI*

According to the ICPS forecast, the CPI will grow 12.5% in 2006 and 7% in 2007. ICPS economists have upgraded their forecast for the CPI for 2006 due to higher-than-expected price rises for imported gas. ICPS economists expect the CPI to slow down in H2'06 and prices to grow at a slower pace over 2007–2008. During the forecast period, the CPI will be affected by six factors:

- slower growth in real personal incomes (see **HOUSEHOLDS**);
- rising rates for residential services, public transport and so on, where rates are controlled by the state, after the Verkhovna Rada and local elections;
- continuing trade wars with Russia (see **FOREIGN TRADE**);
- high inflationary expectations among consumers;<sup>20</sup>
- a poor grain crop in 2006 (see **AGRICULTURE**);
- tighter monetary policy at the National Bank (see **MONETARY POLICY**).

The main risks to the ICPS forecast are the revision of gas agreements with Russia and Turkmenistan, major fluctuations in world grain prices, and unstable foreign exchange and money markets due to political risks coming true (see **POLITICAL ENVIRONMENT**).

### ***Bread and pasta prices will rise in 2006***

#### ***Annual CPI change, %***

<b>2004</b>	<b>12.3</b>
<b>2005</b>	<b>10.3</b>
<b>2006</b>	<b>12.5</b>
<b>2007</b>	<b>7.0</b>
<b>2008</b>	<b>6.0</b>

### ***A political crisis is one risk to the ICPS forecast***

<sup>18</sup> See the *Interfax–Ukraine* newswire of 8 February 2006.

<sup>19</sup> See the *Interfax–Ukraine* newswire of 15 February 2006.

<sup>20</sup> See *consumer confidence* #23.

# Producer prices

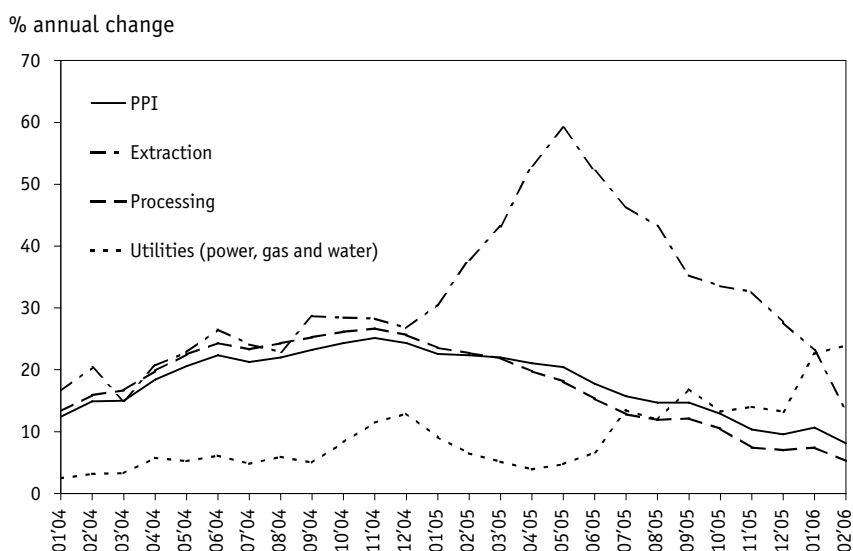
## Current trends

**Growth of PPI components February 2006 vs December 2005, %**

<b>Extraction</b>	<b>0.8</b>
<b>Processing</b>	<b>0.9</b>
<b>Utilities (power, gas and water)</b>	<b>4.4</b>

Over January–February 2006, producer prices grew 1.5%, slowing down the PPI to 8.1% year-on-year. Prices grew the fastest in utilities (power, gas and water). The main factors behind producer price inflation over January–February 2006 were expectations of rising gas prices for industrial consumers and stable world prices for Ukrainian exported commodities.

**Figure 7. Change in the Producer Price Index and its components**



Source: Derzhkomstat; calculations by *quarterly predictions*

Over January–February 2006, prices in the processing industry grew 0.9%. Prices grew the most in non-metal mineral products (7.1%), printing (5.9%) and chemicals (3.8%). The main factor driving prices in these sectors is the expectation of increased gas prices for industrial consumers.<sup>21</sup> Prices in machine-building rose slightly, 1.0%, while prices in the metal industries continued to be stable, 0.1%. According to ICPS economists, stable metal prices despite expected rising gas costs reflects the situation on global markets (see **FOREIGN TRADE**).

**Producer prices are growing due to expectations of higher gas prices**

Prices in extraction grew 0.8% over January–February 2006, due to a 1.9% rise in prices in fuel extraction. At the same time, prices in non-fuel extraction slipped 0.9%. According to ICPS economists, the main factors behind price hikes in extraction are the significant increase in the cost of imported gas and growing demand for domestic energy resources that might replace imported gas.

## Forecast for the PPI for 2006–2008

According to the ICPS forecast, the PPI will grow 10% in 2006, 7% in 2007 and 6.5% in 2008. ICPS economists have upgraded their forecast for the PPI for 2006 due to the higher-than-expected gas price increase in January 2006. Gas prices will have the greatest impact on the chemicals industry, where gas

<sup>21</sup> Price rises in printing industry were affected by the development of the consumer market and the 2006 elections.

is not only an energy resource but also a raw material, and on the metal industries. Price hikes in these sectors will be held back by stable prices for metals and chemicals on global markets (see **FOREIGN TRADE**).

Risks to the ICPS forecast include a revision of prices for Russian and Turkmen gas, aggravated trade wars with Russia, and unpredictable price fluctuations on global markets.

<i>Annual PPI change, %</i>	
<i>2004</i>	<i>24.1</i>
<i>2005</i>	<i>9.5</i>
<i>2006</i>	<i>10.0</i>
<i>2007</i>	<i>7.0</i>
<i>2008</i>	<i>6.5</i>

# MONETARY POLICY

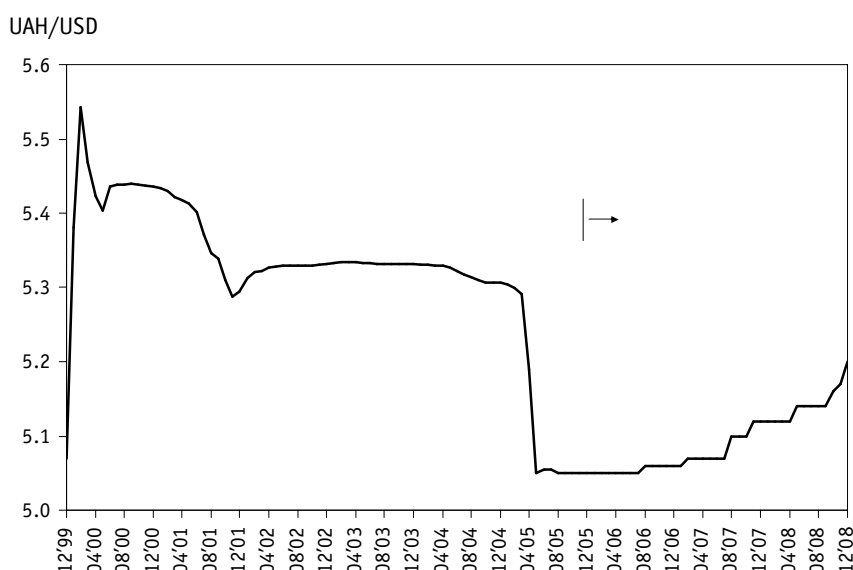
Key indicators of money and foreign exchange markets grew significantly in 2005. Loans to individuals more than doubled. Key money aggregates will grow more slowly in 2006 due to a slowdown in the growth of personal incomes. With foreign banks arriving on the Ukrainian market, the quantity of banking services will increase, while lending rates will gradually shrink. The volume of capital flight from Ukraine will not shrink, however. During the forecast period, the National Bank will switch from effectively pegging the hryvnia to the US dollar, to targeting inflation

## Foreign exchange

Demand for foreign exchange grew steeply in January 2006 due to growing expectations of a depreciation of the hryvnia. The reasons behind this situation were the controversial agreements on gas deliveries and the Verkhovna Rada's decision to dismiss the Government (see **POLITICAL ENVIRONMENT**). The NBU was forced to sell US \$939mn in January 2006. This is the largest intervention sale since November 2004.<sup>22</sup>

In February, pressure on the hryvnia subsided and the market returned to relative equilibrium. The negative balance of interventions shrank to -US \$179mn, while forex reserves slipped US \$313mn or 1.7%, to US \$18.3bn in February 2006.

*Figure 8. Nominal hryvnia exchange rate*



Source: NBU; forecast by *quarterly predictions*

***The hryvnia exchange rate will remain unchanged in 2006***

ICPS economists do not expect fluctuations of the hryvnia against the US dollar to grow in 2006. The NBU has enough gold and currency reserves to keep the exchange rate stable for a long period of time.<sup>23</sup> During the forecast period, the worsening current account balance (see **FOREIGN TRADE**) will not have a

<sup>22</sup> The balance of interventions was US \$1.048bn in November 2004.

<sup>23</sup> By late February, the NBU reserves covered 21 weeks of imports.

significant impact on the exchange rate due to expectations of foreign currency revenues from sales of large assets to foreign investors, both by the government and by private enterprises, and growing borrowings on the foreign market to finance investment (see **BUSINESS**).

According to ICPS economists, one risk to this forecast is growing pressure from exporters on the NBU to improve the competitiveness of Ukrainian goods on world markets through a nominal depreciation of the hryvnia. Another risk is the growing amount of bad debt in sectors where credit portfolios in foreign currency tend to be concentrated: trading, mortgages, and so on.

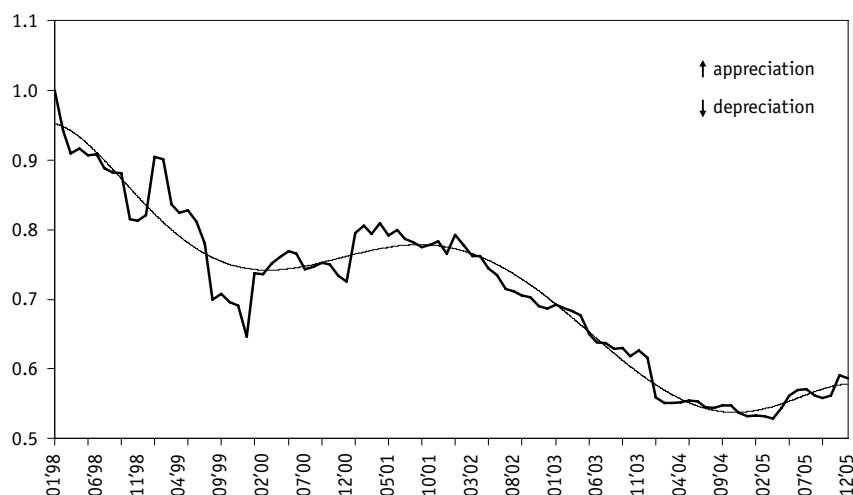
## REER

The real effective hryvnia exchange rate (REER) continued to appreciate throughout the entire year, a total of 9.3% over 2005. Nominal appreciation of the hryvnia against the US dollar in April 2005 accounted for less than 50% of this growth. Inflation both in Ukraine and among its trading partners, fluctuations in US dollar against the euro and other currencies put upward pressure on the hryvnia REER. The expected strengthening of the euro against the US dollar in 2006 should partly counteract growing appreciation due to high inflation in Ukraine (see **PRICES**).

**Hryvnia REER appreciated 9.3% in 2005**

**Figure 9. Real effective hryvnia exchange rate**

January 1998 = 1



Sources: NBU, IMF, national statistics offices; calculations by *quarterly predictions*

## Foreign cash market

The official foreign cash market grew 38.8% in 2005. The main factor behind this spurt was the significant growth of personal incomes (see **HOUSEHOLDS**), which increased demand for foreign currency. The ratio between the foreign cash market and the interbank foreign exchange market remained nearly flat at 54.8%, due to significant expansion on the interbank market from the foreign sale of KryvorizhStal, a positive current account balance and growing private loans abroad.

**The foreign cash market grew rapidly in 2005**

Since September 2005, forex demand has surpassed supply<sup>24</sup> on the official foreign cash market, mainly due to remaining distrust in hryvnia as a store

<sup>24</sup> Over September 2005–February 2006, the negative balance of trade in foreign cash was US \$2.6bn.

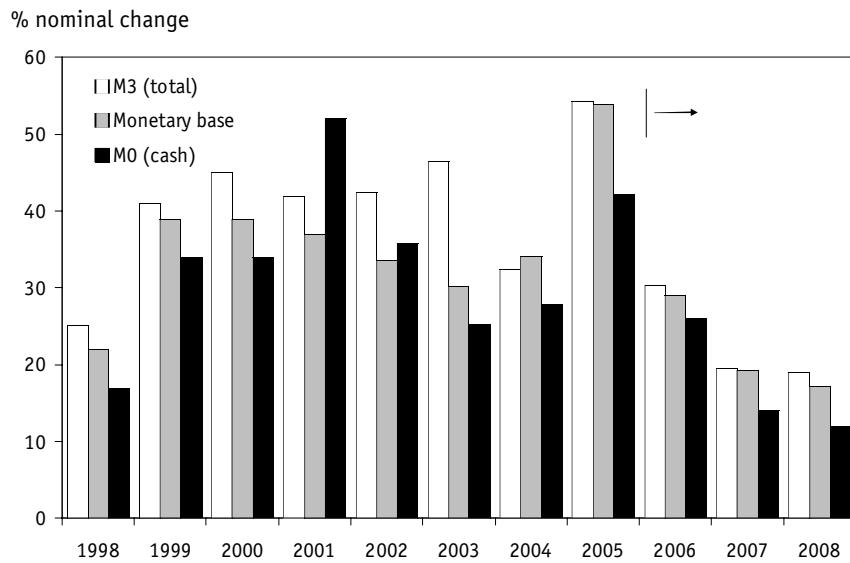
**The dollarization of the economy raises the risk of macroeconomic instability**

of value,<sup>25</sup> large share of shadow economy and repayments of foreign currency loans. The negative balance of forex sales by banks to individuals shrank from -US \$3.5bn in 2004 to -US \$1.3bn in 2005. However, the foreign cash market grew in absolute terms, which points to the growing dollarization of the economy. This trend represents a risk to macroeconomic stability and growing social costs as expectations grow that there will be a change in the exchange rate.

## The money market

The money supply grew at a rapid pace in 2005 due to significant growth of personal incomes, record-high privatization revenues, a lending boom, and growing monetization of the economy.<sup>26</sup>

**Figure 10. Money aggregates**



Source: NBU; forecast by *quarterly predictions*

**In 2005, the money mass M3 expanded 54.3%...**

Broad money (M3) grew a record-high 54.3% in 2005. The main factor pushing it was the expansion of the banking sector, as deposits skyrocketed 59.9%. The share of cash in the structure of M3 shrank from 33.7% to 31%. The M3 aggregate did not slow down over August–December 2005, despite subsiding consumer inflation (see **PRICES**). In January 2006, there was a seasonal decline of M3, -2.7%, that was the result of shrinking cash and commercial deposits, although personal deposits continued to grow. In February 2006, M3 renewed its growth, inching up 1.3%.<sup>27</sup>

<sup>25</sup> Personal deposits in foreign currency shrank from 46.8% in 2004 to 42.3% in 2005, while overall deposits grew 59.9%. This trend persisted over January–February 2006. This means that disbelief in hryvnia is not accompanied by equal disbelief in the banking system.

<sup>26</sup> In 2005, money aggregates also grew significantly, in light of the low baseline of Q4'04 when M3 inched down 3.4% due to capital flight from the banking system as a result of political uncertainty.

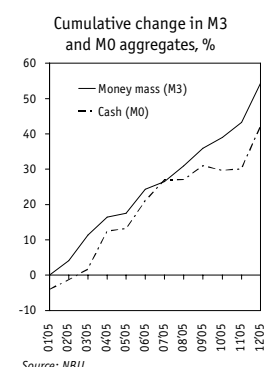
<sup>27</sup> Over January–February 2006, M3 slipped 1.5%. Over January–February 2005, M3 grew 4.1% due to growing public confidence in the banking system after the presidential election.

Cash in circulation (M0) grew 42.2% in 2005.<sup>28</sup> M0 grew the most in Q2'05, due to increased social payments. H1'05 accounts for two-thirds of M0 growth in 2005. Accelerating growth of cash in December (9.3%) was primarily seasonal. In January 2006, cash shrank 9% against to the seasonally high baseline of December 2005 that was the result of holiday shopping, “13th salary” bonuses, and a higher number of official holidays in January.

**...while cash  
in circulation  
jumped 42.2%**

In February 2006, the M0 aggregate climbed 1.7%. ICPS economists say cash in circulation will slow down over 2006 with more sluggish growth in personal incomes (see **HOUSEHOLDS**). Forex demand that is greater than the available supply will also contribute to shrinking cash in circulation in Q1'06.<sup>29</sup>

The monetary base grew 53.9% in 2005 and banking system liquidity nearly doubled in absolute terms. This was primarily the result of an increase in mandatory reserves as lending volumes grew. Measured as disposable bank reserves, liquidity grew 13.5% over one month in December 2005 and reached UAH 22.5bn by year's end. After this peak, it contracted significantly in January 2006, 17.8%, then rose 5.9% February. To increase the liquidity of the banking system in the run-up to the Verkhovna Rada elections, the NBU reduced the mandatory daily reserve requirement from 90% to 70% starting 1 March 2006.<sup>30</sup>



### *What happened with capital flight in 2005?*

*Over 2005, the NBU largely closed down those channels for capital flight that were the most widespread over the previous years: reinsurance and unreturned proceeds.*

*The total amount of insurance premiums collected by insurance companies for insurance and reinsurance fell 29.4%, to UAH 9.9bn, over the first nine months of 2005. This happened primarily as gross premiums for financial risk insurance and voluntary liability insurance declined. Earlier, these two forms of insurance were manipulated to artificially increase costs and remove money abroad through reinsurance schemes. The share of reinsurance in overall insurance premiums paid to nonresident reinsurers fell from 35% in 2003 and 10% in 2004 to a mere 3% over the first nine months of 2005.*

*Unpaid proceeds for exported goods and services and payments for imported goods and services that actually were not delivered to Ukraine also fell. Over January–September 2004, this amount stood at US \$3.86bn, while proceeds worth of US \$40mn were “returned” to Ukraine over the same period in 2005 (that means that the use of this channel was radically reduced).*

*Meanwhile, capital flight through junk stock schemes has mushroomed instead. Here, a resident issues or buys a significant number of shares in non-operating enterprises and sells them at a low price to a non-resident. Another resident then buys the shares from this non-resident, but at a significantly*

<sup>28</sup> M0 grew 52.1% in 2001, 35.8% in 2002, 25.3% in 2003, and 27.9% in 2004.

<sup>29</sup> Private individuals exchange money mainly on the cash market.

<sup>30</sup> See the 9 August 2005 NBU Resolution “On setting the size of service fees and mandatory reserve norms for banks to form mandatory reserves.” This Resolution set bank reserve requirements for call deposits and funds on current accounts at 8%, effective 1 September 2005.

*higher price. The non-resident now exchanges the money from the sale into foreign currency and withdraws it from the country.*

*The balance of payments classifies such operations as “Portfolio investment: Domestic securities: Equity securities.” Over the first nine months of 2005, this item in the balance skyrocketed 88.2%, to US \$2.8bn. This figure is higher than that for direct and portfolio investment in Ukraine over the same period. In short, the level of capital flight did not change much in 2005.*

## *Lending*

Lending leapt 61.9% in 2005, while loans in foreign currency soared 66.3%. Despite the growth of personal incomes in hryvnia, the share of loans in foreign currency inched up even further, from 42.2% in 2004 to 43.3%. Despite this growth, total lending in the economy amounts to only one third of GDP, whereas in Central and Eastern European countries this ratio is around 50–70%.

### ***Personal loans grew rapidly in 2005***

Lending volumes were spurred mainly by personal loans. They more than doubled,<sup>31</sup> their share growing from 16.7% in 2004 to 23.4%. Over January–February 2006, this growth continued, with personal loans climbing 7.1% and their share inching up further, 24%. The share of personal loans grew not only because incomes were growing, but also because corporate business plans for 2005 were being delayed because of the uncertain policies of the new government, specifically as to the property rights. This lack of certainty also caused banks to keep interest rates for commercial loans relatively high, although they lowered interest rates for personal loans.<sup>32</sup>

### ***More and more loans are being issued in foreign currencies***

The share of foreign currency loans grew over 2005. Personal loans in foreign currency soared 142.5%, accounting for 59% of all personal loans, compared to 55.1% over 2004.

Personal loans significantly accelerated in December 2005,<sup>33</sup> after a slight slowdown over October–November. This seems to point to the emergence of a new trend of “holiday loans” prior to the New Year and Christmas period. Despite the higher-than-usual number of holidays in January 2006 and seasonal trends in the past, personal loans continued to rise, 1.8% above December. They jumped an additional 5.1% in February 2006.

One of the main purposes of long-term personal loans in foreign currency, which more than doubled to UAH 16.3bn,<sup>34</sup> is new housing (see **PRICES**). According to the Ukrainian National Mortgage Association (UNMA), mortgage lending passed the UAH 10bn mark in 2005. Such loans represent about 7% of total commercial bank lending portfolios and 44% of investment loans. Nearly three quarters of these loans, 73.8%, are issued in foreign currency, for the most part, 63.9%, to private individuals.

<sup>31</sup> In 2005, personal loans jumped 126.4%, compared to 64.6% over 2004.

<sup>32</sup> Official NBU statistics do not reflect this trend because of the large number of loans issued to “interconnected entities,” which enjoy rates that are much lower than market interest rates. For more on the definition of “interconnected entity,” see the 28 December 1994 Law “On corporate profit tax” with amendments.

<sup>33</sup> 8.7% over November.

<sup>34</sup> As of late November 2005.

## Forecast for 2006–2008

ICPS economists expect the money supply to slow down significantly during the forecast period, based on four factors:

- slower growth in personal incomes;
- the growing sensitivity of the economy to changes in monetary policy as unemployment shrinks and approaches its natural rate (see **HOUSEHOLDS**);
- the further liberalization of the forex market, a switch from effectively pegging the hryvnia to the US dollar, to targeting inflation, starting most likely in 2007;
- the approach of Ukraine's level of monetization to levels typical for CEE countries.

Risks to this ICPS forecast include:

- growing pressure from exporters on the NBU to nominally depreciate the hryvnia;
- growing defaults on loans due to slower-than-expected personal income growth;
- continuing downward pressure on the hryvnia on cash markets after the elections caused by lack of voter confidence in the new Government;
- steep fluctuations in the US dollar against the euro and other major currencies;
- a sudden shift in the NBU policy of pegging the nominal hryvnia exchange rate to the US dollar and a more rapid change to targeting inflation.

## The banking system

### Liabilities

Bank liabilities jumped 62.5% in 2005. Bank funds grew 27.2%. However, the share of bank funds in the structure of liabilities shrank from 17.6% in late 2004 to 17% in late December 2005, as deposits boomed.

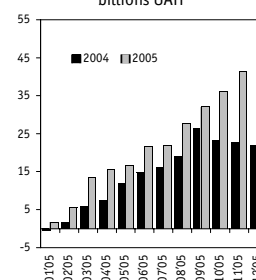
Over Q4'05, there was a significant increase in the share of short-term interbank loans among bank liabilities. The total volume of cash lent reached UAH 115.9bn over November–December 2005, or 36% of annual volume. According to ICPS economists, this is linked to a surge in demand for loans in December 2005.

According to the NBU rules, if more than 50% of a bank's liabilities are personal deposits, this bank is granted "specialized savings bank" status and is subject to stricter regulatory requirements.<sup>35</sup> In November, the NBU eased this rule<sup>36</sup> by allowing banks to include all incoming funds from interbank loans as

<sup>35</sup> See the 15 September 2004 NBU Board Resolution "On amending the Instruction on the procedure for regulating banking activity in Ukraine."

<sup>36</sup> See the 1 November 2005 NBU Board Resolution "On amending the Instruction on the procedure for regulating banking activity in Ukraine."

Growth of deposits since the beginning of the year, billions UAH



Source: NBU

***As the result of an NBU decision, interbank loans grew***

a part of their liabilities. Earlier, only the difference between issued and attracted interbank loans was included in liabilities. The NBU decision allowed banks to increase their liabilities by attracting and simultaneously returning attracted loans on the interbank lending market.

Another factor behind the growing share of interbank loans was the return of UAH 4.8bn to former owners of VAT KryvorizhStal. Some of these funds were channeled to the interbank lending market. As a result, interest rates for interbank loans did not grow, despite growing demand.

### *Interest rates*

Interest rates for loans and deposits shrank in H1'05, only to grow again in H2'05. Interest rates shrank because of rapid growth in deposits over Q1'05 due to renewed public confidence in banks after the presidential election and the increase in personal incomes over 2004. Interest rates grew in H2'05 as a result of growing demand for loans.

Bank rates for hryvnia term deposits slipped 2.2 pp in H1'05 and a mere 0.7 pp in H2'05, due to growing demand for credit. Bank rates for foreign currency term deposits remained flat in 2005, December-on-December, the result of a need to attract foreign currency deposits to match growing demand for foreign currency loans. In January 2006, interest rates for term deposits in foreign currency slipped 0.1 pp. This trend persisted in February, when rates for foreign currency term deposits inched down 0.2 pp.

***Loan rates remained high throughout 2005***

Interest rates for loans remained relatively high in 2005. The average interest rate for bank loans in hryvnia slipped 1.1 pp over the year to 16.4% pa, whereas the average interest rate for bank loans in foreign currency actually inched up 0.4 pp to 11.7% pa. Lower interest rate for foreign currency loans points to higher confidence among market agents in the stability of foreign currency.

The spread between rates for hryvnia and foreign currency loans shrank over the year, but still was 4.7 pp at year-end, which is much higher than the spread in CEE countries.<sup>37</sup> At the same time, the spread between rates for hryvnia and foreign currency term deposits slipped from 4.9 pp in December 2004 to 2 pp in December 2005.

The spread between hryvnia loans and term deposits grew from 4.4 pp to 6.2 pp in 2005, with the annual average spread reaching 4.9 pp. The spread between foreign currency loans and term deposits grew from 3.1 pp to 3.5 pp, the result of growing demand for such loans in late 2005 against stable growth in deposits.

***Over the forecast period, lending rates will slowly shrink***

ICPS economists expect interest rates for loans to shrink slowly with the arrival of foreign banks and growing competition in this sector, hryvnia liquidity to remain high among banks, and inflation to subside during 2007–2008. Hryvnia interest rates will gradually slip and approach foreign currency rates, with the average hryvnia loan rate falling from 16.4% pa in December 2005 to 8.8% pa by late 2008.

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<sup>37</sup> The spread between interest rates for loans in the national and foreign currency is 1.9 pp in Poland, 0.9 pp in Bulgaria and 0.0 pp in the Czech Republic.

## *The arrival of foreign banks: A boon or a loss*

*The interest of foreign banks in the Ukrainian market grew sharply in 2005. Over the year, the share of foreign capital in the statutory capital of domestic banks grew from 9.6% to 19.5%, while the number of active foreign banks grew by 4 banks to 23 banks by year-end.<sup>38</sup> According to expert estimates, about 50 of Ukraine's largest banks are negotiating with foreign banks at this time. UkrSotsBank<sup>39</sup> and NRB-Ukraina have already announced plans to sell their shares in 2006.*

*The growing share of foreign banks is raising concerns among Ukrainian politicians and businesses alike. They worry about the growing economic clout of foreigners who have little interest in local development. Ukrainian bankers are also worried that foreign banks will cherry-pick the domestic market: using the international clout of their brands, they will be able to win over the most profitable customers.*

*The experience of other countries<sup>40</sup> shows that the arrival of foreign banks, as a rule, has three main consequences:*

- The banking system may slow down in the short run. At the beginning of their activity, the new owners of domestic banks tend to reduce lending portfolios. This is the result of cleaning out bad loans on their balance sheets and inevitably strengthens these banks in the medium term;*
- The medium-term profitability of the banking system as a whole grows,<sup>41</sup> which is indirect evidence of the growing efficiency in the banking sector. Of course, there is no way to be absolutely certain that this is precisely the result of the arrival of foreign banks and not of changes in the macroeconomic situation or stronger competition. At the same time, the entry of foreign banks is often linked to shrinking profitability among local banks;*
- The long-term stability of the banking system grows because foreign banks generally have lower ratio of bad loans in their lending portfo-*

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<sup>38</sup> In October 2005, Raiffeisen International Bank-Holding AG, an Austrian group, bought a 93.5% stake in Aval Bank for US \$1.028bn. In December 2005, BNP Paribas S.A. bought a 51% stake in UkrSibBank for US \$1.16bn. In January 2006, a 98% stake in Mriya was sold to Russia's VnyeshTorgBank for US \$70mn.

<sup>39</sup> Italian-based Banca Intesa announced its intention to purchase an 85.42% stake in this bank.

<sup>40</sup> Latin American and CEE countries. Like Ukraine, these countries did not have a developed banking system in the early 1990s, but they witnessed rapid development in this sector over the last few years. Banks in these countries have all faced at least one significant shock that shook public confidence in the system. Just a few years ago, these countries either had no or few foreign banks.

<sup>41</sup> As a rule, foreign banks are more profitable than average and have higher net interest margins.

lios.<sup>42</sup> Lending grows at a less volatile pace among these banks, so, during any crisis, the need to cut back on lending is also lower.<sup>43</sup>

ICPS economists say that the arrival of foreign banks in Ukraine will increase the number of banking services on the market, while the quality of services will improve, and the expansion of the banking sector will accelerate. New services will generally be related to external trade. The number of credit cards is likely to grow exponentially, while better risk management will increase the number of options for clients to choose from.<sup>44</sup> With the arrival of foreign banks, real interest rates on loans should also go down more rapidly.

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<sup>42</sup> *Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina*, by Dages, B. G., Goldberg, L. and Kinney, D. in the Federal Reserve Bank of New York Economic Policy Review, 6, 3, 2000, pp 17–35.

<sup>43</sup> *How Does Foreign Entry Affect Domestic Banking Markets?* by Claessens, S., Demirguc-Kunt, A. and Huizinga, H. in the Journal of Banking and Finance, 25, 5, 2001, pp 891–911.

<sup>44</sup> This refers to such services as revolving loans, remortgaging, simplified indirect access to bank accounts over telephone and internet, and the calculation of individual lending risks for a borrower.

# FOREIGN TRADE

Exports will continue to grow at a more sluggish pace than imports over 2006–2008. As a result, the balance of trade will be negative throughout the forecast period. Ukraine will accede to the WTO in 2006. Trade wars with Russia will continue, forcing Ukrainian producers to further diversify their external markets. During 2006, oil prices on global markets should remain in the US \$55–65/bbl range

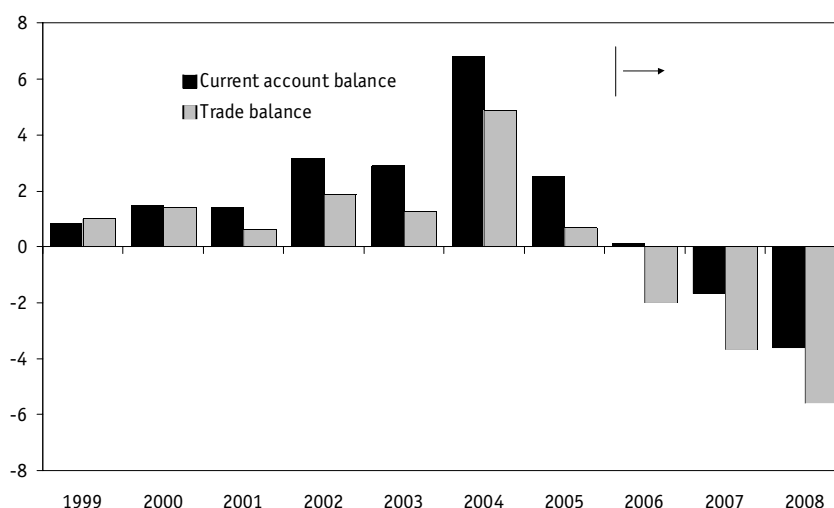
## Current trends

### Exports

Exports of goods and services slowed down to 6.4% in 2005 against a record-high growth of 37.2% in 2004. The reasons behind slower exports were unfavorable external conditions and, to a lesser extent, the appreciation of the hryvnia.

Figure 11. Current account and trade balances

billions USD



Source: NBU; forecast by *quarterly predictions*

Ukrainian exports will grow 4% in 2006, spurred by two main factors: stable global prices for metals<sup>45</sup> and trade wars with Russia, which is the country's second largest trading partner after the EU.

**Exports will grow at a slow pace in 2006**

### Imports

Imports of goods and services to Ukraine grew 25.7% in 2005. The main drivers were growing personal incomes and reduced import duty for nearly all commodity groups. The main factor behind import growth in 2006 will be rising prices for natural gas. This will directly raise the value of imports by leading to price rises for Ukrainian goods where gas is significant portion of production costs, thus, improving price advantages of imported goods on the

**In 2006, imports will grow as energy prices rise**

<sup>45</sup> In Q1'06, exports will grow at a slow pace, also because of the high baseline of Q1'05 as a result of high world steel prices.

**Change in value  
of trade in goods, %**

	<i>Export</i>	<i>Import</i>
2003	28.5	35.6
2004	41.6	26.0
2005	2.6	21.7
2006	4.0	10.0
2007	7.0	11.0
2008	7.0	11.0

**The WTO accession  
process slowed down  
in early 2006**

**The ICPS forecast  
is for Ukraine  
to accede to the WTO  
in 2006**

domestic market. At the same time, the rising cost of gas could negatively affect consumer purchasing power, which will soften demand. The ICPS forecast is for imports of goods and services to grow 9.3% in 2006.

As imports grew faster than exports, Ukraine's balance of trade in goods grew negative in 2005. The current account balance remained positive thanks to transfers and a positive balance of trade in services.

ICPS economists expect exports of goods to be lower than imports over 2006–2008, while volumes of transfers will remain almost flat. The trade balance will be negative.

## Trade negotiations

### *WTO accession*

In H2'05, there was an increase in Government efforts in the process of Ukraine's accession to the WTO and greater attention to it among general public. But this enthusiasm weakened in early 2006. From the second half of December 2005 to February 2006, the Verkhovna Rada approved only three bills: on the procedure for customs clearance of goods,<sup>46</sup> on veterinary medicine<sup>47</sup> and on plant quarantines.<sup>48</sup>

The nation's lawmakers again rejected bills on export duty for ferrous and non-ferrous scrap metal, on livestock and rawhide, and on banks and banking. Because the Government lost support in the Verkhovna Rada (see **POLITICAL ENVIRONMENT**), most likely, the necessary amendments to various laws will not be approved before a new Government is formed. It is possible to prevent accession to the WTO being delayed due to outstanding harmonization commitments by taking advantage of a transitional period. Often, the final harmonization of the legislation in an accession country to WTO requirements can, with the consent of the Working Group, take place after the country's official accession to this organization.

Over December 2005–February 2006, Ukraine completed bilateral protocols on access to markets of goods and services with Dominican Republic, Egypt and Honduras.<sup>49</sup> In March 2006, Ukraine signed the protocol with the US, one of the key members of the Working Group. Practice has shown that, after the US has signed its bilateral protocol, other countries<sup>50</sup> usually become more tractable and rapidly follow suit.

As the bigger part of Ukraine's accession to the WTO has already been completed, ICPS economists expect Ukraine to join the WTO in 2006. The risks to this are a slowdown in the negotiation process due to the Rada elections and the accession of Russia to the WTO earlier than Ukraine.

<sup>46</sup> See the 22 December 2005 Law "On amending some pieces of legislation of Ukraine."

<sup>47</sup> See the 22 December 2005 Bill "On amending the Law 'On veterinary medicine' (new wording)."

<sup>48</sup> See the 19 January 2006 Law "On amending the Law 'On plant quarantine.'"

<sup>49</sup> Ukraine actually signed bilateral protocols on mutual access to markets of goods with the Dominican Republic and Honduras in June 2005.

<sup>50</sup> Ukraine has not signed protocols with Armenia, Australia, Columbia, Kyrgyzstan, Panama, and Taiwan.

## *Market economy status*

As of 1 February 2006, the US deems Ukraine a market economy. As in the case when the EU granted the country market economy status,<sup>51</sup> this is more of a political decision than an economic one. Market economy status will allow Ukrainian producers to participate in anti-dumping probes initiated by US steelmakers against Ukrainian products. From now on, investigations will be initiated against a specific producer instead of the sector as a whole. It is also possible that current anti-dumping measures will be reconsidered. However, this will lead to additional costs for producers and will not guarantee an expansion of exports to the US.<sup>52</sup>

***Market economy status could potentially expand Ukraine's exports to the US***

In January 2006, the US also renewed Ukraine's participation in the Generalized System of Preferences.<sup>53</sup> Ukraine's participation in this system was terminated in 2001 for the distribution of pirated software, audio and video products on digital media. After the Verkhovna Rada adopted a law on intellectual property rights in 2005, the US acknowledged that Ukraine was prepared to fight piracy. The cancellation of 100% US duty on a number of Ukrainian goods—steel products, electrical appliances, rail equipment, proteins, and minerals—will have a positive impact on export volumes.

## *Trade wars with Russia*

Russia is Ukraine's second largest trading partner after the EU. The Russian share in Ukraine's total commodity turnover was nearly 20% over 1998–2005. Such a large portion in this turnover is explained by: (1) the large share of energy resources in Ukrainian imports<sup>54</sup>; (2) traditional integration between industries and producers of the two countries—for example, the machine-building industries of both countries depend on imported components.

***Russia continues to be one of Ukraine's largest trading partners***

Neighboring countries often sign mutually beneficial agreements on setting up free trade areas. The advantages of FTAs include: no customs barriers, cheaper imports, greater turnover between the countries, and more efficient use of resources. Since 1993, an FTA has been in place between Ukraine and Russia with exceptions and restrictions that the two sides must cancel by 2009.<sup>55</sup> Still, the two sides are allowed to continue to exclude goods by providing a persuasive rationale for such exclusions.

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<sup>51</sup> For more on the implications of the EU's granting of market economy status, see *quarterly predictions* #33, Q4'05, p. 41.

<sup>52</sup> According to Derzhkomstat, Ukrainian exports to the US amounted to US \$957mn or 2.8% of total exports of goods in 2005, while Ukrainian imports from the US were US \$710mn or only 2% of total imports.

<sup>53</sup> The US Generalized System of Preferences was developed in the 1970s under the aegis of the UN in order to promote economic growth in the developing world by providing incentives for their exports. The GSP provides preferential duty-free entry of goods to the US. At the moment, this preferential treatment is applied to 3,400 commodity groups exported from 140 countries.

<sup>54</sup> Ukraine satisfies 80% of its needs for oil and petroleum products and 33% of its gas with Russian imports.

<sup>55</sup> See the 25 November 2005 Protocol agreeing deadlines for the phased cancellation of exclusions from the FTA to the 4 October 2001 Protocol on amending the Protocol on exclusions from the FTA to the 24 June 1993 Agreement on Free Trade between the Government of Ukraine and the Government of Russia.

***Russia uses the exclusion of goods from the bilateral FTA as leverage over Ukraine***

Since late 2005, the number of new exclusions proposed by Russia has been steadily growing. ICPS economists say this is linked to Russia's use of economic leverage to influence the internal political situation in Ukraine (see **POLITICAL ENVIRONMENT**).

Russia introduced a special duty on Ukrainian caramel in November 2005, set quotas on incandescent lamps in January 2006, and prohibited the import and transit of all types of animal products in January as well. While restrictions on caramel and lightbulbs did not have much of an impact on Ukrainian exports,<sup>56</sup> the ban on meat and dairy products was more tangible.<sup>57</sup> The official reason behind this ban was the claim that Ukrainian products did not meet Russian veterinary and sanitary requirements. Although Ukrainian veterinaries, customs services and producers denied this, the final conclusion on whether Ukrainian products meet quality requirements will be made by a special commission that came in from Russia.

Russia also imposed anti-dumping duty ranging from 8.9% to 55.3% on certain types of Ukrainian pipes in January 2006. This decision was preceded by a lengthy anti-dumping probe. Any tariff restrictions on pipes going to Russia are significant because there is little room to diversify pipe exports. However, deliveries of pipes subject to anti-dumping penalties account for less than 10% of all Ukrainian piping that goes to Russia. This means that the impact of anti-dumping on total exports will not be significant.

***Trade wars with Russia should spur Ukraine to re-orient its exports***

Ukrainian producers, especially those oriented mainly on Russian markets, have had to face short-term losses. In the long run, however, this trade war will force them to improve the quality of their products for two reasons: (1) to prevent similar steps by Russia in the future and, (2) to re-orient themselves on other markets, where, as a rule, quality requirements are stricter.

In early 2006, Ukraine also initiated anti-dumping probes against imports of Russian steel cable and wire, iron-ore concentrate, and matches. If the dumping is proved, anti-dumping penalties could work in favor of some Ukrainian producers. However, it could also have a negative impact on the domestic market. According to ICPS estimates, Ukraine imported up to 15% of its iron ore, 30% of its steel cable and wire, and 80% of its matches in 2005.

***Trade between Ukraine and Russia will gradually shrink***

ICPS economists say that the two countries are not likely to stop this trade war any time soon. By raising barriers, Russia is improving conditions for its domestic producers to develop, albeit at a cost to consumers. These measures are related to Russia's policy of import substitution. Isolated production may foster greater independence from external shocks, but it is not economically justified and is especially inefficient when it comes to using resources. But Russia's political motives will continue to be strong (see **POLITICAL ENVIRONMENT**).

Should Ukraine and Russia simultaneously accede to the WTO, their membership in this organization will not be a determinant for the development of their trade relations. Although WTO membership will ensure clear procedures for settling trade disputes and international arbitration, the two countries will still not be able to separate the economic and political components of their relationship.

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<sup>56</sup> All in all, these products account for less than 1% of Ukrainian exports to Russia.

<sup>57</sup> According to the Derzhkomstat, 99.8% of Ukrainian meat exports and 70% of Ukrainian dairy exports were delivered to Russia in 2004. Exports of animal products to Russia added up to US \$480mn or 8% of Ukrainian exports to this country in 2004.

# Commodity prices

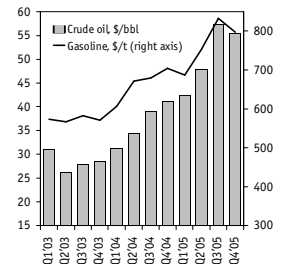
After a steep rise in Summer 2005, oil prices stabilized between US \$55 and US \$65/bbl. The ICPS forecast is that demand for oil will remain flat and oil extraction will not be cut back throughout 2006. The non-economic factors influencing oil supply—seizures of oil infrastructure in Nigeria and the progress of a uranium enrichment program in Iran—will cause prices to fluctuate slightly, but will not have a significant overall impact. Prices for Brent crude will stay within the US \$55–65/bbl range on international markets.

Global prices for steel products were kept from falling in late 2005 only because of mass cutbacks in output in both Europe and America. The steady increase in metal output in China will prevent global prices from climbing to 2004 levels. Still, growing prices for iron ore will keep overall metal prices from falling further. According to ICPS economists, global metal prices will remain unchanged throughout 2006.

World grain markets remained stable over December 2005–February 2006. In early 2006, prices grew because of poor weather conditions in key grain-growing countries. But starting in February 2006, expectations of a good grain crop in Australia and low activity among importers caused prices to contract. ICPS economists expect grain prices to remain relatively stable over 2006.

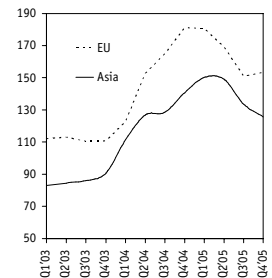
Prices for fertilizers stayed high over late 2005–early 2006. The ICPS forecast is for fertilizer prices to remain high because of high energy prices in 2006.

Average price for oil and gasoline among IEA countries



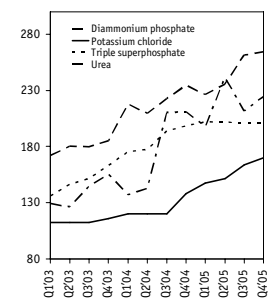
Source: International Energy Agency

Price dynamic for ferrous metals in Asia and the EU, 1997 = 100



Source: MEPS Ltd.

World prices for fertilizers, USD/t



Source: World Bank

# PUBLIC FINANCE

Consolidated Budget revenues grew significantly over 2005. Still, the ICPS forecast is for the deficit to grow over 2006–2008 mostly because of growing social outlays. As in the past, the Budget deficit will be financed both with privatization revenues and domestic&external borrowings

## Revenues

**Consolidated Budget revenues rose to 32% of GDP**

Over 2005, Consolidated Budget revenues grew to 32% of GDP, compared to 26.5% in 2004 as the result of four factors:

- significantly greater VAT revenues as the state offered fewer VAT reimbursements;<sup>58</sup>
- stronger customs control during H1'05 with the launch of the “STOP Smuggling” State program;
- the cancellation of special tax breaks for companies working within SEZs and TPDs;<sup>59</sup>
- the dropping of specific privileges to the car-making, shipbuilding and space sectors.

**Consolidated Budget revenues will slow down in 2006**

The ICPS forecast is for Consolidated Budget revenues to slow down as growth in personal income taxes slows down over 2006 with the slowdown of household income growth (see **HOUSEHOLDS**). In addition, tax receipts from NAK Naftogaz Ukrainy are likely to be cut.<sup>60</sup>

## The deficit

The steep decline in the Consolidated Budget deficit from 3.2% in 2004 to 1.9% in 2005 was primarily due to a sharp rise in tax receipts. 92% of the deficit was covered by privatization revenues.

**Spending on development will go down over the forecast period**

The Government is planning to borrow UAN 11.6bn over 2006 in order to pay off UAH 10.1bn in debt. Borrowing in excess of the amount owed for previous debts is acceptable only if this surplus is directed at funding development expenditures. During 2005, spending on economic activities shrank in Ukraine from 18.2% of Budget spending in 2004 to 13.6% in 2005. ICPS economists say that this will continue to shrink, to 13% for 2006 because of the need to pay off debts and cover social spending.

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<sup>58</sup> State refunds of VAT payments shrank from UAH 16.3bn or 4.9% of GDP in 2004, to UAH 12.1bn or 2.9% of GDP in 2005.

<sup>59</sup> See the 25 March 2006 Law “On amending the Law of Ukraine ‘On the 2005 State Budget.’”

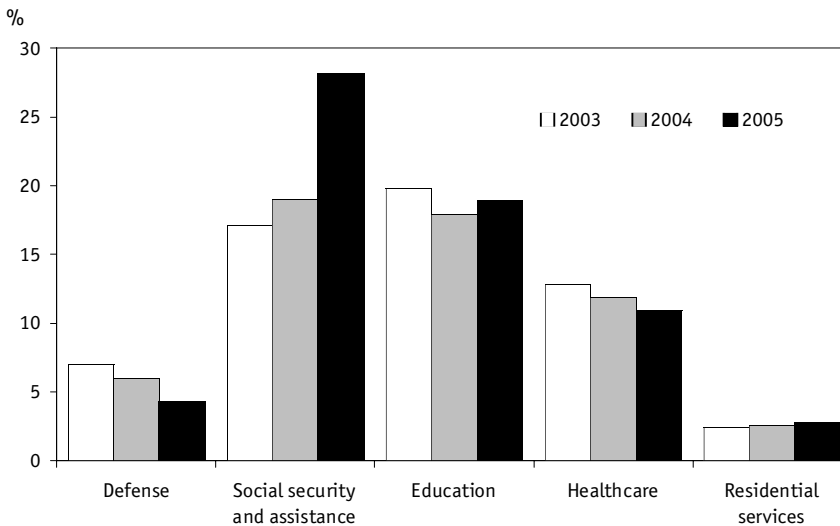
<sup>60</sup> Company profits for 2006 could be reduced as residential subsidies grow with the growing cost of natural gas.

## Expenditures

Funding for social security and other benefits will considerably grow in 2006 as privileges and benefits for “children of the war” are introduced.<sup>61</sup> The Law<sup>62</sup> provides for a 25% subsidy for the use of residential services (gas and power) starting 1 January 2006 and a 30% increase in the minimum pension in the form of a lifetime cash payment or state social assistance step by step during 2006.

***Social outlays  
will grow further  
in 2006***

**Figure 12. Structure of Consolidated Budget spending**



Source: Treasury

The addition of these benefits in the State Budget will expand spending by UAH 11.3bn according to ICPS. Among the negative consequences of these new benefits to “children of the war” are:

- these benefits are extended to pensioners with extremely high revenues, such as working pensioners or military and academic retirees whose pensions range from UAH 1,500 to UAH 4,500 a month;
- compensation for the residential subsidies is not planned for in the 2006 State Budget, which means that the financial state of utilities is likely to grow even worse;
- the lack of funding in the State Budget to institute such massive new payments could lead to higher rates across the board for residential services for those who are working and have no right to subsidization.

In 2006, the Government is cutting back spending on economic activities. Public investment is the most vulnerable form of spending, because cutbacks are the least noticeable in the short term. Still, in the long run, cutting down on investment in fixed assets could kill economic growth altogether, especially due to underdeveloped infrastructure.

***Public investment  
is being cut back***

<sup>61</sup> The 18 November 2005 Law “On social protection for children of the war” defines “children of war” as all citizens who were less than 18 years old on 2 September 1945.

<sup>62</sup> See the 19 January 2006 Law “On amending the 2006 State Budget Law.” The President vetoed the Law, but Verkhovna Rada overturned his veto.

## Forecast for 2006–2008

In 2006, ICPS economists expect Consolidated Budget revenues to be 28.5% of GDP, rising to 29% in 2007 and 2008. Ukraine's accession to the World Trade Organization will make it easier to increase tax receipts on foreign trade operations as volumes grow and the tax base expands.

***Planned expenditures  
will not be easily  
covered in 2006***

The revenue portion of the 2006 State Budget was developed on the basis of an anticipated 7% growth in GDP for the year. The Ministry of Economy has since recalled this forecast. The downgraded forecast for GDP growth will lead to a downgrade in expected VAT receipts. This situation will make it difficult to cover planned expenditures.

There are three main risks to this forecast:

- a devaluation of the hryvnia, which would lead to an increase in external debts;
- reforms to the tax system, which include the simultaneous reduction of several basic tax rates: the VAT, corporate profit tax, and individual income tax. This reform would leave both the State and local budgets strapped for cash;<sup>63</sup>
- the provision of a wide range of tax holidays to business: the renewal of SEZs and TPDs and tax breaks for major corporations.

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<sup>63</sup> See *quarterly predictions* #33, fourth quarter 2005, pp. 18–20.

# HOUSEHOLDS

In 2005, a steep increase in household incomes and high propensity to consume led to a rapid growth in consumption and retail turnover. Incomes will grow at a much slower pace over 2006–2008 due to slower growth in wages and lack of Government initiatives to increase social benefits. A significant decline in the rate of unemployment in 2005 was not the result of any state policies to create new jobs. During the forecast period, unemployment will shrink at a slow pace as it approaches the natural rate of unemployment

## Incomes

Real disposable incomes grew 20.1% in 2005. The main drivers behind this growth were wages and social benefits, which grew 11.7% and 41.5% in real terms.

According to ICPS analysts, real disposable household incomes will grow 5.5% in 2006. Social benefits will continue to rise in nominal terms, but, as indexing slips below the figure for inflation and benefits shrink in real terms, incomes will no longer grow much. In addition, as the rising cost of gas increases overall costs in the private sector, wages are likely to slow down slightly.

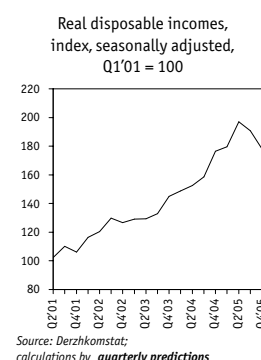
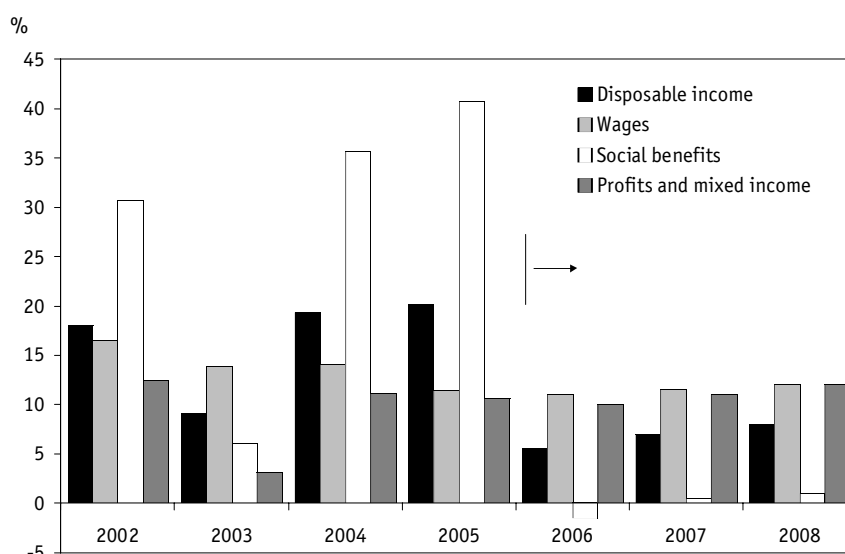


Figure 13. Real change in disposable incomes, wages and social benefits

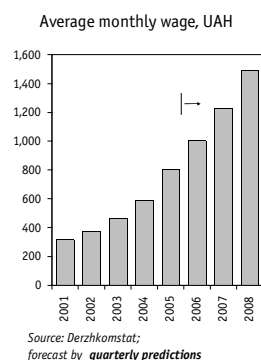


Source: Derzhkomstat; calculations and forecast by *quarterly predictions*

Real disposable incomes will grow 7% in 2007 and 8% in 2008. Social benefits will remain practically flat in real terms, as they will mainly be indexed. However, profits and mixed income, as well as wages, will grow at a more rapid pace as small and medium business expands. This indicator will be affected by changes in taxation: in 2007, personal income tax will go up from 13% to 15%.

***During the forecast period, incomes will grow at a slow pace***

***The steep growth of wages in 2005 testifies to greater competition for labor***



Despite lower-than-expected Budget subsidies,<sup>64</sup> the Government will manage to eliminate the Pension Fund deficit earlier than ICPS economists predicted, most likely during the forecast period. This will be achieved due to lower-than-inflation growth of minimum subsistence level for unemployable individuals.<sup>65</sup> The real incomes of those receiving the basic pension will shrink. However, one risk to the ICPS forecast is further initiatives to raise pensions that might come from a new Cabinet of Ministers formed after the Verkhovna Rada elections in Spring 2006. This kind of initiative could aggravate the crisis in the pension system.

## Wages

In 2005, real wages<sup>66</sup> grew 20.3%. According to ICPS economists, growth factors included:

- an unemployment rate that is approaching its natural level.<sup>67</sup> This is evident in the rapid growth of wages across all sectors of the economy despite slower economic growth and is often a sign of growing competition for labor;
- rapid growth of wages in sectors that grew rapidly during the consumer boom: wholesale and retail trade, and services;<sup>68</sup>
- a growth of 40% in the minimum wage over the year and an adjustment in pay scales and growing salaries among government workers;
- slower consumer price inflation (see **PRICES**).

As of early 2006, wage arrears shrank 14% compared to early 2005, to UAH 959.7mn. While wage arrears went down across many sectors of the economy.

During the forecast period, real wages will grow at a slower pace than in 2005. In 2006, wages will grow 14% in real terms. ICPS economists say that slower growth in real wages is the result of slower overall economic growth (see **OVERVIEW**). An increase in personal income tax from 13% to 15% in 2007 will cut wage growth to 11%. In 2008, real wages will grow 12%. According to ICPS economists, the second pillar of the pension system—the accumulation

<sup>64</sup> The Draft Bill “On the 2006 State Budget” included subsidies to the Pension Fund worth UAH 17bn. But the adopted 2006 State Budget allocated UAH 15.4bn to the Pension Fund, including UAH 7.3bn to cover the pension benefit deficit.

<sup>65</sup> Specifically, the minimum subsistence level for unemployable individuals was UAH 332 in 2005. As of 2006, it has gone up to UAH 350, a 5.4% growth compared to the 2005 indicator, and will rise to UAH 366 by October 2006, for a total growth of 10.2%. However, the CPI grew 10.3% over 2005 alone. The ICPS forecast is for the CPI to rise 12.5% over 2006.

<sup>66</sup> This means the average monthly wages of permanent employees. The indicator refers to both permanent and freelance workers, as well as to those who work unofficially, that is, are not “on the books.”

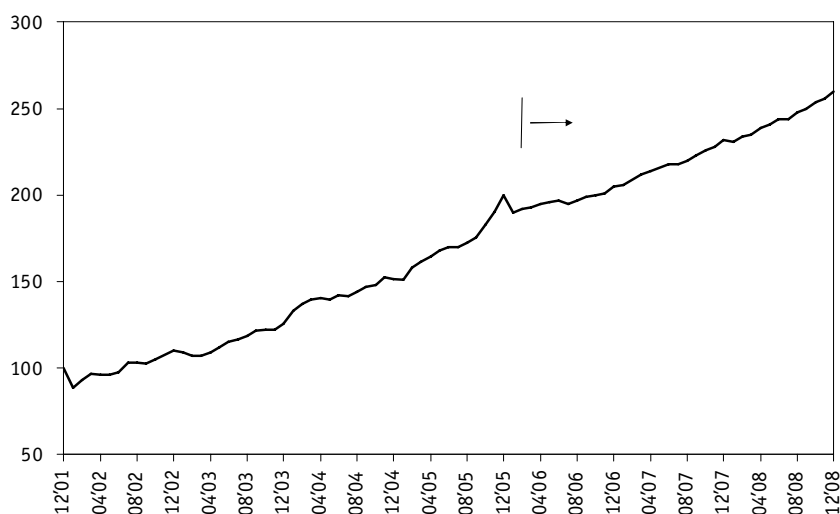
<sup>67</sup> The natural rate of unemployment is the rate when there is full employment. In this instance, the unemployed consist mostly of individuals who have resigned and are looking for a new job and workers who have been laid off because of structural changes in the economy.

<sup>68</sup> In 2005, nominal wages grew 40.2% in retail and wholesale trade, and 55.1% in the service sector.

fund—will not be instituted during the forecast period and, thus, the size of social insurance contributions will not change significantly.

### Figure 14. Real wages

index, December 2001 = 100, seasonally adjusted



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

## Consumption

Private consumption grew 15.9% in 2005. The main drivers were rapid growth in household incomes and a high propensity to consume.<sup>69</sup> According to ICPS calculations, the latter grew to 90%, against 87.5% in 2004. Consumption grew primarily among consumers with below-average incomes as social benefits were increased.

During the forecast period, slower growth in household incomes will result in slower growth in consumption. The ICPS forecast is for consumption to grow 6.5% in 2006, 6.5% in 2007 and 8% in 2008. The acceleration at the end of the forecast period will be the result of slower price rises (see **PRICES**). The propensity to consume will remain high.<sup>70</sup>

### Real change in private consumption, %

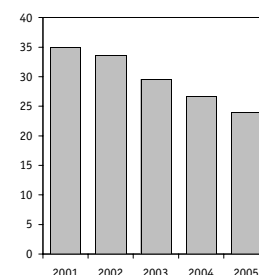
<b>2002</b>	<b>9.0</b>
<b>2003</b>	<b>12.1</b>
<b>2004</b>	<b>14.5</b>
<b>2005</b>	<b>15.9</b>
<b>2006</b>	<b>6.5</b>
<b>2007</b>	<b>6.5</b>
<b>2008</b>	<b>8.0</b>

## Retail trade turnover

Growing consumption resulted in a steep growth of retail trade turnover—23% over 2005. At the same time, the trend towards a shrinking share of both organized and non-organized open markets in the retail trade continued.

As of September 2005, the network of stationary and semi-stationary retailers, that is, shops and kiosks, has tripled compared to 1999. This retail network has grown primarily because of kiosks, 91% of which belong to sole proprietors. The number of shops has also grown and the share of shops belonging to sole proprietors has risen from 21% to 69%.

The share of markets in retail trade turnover, %



Source: Derzhkomstat

<sup>69</sup> The average propensity to consume is the percentage of disposable income spent by households on consumption.

<sup>70</sup> In Q4'05, the Index of Propensity to Consume reached a record high for the entire history of consumer confidence surveys in Ukraine. See *consumer confidence* #23.

The network of restaurants has grown almost 33% over 1999, also thanks to sole proprietors. Their share of this market has risen from 22% in 1999 to 51% in 2005.

**Table 2. Network of retail trade and food service points**

	1999	2005	Growth
Shops	107.8	190.0	76%
Kiosks	43.0	275.0	540%
Eateries	43.8	57.2	31%

Source: Derzhkomstat

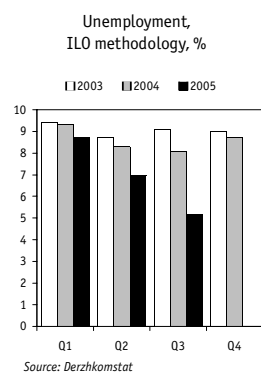
Growing household incomes and a high propensity to consume have spurred further growth in the retail trade, which should grow 13.5% in 2006 and 9% per annum over 2007–2008. The share of organized and non-organized open markets in retail turnover will continue to shrink as supermarkets and shopping centers replace them.

## Labor

Using International Labor Organization methodology, unemployment slipped to a record-low 5.2% in Q3'05. Over January–September 2005, the unemployment rate was 7%. The main factors behind this trend were:

- SHRINKING NUMBERS OF COMMERCIALY ACTIVE AND EMPLOYED INDIVIDUALS IN CITIES.** Commercial activity shrank as those of pensionable age retired and employable individuals withdrew from the market to take care of their households, children, the sick or other family members. These vacancies were filled by working-age individuals. Since employment shrank far less than commercial activity, the rate of unemployment in cities dropped from 8.7% over the first nine months of 2004 to 7.6% over January–September 2005.
- GROWING COMMERCIAL ACTIVITY AND EMPLOYMENT IN RURAL AREAS.** This caused unemployment in rural areas to shrink from 8.2% over the first nine months of 2004 to 5.5% over January–September 2005. ICPS economists say this happened because individuals who earlier had also worked on their homesteads began to declare themselves employed.<sup>71</sup>

The ICPS forecast is for the rate of unemployment in Ukraine to continue to shrink to 6.7% in 2006, 6.5% in 2007 and 6.4% in 2008. This indicator is gradually approaching the natural rate of unemployment. This is confirmed by the steep increase in wages across all sectors of the economy despite slow economic growth in 2005.



**Unemployment is approaching the natural rate**

<sup>71</sup> This was the result of a change in the formulation of questions during surveys. Previously, an individual was considered employed if they *worked* for no pay at an enterprise or a business that belonged to any member of their household or on their own homestead with the aim of selling their own products *throughout the week under consideration*. As of Q2'05, such an individual is considered employed if they *worked at least one hour* during the week under consideration in these activities.

## *New jobs: Quantity and quality*

*The “Ten Steps Towards the People” program mentioned the creation of 5mn jobs within the five years of Viktor Yushchenko’s presidency, regardless of the fact that the number of unemployed was only 1.9mn at the end of 2004. Most likely, the idea of creating 5mn jobs is to eliminate unemployment completely and to bring back Ukraine’s legal and illegal migrant workers, who add up to more than 4mn employable individuals.<sup>72</sup>*

*The Government reports that it created 1,024,000 jobs in 2005<sup>73</sup> based on current vacancies on the labor market and vacancies generated at businesses (70%) and through self-employment (30%).<sup>74</sup> At the same time, the majority of new jobs are low-paid—at the minimum subsistence level or below—which indicates to low productivity. Such jobs are unlikely to draw the country’s migrant workers home.*

*ICPS economists say that, to fight unemployment in Ukraine, the Government must concentrate not on the immediate creation of additional jobs, but on three longer-term measures:*

- develop retraining programs that will match new HR needs in the economy. Specifically, they would make it possible for part of the rural population that is working on its homesteads to become involved in more productive activity in other sectors of the economy;*
- encourage interregional migration, for instance, through the State Employment Service;*
- create better conditions for private initiatives.<sup>75</sup>*

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<sup>72</sup> See *quarterly predictions* for Q4’05, p. 25–26.

<sup>73</sup> See the *Interfax–Ukraine* newswire of 17 January 2006.

<sup>74</sup> Self-employment grew because of those who are working on their private homesteads, not because of small businesses.

<sup>75</sup> For example, make regulatory reform more effective (see *quarterly predictions* for Q4’05, p. 50–51).

# AGRICULTURE

The inability of agricultural producers to ensure stable grain harvests will lead to significant fluctuations in overall agricultural indicators during the forecast period. Livestock will grow at a record-high pace in 2006, 6%, the highest for the last five years. For lack of effective mechanisms to support livestock breeding, this sub-sector will slow down to 4% per annum over 2007–2008. In 2007, farmland will start to be sold openly, but this will not lead to a sharp increase in efficiency or to greater investment

## Forecast

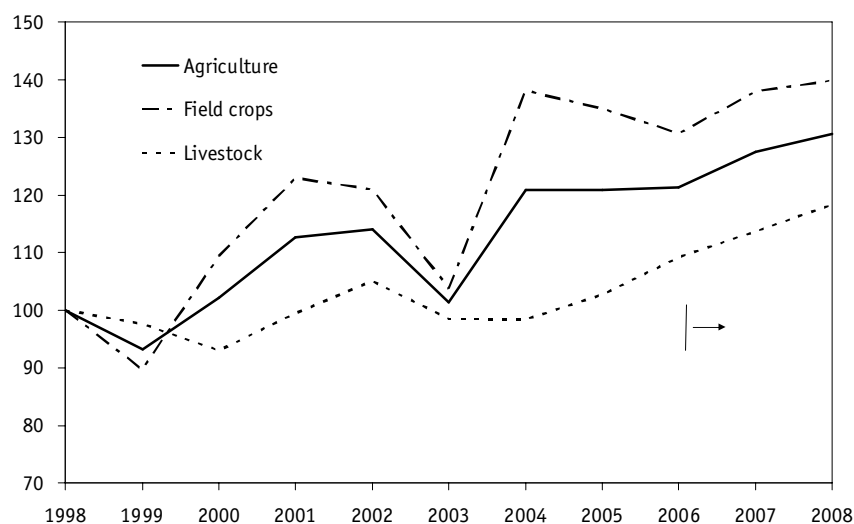
### Agricultural output growth, %

2003	-11.0
2004	19.9
2005	0.0
2006	0.5
2007	5.0
2008	2.0

Agriculture will grow at a slow pace over 2006–2008. Due to shrinking crops and relatively slow growth in livestock, farm output will rise a mere 0.5% in 2006. In 2007 and 2008, field crops will pick up again and agricultural output will grow 5% and 2%.

Figure 15. *Agricultural output*

index, 1998 = 100



Source: Derzhkomstat; forecast by *quarterly predictions*

## Field crops

### The 2006 grain crop will be lower than the 2005 crop

Because areas under winter crops<sup>76</sup> have been reduced and a major portion of the crop was killed during the mid-winter cold spell,<sup>77</sup> the overall grain crop will be down 10% in 2006. This will be the main reason behind shrinking grain products,<sup>78</sup> which, according to the ICPS forecast, will decline 3% in 2006 over 2005.<sup>79</sup>

<sup>76</sup> Areas sown under winter crops shrank 18.8% compared to 2004.

<sup>77</sup> According the State Hydro-Meteorological Center, some 30% of this year's winter crops are dead and another 25–28% are severely damaged. See the *Interfax-Ukraine* newswire of 20 February 2006.

<sup>78</sup> Grains account for about 60% of crop output.

<sup>79</sup> Field crops shrank 2.4% in 2005.

If farmers fail to compensate for the reduced winter sowing areas and dead winter crops with spring crops, the ICPS forecast for 34mn t of grain this year could prove too optimistic. As a result of steep price hikes for fuel and lubricants, plant protection products and mineral fertilizers, the production cost of grain grew almost 40% in 2005, which further weakened financial standing of farm enterprises. Grain production costs will continue to rise in 2006 as fuel, lubricants and mineral fertilizers continue to grow more expensive (see **PRICES**). Expectations of growing costs could discourage farmers from re-sow grain, favoring other crops or leaving their lands to fallow. Lastly, rural residents may fail to carry out sowing in the necessary volumes and in time because of this year's late spring.

Despite growing production costs, grain will continue to be the main farm crop in Ukraine throughout the forecast period. Agriculture will only slowly re-orient towards other crops, given the inertia of farm enterprises and the lack of a state plan to reform agriculture, effective state support, and investment. According to ICPS economists, the grain crop will be around 38mn t per annum over 2007–2008.

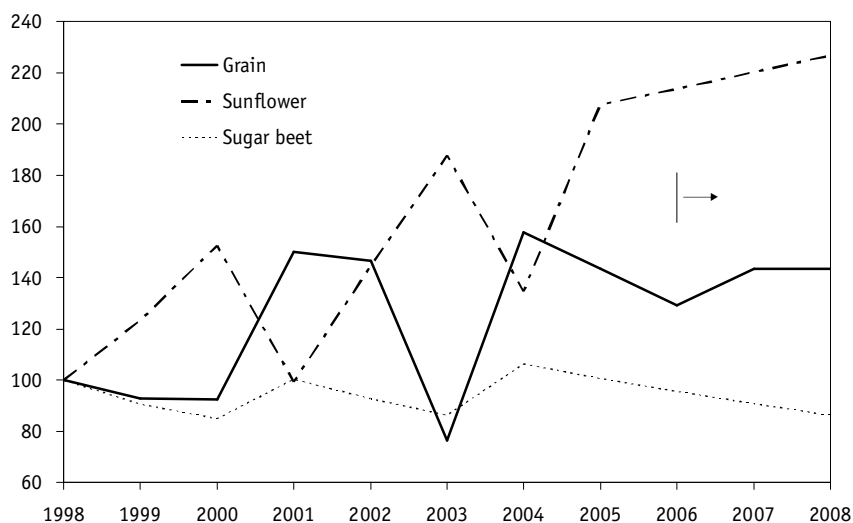
**Over 2006–2008, grain will continue to be the main farm crop in Ukraine**

### Other crops

ICPS economists do not expect sunflower output to increase significantly during the forecast period.<sup>80</sup> Firstly, this crop tends to exhaust soil quickly, so its cultivation requires increased fertilizer inputs. Secondly, sunseed export is complicated by export duty.<sup>81</sup> The ICPS forecast is for sunseed output to grow 3% per annum during 2006–2008.

**Figure 16. Crop output**

index, 1998 = 100



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

Sugar beet output will shrink 5% per annum during the forecast period. According to ICPS economists, growing global sugar prices will not stimulate sugar output to rise in Ukraine, at least not sugar refined from domestic sugar beets. Firstly, sugar beet growers have a small profit margin in Ukraine.

**Sugar beet output will shrink 5% per annum over 2006–2008**

<sup>80</sup> Sunseed output jumped 54.2% in 2005.

<sup>81</sup> Export duty for this crop was 17% in 2005. Starting in 2006, duty will shrink 1 pp per annum until it reaches 10%.

Secondly, refining sugar from beets is an energy-intensive industry (see **BUSINESS**), which means production costs will continue to rise along with the price of natural gas.

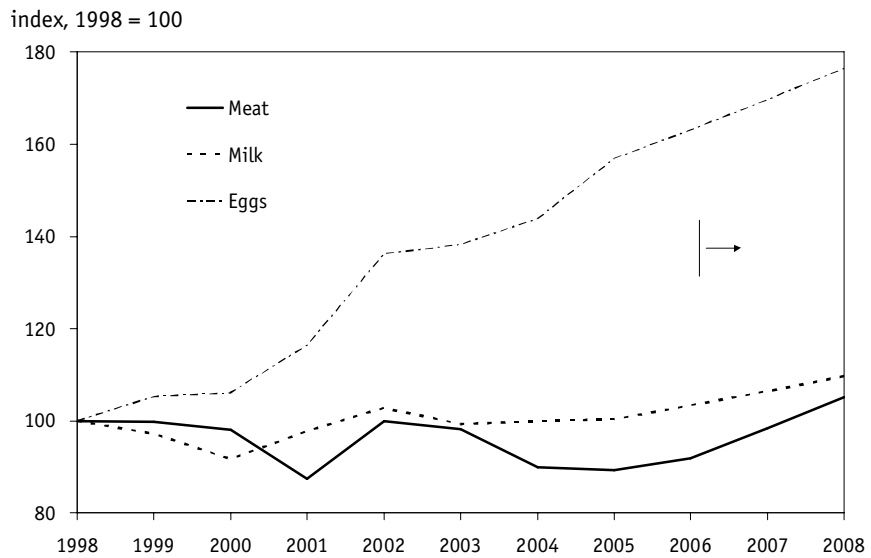
According to the ICPS forecast, potato output will grow 3% per annum over 2006–2008. Vegetable output will grow 5% per annum during the forecast period. Demand for vegetables will increase with positive changes in food intake among Ukrainians as personal incomes grow (see **HOUSEHOLDS**).

### Livestock

**Cattle and poultry numbers will grow 10% in 2006**

Livestock will grow at a record-high pace compared to the last five years, rising 6% in 2006. Livestock and poultry numbers will grow 10% as pig and poultry counts rise. The ICPS forecast is for cattle numbers, which have been declining over the last four years, to level off in 2006. The growth of livestock and poultry numbers could be slowed down with a worse-than-expected grain crop or significant rises in grain prices.

**Figure 17. Livestock output**



Source: Derzhkomstat; forecast by *quarterly predictions*

**Without effective state programs, livestock will not grow rapidly**

ICPS economists expect this sector to slow down to 4% per annum over 2007–2008. Livestock and poultry numbers will grow 5% per annum. A more rapid growth of livestock is possible if the state provides much-needed support.

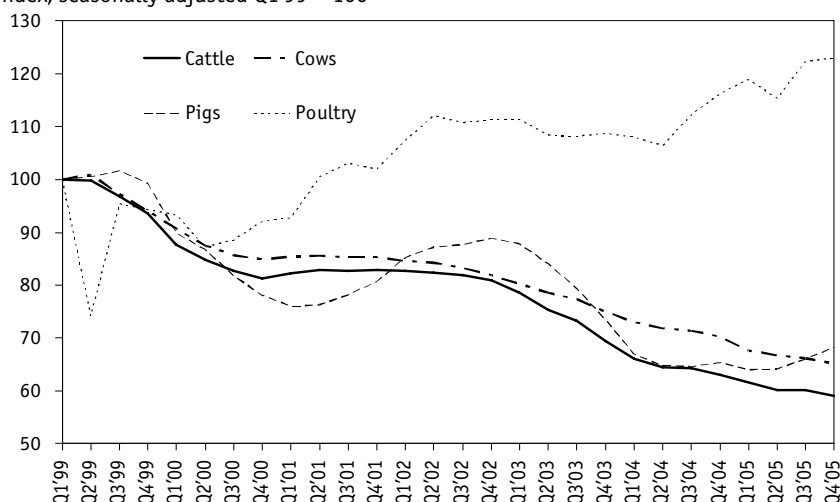
As cattle herds stabilize, milk output will accelerate to 3% in 2006. ICPS economists say that milk output will continue to grow at this pace over 2007–2008. Getting milk output up any more will be difficult due to the slow growth in dairy counts. On the other hand, domestic demand for dairy products will also grow at a sluggish pace, with shrinking population numbers and a saturated market. ICPS economists do not expect exports of Ukrainian dairy to expand during the forecast period.

### Land reform

According to the Land Code of Ukraine, citizens and legal entities that own farmland will gain the right to sell or otherwise alienate their land parcels and

**Figure 18. Cattle and poultry headcounts**

index, seasonally adjusted Q1'99 = 100



Source: Derzhkomstat; calculations by *quarterly predictions*

land shares starting 1 January 2007.<sup>82</sup> Although the free sale of farmland should help improve efficiency in the farm sector and attract additional investment into this sector, ICPS economists do not expect the positive impact of farmland becoming a commodity to make itself felt over 2007–2008. According to ICPS, the market for farmland will not begin to function effectively in 2007 for six reasons:

- not all owners of land deeds will obtain the right to a land parcel (share);<sup>83</sup>
- the government has not completed the inventory and assessment of land. Some oblasts report that they have taken inventory of only 20% of their land;
- no solution has been developed to the problem of squatting or unauthorized occupation of land;
- due to inadequate funding and flawed legislation, work to demarcate land in state and communal ownership is moving at a slow pace;
- for lack of effective regulatory support, no unified state land title registration system has been set up;
- legislation has not been regulated to make those who violate land legislation accountable.

ICPS economists say that the rapid conclusion of land reform must become a policy priority. During the development of the 2007 State Budget, targeted funding should be allocated to set up a unified state land title registration system. Over 2006–2007, the relevant regulations should be adopted and appropriate legislation amended, to remove legal obstacles to an effective land market.

***The market for farmland will not start to function effectively in 2007***

***Targeted funding is needed to complete land reform***

<sup>82</sup> There is a risk that, during 2006, the Verkhovna Rada will extend the moratorium on the sale of farmland.

<sup>83</sup> As of 1 January 2006, 1.72mn land deeds still had to be exchanged. 83.5% of Ukrainians who obtained land deeds have received state certificates of land ownership.

# WORLD ECONOMY

In 2006, the growth of the world economy and that of Ukraine's trading partners will fall 0.7 pp. This slowdown will be registered among all key trading partners, except euro-area countries. During the forecast period, economic growth among these trading partners will remain stable at 3.8–4.1%. Key risks to the ICPS forecast are problems in the Russian economy as a result of over-dependence on oil exports and the likelihood that the real estate bubble in the US will burst

## General trends

According to ICPS estimates, the economies of Ukraine's main trading partners grew 4.8% in 2005. On the whole, the macroeconomic situation on Ukraine's external markets deteriorated: growth slowed down among nearly all of Ukraine's economic partners.

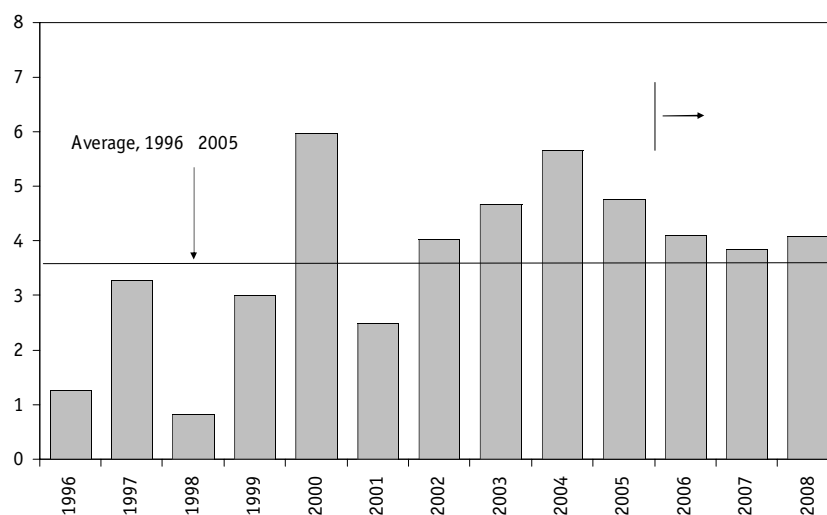
***In 2006, trading partner economies will continue to slow down***

The ICPS forecast for 2006 is for economic growth among key trading partners to continue to slow down mainly because of China, Russia, Turkey, and the US. Growth among key trading partners will be 4.1% in 2006.

Over 2007–2008, economic growth among trading partners will remain stable at 3.8% and 4.1%. Key risks will be a price drop in oil, a steep real appreciation of the Russian ruble in Russia, or the bottom falling out of the US real estate market.

**Figure 19.** Growth among key trading partners<sup>84</sup>

% real annual change



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

Nevertheless, Ukraine's key trading partners will grow faster than the global economy during the forecast period. ICPS economists expect the world economy to grow 3.4% in 2006. Over 2007–2008, it should grow 3.6% and 3.7%.

<sup>84</sup> A list of Ukraine's key trading partners can be found on p. 65.

## The US

According to preliminary data, the US economy grew 3.5% in 2005. By year-end, economic growth slowed down due to sluggish consumer spending<sup>85</sup> and real estate sales. Key factors behind these trends were a slowdown in property prices and high energy prices that limited activity on the consumer market.

According to the ICPS forecast, US real estate prices will stop growing in 2006, mainly due to high interest rates.<sup>86</sup> As a result, consumer spending, which was driven by the lively growth of property prices over the last few years, will be limited. The ICPS forecast is for real GDP to grow 4–5% over Q1'06 due to inertia on the consumer market. By Q2'06, the US economy should begin to slow down significantly.

ICPS economists expect the US economy to grow 2.8% in 2006, mainly due to a slowdown in consumer demand. Investment will continue to be strong thanks to the solid financial standing of businesses.

The main risk for the US economy in 2006 will be a plunge in property prices in response to external shocks, such as skyrocketing energy prices. In light of this risk, the Federal Reserve is likely to suspend its current policy of raising interest rates in H1'06. ICPS economists expect the prime rate go no higher than 5%.

As interest rates stop growing, a double deficit in the US Budget and the balance of payments, and slower economic growth will put additional downward pressure on the US dollar. ICPS economists continue to view a possible sharp depreciation of the US dollar as a major risk. The ICPS forecast is for the average annual exchange rate in 2006 to be USD 1.25/EUR.<sup>87</sup>

ICPS economists expect the US economy to grow 2.7% in 2007. This slower growth will be the result of slow consumer demand and a switch in Budget policy from stimulating the economy to reducing the Budget deficit. In 2008, the US economy should accelerate to 3.2%.

## Euro-area countries

According to preliminary data, the euro-area economy grew 1.3% in 2005. Economic growth in the euro-area is being driven by investments and exports, as consumer demand continues to be extremely weak.<sup>88</sup> This makes long-term economic growth unsustainable, especially with a slowdown in the global economy and high energy prices. ICPS economists expect the euro-area economy to accelerate slightly to 1.6% in 2006 due to enlivened investments as a result of the high current profit margin among European companies.

Consumer demand will continue to be weak throughout the entire forecast period. ICPS analysts expect consumer demand to accelerate in late

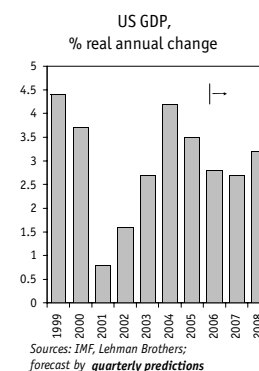
<sup>85</sup> In Q4'05, consumer spending grew a mere 1.2%, a record low for the last 22 quarters.

<sup>86</sup> As of 2 March 2006, the prime rate was 4.5%.

<sup>87</sup> The average monthly rate was USD 1.19/EUR in February 2006.

<sup>88</sup> Real wages in the euro-area shrank 0.4% over 2004–2005, including 1.3% in Germany.

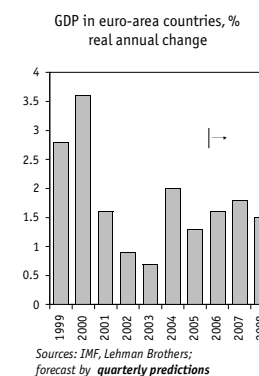
### **The US economy grew 3.5% in 2005**



### **The main risk is a collapse in real estate prices**

### **The US dollar will gradually shrink**

### **The euro-area economy grew 1.3% in 2005**



2006—early 2007 due to labor market reforms and changes to the tax systems in large euro-area economies, primarily in Germany.<sup>89</sup>

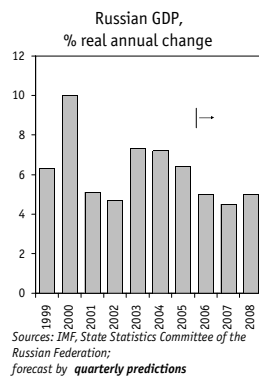
**During the forecast period, the economy will grow 1.5–2%**

Slow economic growth is limiting inflation risks in euro-area economies. In light of this, the European Central Bank will continue its passive policy towards interest rates.<sup>90</sup> ICPS economists expect the refinancing rate to remain flat at 2.5% throughout 2006.

According to ICPS economists, the euro-area economy will grow 1.8% in 2007 and 1.5% in 2008. The main risk to this forecast during the entire forecast period will be the blocking of initiatives in economic reforms and European integration.

## Russia

**Russia's economy grew 6.4% in 2005**



According to preliminary data, Russia's economy grew 6.4% in 2005. The main factor behind this growth was high oil prices: this factor was responsible for nearly one third of GDP growth.<sup>91</sup> Industrial output grew a mere 4%.

Rapid growth of exports resulted in a steep improvement in the country's financial standing. The Federal Budget surplus reached 7.5% of GDP. By early 2006, the Stabilization Fund had accumulated RUR 1,240bn or US \$44bn. The Central Bank's gold and foreign exchange reserves grew US \$57.7bn over the year, reaching US \$182.2bn by early 2006.

Sectors that grew the most in 2005 were those oriented towards the consumer market: retail trade and hospitality. The government has continued its policy of import substitution: the share of imports in domestic demand shrank from 64.1% in 2004 to 44.9% in 2005.

ICPS economists expect Russia's economy to slow down to 5% in 2006. The main growth factor will be continuing high world prices for oil (see **FOREIGN TRADE**). Russia's growth will reach 4.5% in 2007 and 5% in 2008. Domestic demand will slowly begin to play a more important role in the development of the country's economy.

**Over-dependence on oil exports presents two key risks for development**

During the forecast period, the main risks for Russia's economy will be a drop in world oil prices and accelerating real appreciation of the ruble, which will reduce the competitiveness of Russian goods.

## China

**China's economy grew 9.9% in 2005**

According to preliminary data, China's economy grew a brisk 9.9% in 2005. Despite Government steps to hold back economic growth to avoid overheating, growth in nearly all sectors remained stable and high. Investment in fixed capital grew 25.7%, while exports jumped 28.7%.

ICPS economists expect economic growth in China to slip to 8% in 2006. Accelerating appreciation of the yuan and slower global growth—specifically,

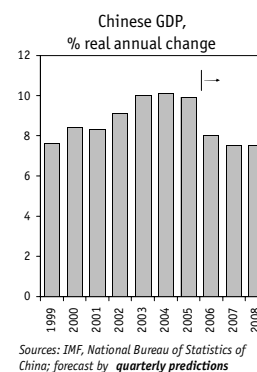
<sup>89</sup> In particular, a VAT rate increase in Germany scheduled for early 2007 should spur consumption in Q4'06.

<sup>90</sup> On 2 March 2006, the ECB raised the refinancing rate 25 base points to 2.5%.

<sup>91</sup> Physical volumes of oil exports actually shrank 2.1%.

growth in the US, an important trading partner—will slow down exports somewhat.

Over 2007–2008, economic growth will reach 7.5% per annum in China. An important growth factor in 2008 will be the Olympic Games, which should spur growth in the service sector. During the entire forecast period, the main risk for China’s economy will be the threat of overproduction.<sup>92</sup> Eliminating this threat will be complicated due to the limited nature of instruments of monetary regulation and slower growth in the world economy.



### *China’s service sector—the surprise over-achiever*

*In late 2005, Chinese statistics agencies finished a large-scale reassessment of their country’s economy. This reappraisal resulted in major adjustments to the reported volumes and structure of the economy.*

*Based on the new data, the government revised indicators of economic growth backwards. Over 1979–2004, average economic growth appears to have been 0.2 pp higher than previously calculated. This revision had a particular impact on indicators for recent years. For instance, growth in 2004 was 10.1% instead of the previous estimate at 9.5%.*

*In 2004, the volume of China’s economy appears to have been 17% higher than previously calculated. The main factor behind this reappraisal was an upward revision in the service sector, which accounted for 93% of the overall adjustment to GDP. The share of the service sector in China’s economy grew 9 pp, to 41%. The reappraisal of services provided by small businesses to the general population, which were traditionally underestimated, played an especially important role in this revision.*

*The results of the revised statistical data testify to greater stability of economic growth in China. Where earlier its economy was viewed as an export-oriented industrial economy, now the share of services in the economy is almost equal to the share of processing (46%).<sup>93</sup> This means that China’s economy is less dependent on the global situation than was thought.*

<sup>92</sup> As the global economy slows down, it will become more difficult to channel excessive supplies to foreign markets.

<sup>93</sup> The typical share of services in developed economies is 60–80%. Ukraine’s service sector accounts for 61% of GDP.



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*Table A1. GDP and gross national disposable income, 1999–2008, millions UAH (unless otherwise specified)*

	1999	2000	2001	2002	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast
Gross domestic product	130,442	170,070	204,190	225,810	267,344	344,822	418,500	492,600	544,700	611,100
Consumption	100,481	127,982	156,344	170,325	201,624	252,758	325,400	394,600	440,700	498,700
Private consumption	74,615	96,315	116,277	128,786	150,794	190,369	243,700	297,000	333,900	381,300
Public consumption	25,866	31,667	40,067	41,539	50,830	62,389	81,700	97,400	106,800	117,300
Gross investment	22,746	33,531	44,525	45,594	58,851	66,134	91,300	106,900	120,900	138,100
Net export of goods and services	7,215	8,557	3,321	9,891	6,869	25,930	1,800	-8,800	-16,900	-25,700
Export of goods and services	70,884	106,200	113,245	124,392	154,394	211,248	217,100	228,600	245,100	268,900
Import of goods and services	-63,669	-97,643	-109,924	-114,501	-147,525	-185,318	-215,300	-237,400	-262,000	-294,600
Consumption, % GDP	77.0	75.2	76.6	75.4	75.4	73.3	77.8	80.1	80.9	81.6
Private consumption, % GDP	57.2	56.6	57.0	57.0	56.4	55.2	58.2	60.3	61.3	62.4
Public consumption, % GDP	19.8	18.6	19.6	18.4	19.0	18.1	19.5	19.8	19.6	19.2
Gross investment, % GDP	17.5	19.8	21.8	20.2	22.0	19.2	21.8	21.7	22.2	22.6
including change in inventory, % GDP	-1.9	0.0	2.1	1.0	0.5	-1.1	0.7	0.1	-0.1	0.0
Net export of goods and services, % GDP	5.5	5.0	1.6	4.4	2.6	7.5	0.4	-1.8	-3.1	-4.2
Export of goods and services, % GDP	54.3	62.4	55.4	55.1	57.8	61.3	51.9	46.4	45.0	44.0
Import of goods and services, % GDP	-48.8	-57.4	-53.8	-50.7	-55.2	-53.7	-51.4	-48.2	-48.1	-48.2
Annual real change in GDP, <sup>94</sup> %	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	3.8	4.5	4.6
GDP deflator, <sup>95</sup> %	27.3	23.1	9.9	5.1	8.0	15.1	18.3	13.4	5.8	7.3

*Table A2. Gross domestic product by income source, 1999–2008, millions UAH (unless otherwise specified)*

	1999	2000	2001	2002	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast
Gross domestic product	130,442	170,070	204,190	225,810	267,300	344,800	418,500	492,600	544,700	611,100
Wages	57,838	71,930	86,440	103,117	122,200	157,800	190,600	239,600	285,900	314,300
Taxes net of subsidies	22,975	28,523	27,264	27,639	30,200	44,600	48,100	59,100	68,100	76,400
Operating surplus	49,629	69,617	90,486	95,054	114,900	142,400	179,800	193,900	190,700	220,400
<i>Structure of GDP, %</i>										
Wages	44.3	42.3	42.3	45.7	45.7	45.8	45.5	48.6	52.5	51.4
Taxes net of subsidies	17.6	16.8	13.4	12.2	11.3	12.9	11.5	12.0	12.5	12.5
Operating surplus	38.1	40.9	44.3	42.1	43.0	41.3	43.0	39.4	35.0	36.1

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

<sup>94</sup> The GDP forecast figures represent a consensus between supply-side and demand-side forecasts.

<sup>95</sup> The GDP deflator is a weighted sum of deflators for GDP components.

Table A3. Breakdown of real GDP change factors, 1999–2008,<sup>96</sup> %

	1999	2000	2001	2002	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast
GDP change <sup>97</sup>	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	3.8	4.5	4.6
GDP change by expenditure groups	-0.1	4.0	11.4	6.4	10.6	11.9	2.6	3.6	4.9	4.9
Gross national spending <sup>98</sup>	-6.6	3.9	12.7	3.4	13.3	10.8	7.0	6.4	6.3	7.0
Total consumption	-3.0	1.5	11.0	3.8	9.6	9.1	7.8	4.8	4.4	5.5
Private consumption	-1.3	1.3	9.1	5.1	6.9	8.2	7.0	3.8	3.9	4.9
Public consumption	-1.7	0.2	1.9	-1.3	2.7	0.9	0.7	1.0	0.6	0.6
Gross fixed investment	0.0	2.4	1.2	0.7	3.2	2.1	-0.8	1.5	1.9	1.6
Change in inventories	-3.6	0.0	0.4	-1.2	0.5	-0.4	0.0	0.1	-0.1	0.0
Export of goods and services	-0.9	11.7	2.2	5.0	5.8	10.5	-4.8	2.0	3.4	3.1
Import of goods and services	7.4	-11.6	-3.5	-2.0	-8.5	-9.4	0.4	-4.8	-4.8	-5.2
Statistical discrepancies	-0.1	1.9	-2.2	-1.2	-1.2	0.2	0.0	0.2	-0.4	-0.4
<i>Annual real change</i>										
Total consumption	-3.7	2.0	9.3	5.0	12.8	12.1	10.5	6.1	5.7	6.8
Private consumption	-2.2	2.3	9.0	9.0	12.1	14.5	12.7	6.5	6.5	8.0
Public consumption	-7.9	1.0	10.4	-6.7	14.8	4.7	4.1	5.0	3.0	3.0
Gross fixed investment	0.1	12.4	6.2	3.4	15.8	10.0	-4.0	7.0	9.0	7.0
Change in inventories	...	0.0	2.1	1.0	0.5	-0.4	0.0	0.1	-0.1	0.0
Export of goods and services	-2.2	21.5	3.5	7.4	10.3	18.1	-7.8	3.8	7.5	7.0
Import of goods and services	-16.7	23.8	6.0	3.3	16.4	17.0	-0.8	9.3	10.2	10.9

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

<sup>96</sup> Items contributing to GDP change are given as the real annual change of the item multiplied by its share. Numbers may not add up due to rounding off.

<sup>97</sup> The GDP forecast figures represent a consensus between supply-side and demand-side forecasts.

<sup>98</sup> Comprises consumption, investment and change in inventories.

*Table A4. Gross value-added by sector, 2003–2008, % real change*

	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast	% of gross value-added in 2005
Agriculture, hunting and forestry	-9.9	19.5	0.4	0.5	5.0	2.0	10.8
Extraction	5.5	4.2	3.7	2.0	3.0	4.0	4.2
Processing	18.1	14.7	2.0	3.5	2.5	3.0	19.7
Utilities (power, gas and water)	4.7	-1.0	2.4	3.5	1.0	1.0	3.7
Construction	23.1	21.3	-6.7	4.0	6.0	6.0	19.5
Wholesale/retail trade, trade in motor vehicles, repair services	19.6	13.4	-8.5	6.0	6.0	6.0	4.2
Transport	12.4	11.4	7.4	6.0	6.0	6.0	14.7
Education	1.9	6.7	0.3	4.3	5.0	6.0	-1.0
Healthcare and social security	2.8	5.5	2.1	4.8	5.5	6.0	19.5
Other types of economic activity	8.3	8.1	1.9	4.0	6.0	7.0	4.2
Net tax on products	10.9	12.6	23.1	2.0	2.5	2.0	14.7
GDP <sup>99</sup>	9.6	12.1	2.6	3.8	4.5	4.6	-1.0

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

<sup>99</sup> The GDP forecast figures represent a consensus between supply-side and demand-side forecasts.

**Table A5. Industrial output, 2003–2008**

	2003 <sup>100</sup>		2004 <sup>100</sup>		2005		2006	2007	2008
							forecast		
	millions UAH	arc, %	millions UAH	arc, %	millions UAH	arc, %	arc, %	arc, %	arc, %
arc = annual real change									
Total industrial output	220,605.1	15.8	326,543.9	12.5	385,398.5	3.1	3.0	2.5	3.0
Extraction	21,900.4	5.5	26,881.6	4.1	34,997.3	4.4	2.0	3.0	4.0
Fuel extraction	13,778.7	3.6	15,014.3	1.9	17,815.0	3.1	1.0	2.0	3.0
Non-fuel extraction	8,121.7	9.1	11,106.3	7.6	17,182.4	5.7	3.0	4.0	5.0
Processing industry	171,592.6	18.2	253,706.3	14.6	298,686.9	3.0	3.5	2.5	3.0
Food industry and processing of farm output	38,409.0	20.0	49,150.7	12.4	60,492.5	13.7	8.0	6.0	7.0
Textiles/apparel	2,498.1	4.0	3,434.0	13.6	3,898.3	0.3	3.0	4.0	6.0
Timber production and wood products	1,499.4	23.6	1,931.8	25.5	2,471.1	19.5	10.0	6.0	8.0
Pulp&paper, printing, and publishing	4,294.7	25.7	6,261.5	25.9	7,596.3	12.7	18.0	4.0	10.0
Coke production and petroleum refining	16,896.9	8.7	27,831.4	3.4	35,835.1	-13.4	-10.0	-10.0	-5.0
Chemicals and petrochemicals	14,523.1	16.8	21,204.9	14.4	25,964.4	9.8	-4.0	-7.0	-7.0
Other non-metal mineral products	6,797.3	17.9	9,149.1	19.3	11,980.5	14.3	15.0	15.0	15.0
Metallurgy and metal processing	53,650.9	14.3	86,674.2	12.0	96,955.5	-1.5	-2.0	-2.0	-2.0
Machine building	30,091.4	35.8	43,782.0	28.0	49,333.3	7.1	6.0	7.0	6.0
Utilities (electricity, gas and water)	27,112.1	4.7	45,955.9	-1.1	51,714.3	2.9	3.5	1.0	1.0

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

<sup>100</sup> The revised industrial output for 2003 and 2004 are UAH 289,117.3mn and UAH 327,282.2mn. The Derzhkomstat provided revised data for the total indicator only, without the breakdown by sectors.

Table A6. Budget revenues, expenditures, balance, state debt, 2003–2008, % GDP

	2003			2004			2005	2006	2007	2008
	Consolidated	State	Local	Consolidated	State	Local	Consolidated estimate	Consolidated forecast		
Total revenues	28.5	20.8	13.0	26.5	19.9	6.6	32.0	28.5	29.0	29.0
Tax revenues	20.6	13.5	7.0	18.3	13.0	5.3	23.4	20.0	20.5	20.5
Personal income tax	5.1	0.0	5.1	3.8	0.2	3.6	4.1	3.8	4.3	4.3
Corporate profit tax	5.0	5.0	0.1	4.7	4.6	0.0	5.6	4.8	4.9	4.9
VAT	4.8	4.8	—	4.8	4.8	—	8.1	6.0	6.1	6.1
Excise	2.0	1.9	—	1.9	1.9	—	1.9	1.9	1.9	1.9
Tax on foreign trade	1.4	1.4	—	1.5	1.5	—	1.6	1.6	1.6	1.6
Land excise fees	0.8	—	0.8	0.7	—	0.7	0.6	0.6	0.6	0.6
Local taxes and levies	0.2	—	0.2	0.2	—	0.2	0.1	0.1	0.1	0.1
Non-tax revenues	6.9	6.0	0.9	7.1	6.5	0.6	7.6	7.4	7.4	7.4
Revenues from capital operations	0.7	0.3	0.4	0.7	0.3	0.4	0.7	0.7	0.7	0.7
State targeted funds	0.3	0.1	0.2	0.2	0.1	0.1	0.3	0.1	0.1	0.1
Official transfers	—	0.9	4.4	—	0.5	...	—	—	—	—
Total spending	28.7	21.2	12.8	29.7	21.1	11.5	33.9	31.0	31.0	32.0
General public functions	3.8	3.0	0.8	3.6	2.8	0.8	3.7	3.6	3.6	3.6
Foreign debt servicing	0.9	0.9	—	1.0	1.0	—	0.5	0.6	0.6	0.6
Domestic debt servicing	0.1	0.1	—	0.2	0.2	—	0.2	0.3	0.3	0.3
Defence	2.0	2.0	—	1.8	1.8	—	1.4	1.3	1.3	1.3
Public administration, security and law enforcement	2.2	2.2	0.1	2.3	2.2	0.1	2.4	2.3	2.3	2.3
Economy	4.6	3.5	1.1	5.4	4.4	1.3	4.6	4.0	4.0	4.3
Environment	0.3	0.3	0.1	0.3	0.3	0.1	0.3	0.3	0.3	0.3
Welfare	4.9	2.6	2.3	5.6	3.6	2.1	9.5	8.0	7.5	7.5
Education	5.7	2.2	6.5	5.3	2.1	3.2	6.4	6.0	6.0	6.2
Healthcare	3.7	0.9	2.8	3.5	1.0	2.5	3.7	3.5	3.5	3.7
Residential services	0.7	—	0.7	0.8	—	0.8	0.9	1.2	1.7	2.0
Other expenditures	0.8	0.2	0.5	0.7	0.3	0.4	0.2	0.1	0.1	0.1
State loans	—	—	—	0.3	—	—	0.1	—	—	—
Budget balance	-0.2	-0.4	0.2	-3.2	-1.2	-2.0	-1.9	-2.5	-2.0	-3.0
Privatization proceeds	0.8	0.8	—	2.8	2.8	—	6.0	1.8	0.6	0.5
Total debt	—	29.4	—	—	24.8	—	18.7	15.4	16.0	13.0
Foreign debt	—	21.6	—	—	18.7	—	14.1	12.7	14.2	12.5
Domestic debt	—	7.8	—	—	4.3	—	4.6	2.7	1.8	0.5

Sources: Treasury, Ministry of Finance; calculations and forecast by *quarterly predictions*

Table A7. Major indicators of monetary policy, 1998–2008, millions UAH, end of period<sup>101</sup>

	Monetary base	%	Broad money M3	%	Cash in circulation	%	Exchange rate, UAH/USD	NBU gross reserves, millions USD	Reserve/monetary base ratio, %	Commercial bank interest rates on hryvnia loans, % pa	Lending by commercial banks	Deposits at commercial banks
12'98	8,625	22	15,705	25	7,158	17	3.427	793	31.5	60.4	8,873	8,278
12'99	11,988	39	22,070	41	9,583	34	5.216	1,094	47.6	51.9	11,787	12,156
12'00	16,780	39	32,252	45	12,799	34	5.435	1,476	47.8	37.3	19,574	18,738
03'01	16,742	—	33,029	—	12,736	—	5.419	1,516	49.1	33.8	21,547	20,022
06'01	18,998	—	36,956	—	14,487	—	5.383	1,860	52.7	32.1	24,466	21,907
09'01	20,434	—	39,643	—	16,208	—	5.331	2,723	71.0	30.6	25,947	22,852
12'01	23,055	37	45,755	42	19,465	52	5.299	3,090	71.0	29.6	28,373	25,674
03'02	25,076	—	47,345	—	19,646	—	5.322	3,112	66.0	27.6	29,669	27,101
06'02	26,227	—	51,195	—	21,441	—	5.329	3,405	69.2	25.0	32,653	29,296
09'02	29,158	—	57,729	—	23,655	—	5.330	4,019	73.5	23.5	36,400	33,533
12'02	30,808	34	64,870	42	26,434	36	5.332	4,417	76.4	21.8	42,035	37,715
03'03	31,191	—	70,114	—	26,002	—	5.335	4,615	78.9	18.0	46,021	43,503
06'03	35,178	—	79,034	—	29,375	—	5.333	6,172	93.6	17.2	52,656	49,017
09'03	38,021	—	86,495	—	30,862	—	5.332	6,682	93.7	17.2	60,491	54,946
12'03	40,089	30	95,043	47	33,119	25	5.332	6,937	92	17.7	67,835	61,365
03'04	41,438	—	101,151	—	33,580	—	5.329	7,923	102	17.2	73,430	66,964
06'04	47,222	—	113,971	—	36,890	—	5.321	9,628	108	16.6	80,970	76,060
09'04	55,394	—	130,277	—	42,296	—	5.308	12,105	116	17.0	87,128	87,583
12'04	53,763	34	125,801	32	42,435	28	5.305	9,525	94	17.7	88,579	83,138
03'05	60,294	—	140,123	—	43,063	—	5.281	11,952	105	17.3	95,702	96,601
06'05	65,508	—	156,339	—	51,304	—	5.055	13,072	101	15.9	108,742	104,798
09'05	70,471	—	171,011	—	55,465	—	5.050	14,256	102	15.4	126,272	115,255
12'05	82,760	53	194,071	54	60,231	42	5.050	19,394	118	16.4	143,418	132,914
12'06 (forecast)	106,800	29	253,000	30	75,900	26	5.060	20,600	98	12.8	184,800	176,000
12'07 (forecast)	127,400	19	302,400	19	86,600	14	5.120	20,400	82	8.9	236,100	214,600
12'08 (forecast)	149,300	17	359,800	19	96,900	12	5.200	20,400	71	8.8	293,500	262,100

Source: Derzhkomstat; calculations and forecast by *quarterly predictions*<sup>101</sup> Starting 2000, monetary indicators include accrued interest.

Table A8. Consumer and producer prices, 1998–2008

Year	Quarter	Consumer prices			Producer prices				
		Quarterly change	End of period	Average	Index, 12'95 = 100	Quarterly change	End of period	Average	Index, 12'95 = 100
1998			20.0%	10.6%	184.6		35.4%	13.2%	166.7
1999			19.2%	22.8%	220.2		15.7%	32.0%	192.6
2000			25.8%	28.2%	276.8		20.9%	20.9%	232.6
2001			6.1%	12.2%	293.7		0.9%	8.9%	234.7
2002			-0.6%	0.8%	292.0		5.7%	3.0%	248.1
2003			8.2%	5.2%	316.1		11.1%	7.7%	275.7
2004			12.3%	9.0%	355.0		24.1%	20.1%	342.7
2005			10.3%	13.5%	391.6		9.5%	17.0%	375.7
2006 (forecast)			12.5%	12.5%	440.6		10.0%	9.9%	413.3
2007 (forecast)			7.0%	9.8%	471.4		7.0%	8.2%	442.2
2008 (forecast)			6.0%	6.5%	499.7		6.5%	6.8%	470.9
2004	I		2.2%		323.1		6.8%		294.6
	II		2.1%		329.9		7.1%		315.3
	III		1.2%		333.9		3.6%		326.8
	IV		6.3%		355.0		4.9%		342.7
2005	I		4.4%		370.5		4.9%		359.4
	II		1.9%		377.6		3.3%		371.3
	III		0.7%		380.2		1.0%		374.9
	IV		3.0%		391.6		0.2%		375.7
2006 (forecast)	I		4.3%		408.4		2.8%		386.2
	II		4.6%		427.2		3.2%		398.6
	III		1.3%		432.8		1.4%		404.2
	IV		1.8%		440.6		2.3%		413.3
2007 (forecast)	I		2.5%		451.6		2.0%		421.6
	II		2.1%		461.1		1.7%		428.7
	III		0.7%		464.3		1.6%		435.5
	IV		1.5%		471.4		1.5%		442.2
2008 (forecast)	I		2.2%		481.8		1.8%		450.2
	II		1.8%		490.4		1.6%		457.4
	III		0.5%		492.8		1.5%		464.3
	IV		1.4%		499.7		1.4%		470.9

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

**Table A9. Balance of payments, 1999–2008,<sup>102</sup> millions USD**

	1999	2000	2001	2002	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast
Current account balance	1,658	1,481	1,402	3,173	2,891	6,804	2,531	86	-1,665	-3,603
Trade balance in goods and services	1,821	1,575	613	1,857	1,288	4,873	671	-2,014	-3,665	-5,603
Merchandise trade balance	244	779	198	710	-269	3,741	-1,135	-4,097	-5,974	-8,157
Exports of goods	13,189	15,722	17,091	18,669	23,739	33,432	35,024	35,658	38,154	40,825
Imports of goods	-12,945	-14,943	-16,893	-17,959	-24,008	-29,691	-36,159	-39,755	-44,128	-48,982
Balance of services	1,577	796	415	1,147	1,557	1,132	1,806	2,083	2,308	2,554
Exports of services	3,869	3,800	3,995	4,682	5,214	6,287	9,354	10,009	10,709	11,459
Imports of services	-2,292	-3,004	-3,580	-3,535	-3,657	-5,155	-7,548	-7,295	-8,401	-8,905
Income	-869	-942	-667	-606	-581	-645	-985	-900	-1,000	-1,000
Transfers	706	848	1,456	1,922	2,184	2,576	2,845	3,000	3,000	3,000
Capital account (excluding changes in reserves)	-421	-925	435	-1,243	107	-4,540	-2,683	-770	-1,900	-3,870
Direct investments <sup>103</sup>	489	594	769	688	1,411	1,711	7,533	6,000	3,000	2,700
Portfolio investments	-86	-201	-866	-1,716	-922	-76	2,757	-2,350	-4,100	-5,800
Other investments	-814	-1,318	529	-240	-365	-6,182	-2,483	-2,960	-1,474	-1,200
Net change in NBU reserves	-283	-398	-1,606	-1,045	-2,045	-2,226	-10,425	-1,200	200	0
Errors/omissions	-954	-150	-231	-885	-953	-38	0	346	-389	-583

Source: NBU; forecast by *quarterly predictions*

<sup>102</sup> Table is constructed using NBU methodology. Numbers may not add up due to rounding off.

<sup>103</sup> Calculated as net foreign investments in Ukraine minus net investments of Ukrainian residents abroad.

**Table A10. Gross agricultural output, 1999–2008, in 2000 prices**

	Total, millions UAH	Annual real change, %	Crop production, millions UAH	Annual real change, %	Livestock production, millions UAH	Annual real change, %
1999	50,736.4	-6.9	27,579.4	-10.3	23,157.1	-2.4
2000	55,689.6	9.8	33,631.7	21.9	22,057.9	-4.7
2001	61,397.5	10.2	37,804.4	12.4	23,593.1	7.0
2002	62,106.1	1.2	37,189.7	-1.6	24,916.4	5.6
2003	55,266.8	-11.0	31,906.9	-14.2	23,359.9	-6.2
2004	66,257.2	19.9	42,612.1	33.6	23,645.1	1.2
2005 (estimate)	66,257.2	0.0	41,571.7	-2.5	24,685.5	4.4
2006 (forecast)	66,588.5	0.5	40,421.9	-2.7	26,166.6	6.0
2007 (forecast)	69,917.9	5.0	42,704.6	5.6	27,213.3	4.0
2008 (forecast)	71,316.3	2.0	43,014.5	0.7	28,301.8	4.0

**Table A11. Major agricultural commodities, 1995–2008**

	Grain, '000 t	Annual change, %	Sunseed, '000 t	Annual change, %	Sugar beets, '000 t	Annual change, %	Meat, '000 t (liveweight)	Annual change, %	Milk, millions t	Annual change, %	Eggs, millions	Annual change, %
1995	33,930	-4.4	2,860	82.3	29,650	5.4	3,581	-13.0	17.3	-4.8	9,404	-7.4
1996	24,571	-27.6	2,123	-25.8	23,009	-22.4	3,351	-6.4	15.8	-8.4	8,763	-6.8
1997	35,472	44.4	2,308	8.7	17,663	-23.2	2,976	-11.2	13.8	-13.0	8,242	-5.9
1998	26,471	-25.4	2,266	-1.8	15,523	-12.1	2,653	-10.8	13.8	-0.1	8,301	0.7
1999	24,581	-7.1	2,794	23.3	14,064	-9.4	2,647	-0.3	13.4	-2.8	8,740	5.3
2000	24,459	-0.5	3,457	23.7	13,199	-6.2	2,600	-1.8	12.7	-5.6	8,809	0.8
2001	39,706	62.3	2,251	-34.9	15,575	18.0	2,317	-5.0	13.4	6.0	9,668	9.8
2002	38,804	-2.3	3,270	45.3	14,453	-7.2	2,509	7.6	14.1	5.2	11,309	17.0
2003	20,234	-47.8	4,254	30.1	13,392	-7.0	2,607	-1.8	13.7	-3.4	11,477	1.5
2004	41,718	106.2	3,052	-28.3	16,502	23.2	2,387	-8.4	13.7	0.6	11,944	4.1
2005 (estimate)	37,997	-8.9	4,705	54.2	15,617	-5.4	2,368	-0.8	13.8	0.3	13,026	9.1
2006 (forecast)	34,197	-10.0	4,846	3.0	14,836	-5.0	2,439	3.0	14.2	3.0	13,547	4.0
2007 (forecast)	38,000	11.1	4,992	3.0	14,094	-5.0	2,610	7.0	14.6	3.0	14,089	4.0
2008 (forecast)	38,000	0.0	5,141	3.0	13,390	-5.0	2,792	7.0	15.1	3.0	14,652	4.0

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

Table A12. Wages, 2004–2008

	Quarter	Nominal monthly wage, UAH	Real % change, q-o-q	Real % change, y-o-y	Annual average, <sup>104</sup> change
2004 <sup>105</sup>	I	518.26	4.5	26.8	26.8
	II	568.10	7.0	25.3	26.0
	III	614.33	6.9	21.2	24.3
	IV	661.42	2.3	22.3	23.8
2005	I	676.54	-1.9	14.8	15.3
	II	773.71	11.1	19.1	17.5
	III	841.51	7.5	19.8	18.0
	IV	932.80	8.2	26.7	20.3
2006 (f.)	I	931.23	-5.3	22.3	22.3
	II	1,029.25	6.3	17.0	18.1
	III	1,084.92	4.8	14.1	17.5
	IV	1,159.37	0.2	5.7	14.0
2007 (f.)	I	1,100.74	-2.3	9.1	9.1
	II	1,215.23	7.4	10.2	9.7
	III	1,285.90	6.3	11.8	10.4
	IV	1,376.55	1.4	13.2	11.0
2008 (f.)	I	1,301.13	-3.7	11.6	11.6
	II	1,424.17	7.5	11.7	11.7
	III	1,498.84	6.8	12.3	11.9
	IV	1,633.96	1.4	12.2	12.0

Source: Derzhkomstat; forecast by *quarterly predictions*

Table A13. Retail turnover, 2004–2008

	Retail turnover, quarterly, millions UAH	Real % change, <sup>106</sup> y-o-y
2004 <sup>105</sup>	12,599	17.5
	15,305	26.0
	17,623	23.1
	20,211	24.4
2005	17,365	21.4
	21,301	21.5
	25,386	25.8
	27,827	23.4
2006 (f.)	23,386	22.7
	26,556	13.8
	29,554	7.9
	32,038	6.5
2007 (f.)	27,664	9.5
	31,073	9.7
	34,973	11.1
	38,311	12.7
2008 (f.)	32,913	14.1
	37,615	17.6
	40,749	12.6
	43,884	12.9

Source: Derzhkomstat; forecast by *quarterly predictions*

<sup>104</sup> The ratio of the average real wage during the four latest quarters to the real average wage during the previous four quarters. As of January 2004, the ratio of the average real wage since the beginning of the year to the average real wage during the corresponding period of the previous year.

<sup>105</sup> In January 2004, Derzhkomstat changed its methodology for calculating wage statistics. The new methodology takes into account international recommendations and the standards of the System of National Accounts. Data for 2004 and on is not comparable across prior years.

<sup>106</sup> The CPI was used to calculate indicators for real quarterly retail turnover. In its calculations of this same indicator, Derzhkomstat uses a retail price index that it does not publish.

**Table A14. Household income and spending, 2003–2008, millions UAH (unless otherwise specified)**

	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast
Household income <sup>107</sup>	215,672	274,241	365,923	—	—	—
Wages	94,680	117,227	148,232	—	—	—
Operating surplus	36,233	43,828	55,017	—	—	—
Property incomes	6,686	7,495	9,091	—	—	—
Social assistance and other current transfers	78,073	104,849	153,583	—	—	—
Disposable income	162,578	212,033	278,386	—	—	—
Real disposable income after taxes, annual % change	9.1	19.6	20.1	5.5	7.0	8.0
Expenditures	199,395	243,164	323,967	—	—	—
Real consumption, <sup>108</sup> annual % change	12.5	14.5	15.9	6.5	6.5	8.0
Savings (cumulative)	16,277	31,077	32,956	—	—	—

Source: Derzhkomstat; forecast by *quarterly predictions*

<sup>107</sup> Overall household income, less income from the sale of foreign currency.

<sup>108</sup> Including non-profit organizations delivering services to households.

**Table A15. Real GDP among major trading partners, 1999–2008, % change**

	1999	2000	2001	2002	2003	2004	2005 estimate	2006 forecast	2007 forecast	2008 forecast	% in Ukraine's exports (2005)	% in world output (2004)
Russia	6.3	10.0	5.1	4.7	7.3	7.2	6.4	5.0	4.5	5.0	21.9	2.6
Euro area	2.8	3.6	1.6	0.9	0.7	2.0	1.3	1.6	1.8	1.5	15.2	15.3
Turkey	-4.7	7.4	-7.5	7.9	5.8	8.9	5.5	4.5	4.0	5.0	5.9	—
Poland	4.1	4.0	1.0	1.4	3.8	5.4	3.5	4.0	3.5	4.5	2.9	—
US	4.4	3.7	0.8	1.6	2.7	4.2	3.5	2.8	2.7	3.2	2.8	20.9
Belarus	3.4	5.8	4.7	5.0	7.0	11.0	9.2	6.0	5.0	4.0	2.6	—
China <sup>109</sup>	7.6	8.4	8.3	9.1	10.0	10.1	9.9	8.0	7.5	7.5	2.1	13.2
Hungary	4.2	5.2	3.8	3.5	2.9	4.2	4.3	3.5	3.0	3.5	2.0	—
Moldova	-3.4	2.1	6.1	7.8	6.6	7.3	8.0	3.5	4.5	4.5	2.0	—
Kazakhstan	2.7	9.8	13.5	9.8	9.3	9.4	9.2	7.8	8.0	7.0	1.9	—
Bulgaria	2.3	5.4	4.1	4.9	4.3	5.6	5.2	4.5	4.5	5.0	1.6	—
Romania	-1.2	2.1	5.7	5.1	5.2	8.3	4.1	5.0	4.5	5.0	1.4	—
Total <sup>110</sup>	3.0	6.0	2.5	4.0	4.7	5.7	4.8	4.1	3.8	4.1	62.3	—

Source: IMF, Derzhkomstat; forecast by *quarterly predictions*

<sup>109</sup> Data reflects the reassessment of historical real GDP growth in China that was finished in 2005.

<sup>110</sup> For the forecast of growth among key trading partners in 2006–2008, structure of Ukrainian goods exports in 2005 is used.

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