

# ICPS newsletter<sup>®</sup>

## High inflation: An unavoidable component in Ukraine's economic growth over 2008–2010

*ICPS has published the latest issue of its periodical report called quarterly predictions, containing its updated forecasts for economic and political developments in Ukraine for the next three years. According to its economists, Ukraine's economy will continue to grow, with real GDP rising 6.7% in 2008, 6.6% in 2009 and 5.9% in 2010*

### Inflationary trend unfolds

Consumer prices continue to grow sharply in 2008. As in 2007, food prices are rising the fastest among the items in the consumer basket. ICPS analysts say that this rise in food prices is a consequence of greater demand as disposable incomes continue to rise steeply, on one hand, and a tighter supply of agricultural products, on the other.

Supplies have grown shorter due to the poor harvest in 2007 and a reduction in milk and egg output. In addition, world inflationary processes are having a major impact on domestic prices due to the openness of Ukraine's economy. Growing demand for agricultural and food products on world markets and the resulting rise in prices are encouraging greater exports from Ukraine. Such exports are growing both in value and in volume.

Price growth of nearly 20% per annum poses a threat to macroeconomic stability. High inflation will lead to an increase in nominal interest rates on loans and to a slowdown in long-term credits. Indexation in the public sector and a new subsistence minimum will cause a jumpy change in household incomes.

To slow down inflation, the NBU has been tightening monetary policy, while the Government has put together an anti-inflation plan and restricted exports of sunflower oil and seed. ICPS analysts say that tighter monetary policy will not have much of an impact on prices because of the non-monetary nature of the main

factors driving inflation. Most of the Government's anti-inflationary measures will not work, either.

### Forecast for 2008–2010

ICPS analysts expect GDP to grow 6.7% in 2008, 6.6% in 2009 and 5.9% in 2010. Consumption will continue to be the main driver of economic growth throughout the forecast period, but the relative role of investment will continue to rise. Investment share of GDP will grow from 26% in 2007 to 31% by 2010, while consumption will decline slightly, from 79% to 76%.

ICPS analysts expect imports to continue to grow faster than exports in 2008–2010. As a result, the negative trade and current account balances will continue to grow, reaching 8.4% and 7.6% of GDP by 2010.

The ICPS forecast is for the current account deficit to be compensated for by a major inflow of investment and debt capital on the capital account of the balance of payments over 2008–2009. In 2010, currency reserves will shrink because of the need to cover the trade deficit and the repayment of foreign loans by the private sector.

ICPS analysts expect the NBU to keep the hryvnia exchange rate unaltered at UAH 5.05/USD for the entire forecast period. Pressure to reevaluate will ease as the trade deficit grows and by 2010 it will change to pressure to devalue. The undervalued hryvnia and a slowdown in inflation will make it possible to keep the exchange rate stable.

Our next *newsletter* will be published on May 12!

### By the way...

- On 17 April, ICPS Senior Economist Olha Romaniuk participated in an international conference called "Gender Policy: European practice for Ukraine." The purpose of this event was to bring together and systematize the experience of international organizations and other European countries in carrying out gender policies, to uncover problems with the way that gender policy is being implemented in Ukraine, especially gender legislation, and to determine the role of women in contemporary Ukrainian society.
- On 9 April, ICPS's Director of Political Analysis and Security Programs Viktor Chumak and political analyst Ivan Presniakov participated in a conference entitled, "Legislation Governing the Election of National Deputies: Problems with reforms." During this event, Mr. Chumak presented a report on possible directions for Ukraine's Verkhovna Rada electoral system to evolve. This report is based on the results of a similarly named project carried out by ICPS with funding from the Matra KAP program of the Royal Netherlands Embassy in Ukraine.
- On 9 April, ICPS experts also participated in a Forum on "The Free Trade Zone: Towards the success of the European project in Ukraine." This was organized by the Yalta European Strategy (YES).

Despite the growth of social outlays in the Budget, rising public sector salaries and growing defense expenditures, the

Consolidated Budget deficit will remain below 2% of GDP throughout the forecast period. With better oversight of tax payments, the GDP share of Consolidated Budget revenues will grow. The main source of financing the deficit will be privatization revenues in 2008 and an equal share of internal and external borrowings in 2009–2010.

ICPS analysts say that consumer prices will continue to grow at a relatively high pace throughout the forecast period because of the continuing rapid rise in disposable incomes, high inflationary expectations, and inflationary processes worldwide. They also expect the effect of all these factors to weaken over the forecast period. Incomes and consumption will both grow more slowly, the 2008–2010 harvests will be better than in 2007, and world prices will begin to slow down in H2'08. The ICPS forecast is for the CPI to rise 19.5% in 2008, 12% in 2009, and 10% in 2010.

Rapid economic growth and the crisis hitting developed economies will spark demand for Ukrainian assets. The ICPS forecast is for FDI into Ukraine to average US \$10bn per annum over 2008–2010.

## Assumptions

This forecast is based on eight main assumptions:

- the price of imported natural gas will remain at US \$179.50/1,000 cu m in 2008, rising to US \$250–270 in 2009 and US \$290–320 in 2010;
- steel prices will continue to rise for the entire forecast period;
- prices for mineral fertilizers will continue to grow during the forecast period;
- VAT Odesa Port Plant and VAT Ukrtelecom will be privatized in 2008;
- the accumulative pillar of the pension system will be launched in 2009;
- a Tax Code will be adopted no earlier than 2009 and come into effect only in 2010;
- compensation for depreciated deposits at the Soviet State Savings bank will be UAH 12bn per annum over 2008–2010;
- the National Bank will maintain the hryvnia-dollar exchange rate at its current level for the entire forecast period.

## Risks

There are 10 possible risks to this forecast:

- a steep fall in steel prices on world markets in 2009–2010, which would lead to a slowdown in exports and GDP growth during the forecast period;
- an increase in the price of imported natural gas in H2'08 and an increase to over US \$300/1,000 cu m in 2009, which will lead to a slowdown in industrial growth, compared to the forecast level;
- a sharp reduction or increase in the volume of compensation for depreciated deposits in either 2009 or 2010;
- the failure to launch the accumulative pension system in 2009 because of an ineffective legislature;
- the introduction of a property tax in 2009 or 2010, which would increase Budget revenues above forecast levels;
- a revaluation of the hryvnia exchange rate in 2008, which the Government might try in order to make imports less costly and slow down inflation;
- restrictions on lending in response to a tighter monetary policy or complete loss of access to external financing;
- a switch to targeting inflation or a floating exchange rate, which would cause prices to rise more slowly than forecast;
- major unanticipated inflows of foreign currency.

## Key macroeconomic indicators

Year	2006	2007	2008	2009	2010
Indicator	evaluation		forecast		
GDP, apc, %*	7.3	7.3	6.7	6.6	5.9
Real industrial output, apc, %	6.2	10.2	8.0	7.0	6.0
Real agricultural output, acc, %	2.5	-5.6	7.0	2.0	2.0
Gross investment, % of GDP	24.8	26.4	28.2	29.7	31.1
Real gross fixed investment, apc, %	21.2	21.9	18.0	15.0	15.0
Real consumption, apc, %	12.4	14.0	10.3	9.5	7.7
Net FDI, mn USD	5,737	9,218	10,000	10,000	10,000
Real disposable household income, apc, %	11.8	12.8	13.0	11.5	9.0
Real retail trade, apc, %	26.4	29.3	26.0	23.0	18.0
Consumer price index, apc, %	11.6	16.6	19.5	12.0	10.0
Producer price index, apc, %	14.1	23.3	25.0	12.0	10.0
Population, mn	46.9	46.6	46.4	46.1	45.9
Average monthly real wages, apc, %	18.3	12.5	11.5	11.5	10.0
Unemployment rate (ILO methodology), %	6.8	6.7	6.4	6.2	5.9
Exports of goods and services, apc, %	13.2	27.4	22.8	20.2	20.0
Imports of goods and services, apc, %	22.0	34.8	27.2	22.8	21.0
Current account balance, % of GDP	-1.5	-4.2	-6.1	-7.2	-7.6
Consolidated Budget balance, % of GDP	-0.7	-1.1	-1.7	-1.9	-1.7
Official exchange rate (average annual), UAH/USD	5.05	5.05	5.05	5.05	5.05

\* apc = annual percent change

Sources: Derzhkomstat, Ministry of Finance, NBU; calculations and forecast: **quarterly predictions**

*ICPS economists have been publishing a regular forecast for the development of Ukraine's economy since 1997. This forecast is updated every quarter and published as **quarterly predictions**.*

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