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Economic growth in 2006: risks that did not materialised

According to preliminary information by the Derzhkomstat, in the first six months of the year the real GDP increased by 5.0% yoy. Moreover, the Derzhkomstat revised upwards the growth rate of the real GDP in the first quarter by 0.8 percentage points to 3.2% yoy. These growth rates are surprisingly high taking into account risks that the country has faced. The consensus forecast for the real GDP growth for Ukraine in 2006 was 2.6%. This situation raises the question about factors behind this rather unexpected upswing in economic growth.

One of the reasons for high GDP growth is a boom in domestic private demand. In the first quarter final households consumption increased by historically highest 19.7% yoy, financed by growing incomes and expanding bank credits. However, more importantly, some major risks for economic growth in 2006 did not materialize.

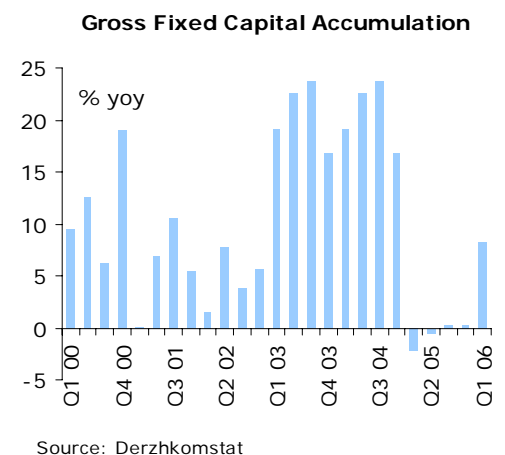
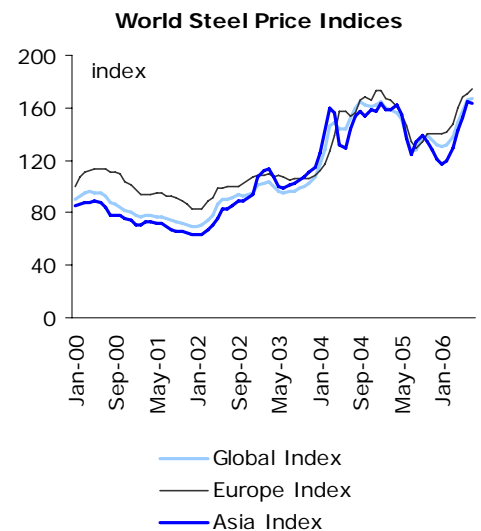
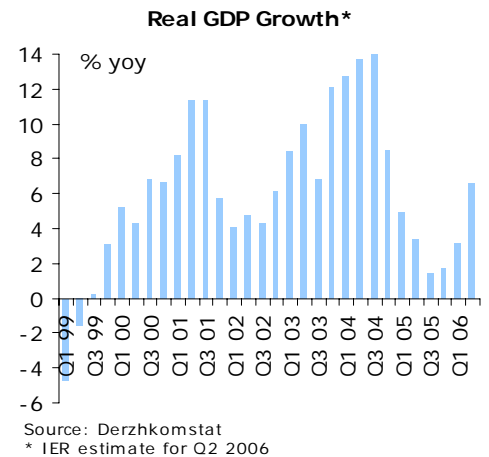
The key risk was the sharp increase in the imported gas price. According to the IER estimates, this increase could lead to 5.5% cumulative reduction in the GDP growth rate over medium-term if no compensatory mechanisms are involved. To balance this shock, the gas consumption in the industrial sector should have declined by approximately one third. It is widely known that Ukraine is the most energy inefficient country in Europe, but timeframe and investments necessary to improve the efficiency was unclear. As metallurgy and chemical industry are major consumers of gas among manufacturing industries, it was expected that the shock would lead to a significant reduction of their production. However, so far both industries demonstrated unexpectedly high resilience to increased gas prices. Although it remains unclear whether enterprises have paid higher gas bills in full, there is no indication of severe non-payments in the sector. Contrary, enterprises increased the efficiency of gas consumption that allowed reducing the physical volumes of imported gas by 15%. Also, these industries started investments in energy efficient technologies without redirecting funds from wage bills, thus not preventing the growth of final consumption.

Yet other risk was low external demand on Ukrainian ferrous metals and products thereof due to reduced world prices and higher competition from China that turned from net importer to net exporter of metals. However, the sharp rise in world metal prices and demand in the spring-summer 2006 allowed Ukraine to restore the growth of its ferrous metal exports, stimulating real GDP growth as well.

The third risk was political instability expected to adversely affect investment activity. However, despite continued political turmoil, growth of investment activity restored. In the first quarter of 2006 the real gross fixed capital accumulation increased by 8.2% yoy compared to 2.3% yoy decline in the same period of 2005. Moreover, the FDI significantly accelerated. It seems that need for investment stimulated by obsolete equipment on the one hand and growing domestic demand on the other outweighed risks of investing under political uncertainty.

Moreover, some of the risks for the second half of the year seem not to happen, increasing the chances for continued higher real GDP growth. First, there will be no increase in gas price in the third quarter. In June it was agreed on gas supply to Ukraine at USD 95 per thousands cubic meters at the border for July-September 2006. Although the gas price in the fourth quarter is still under negotiations, the economy received a chance adapt to new prices to even better. Also, the risk of modest grain harvest disappeared. If in the spring the grain harvest was expected at nearly 31-32 m tons compared to 38 m tons in 2005, now the official forecast is around 40 m tons. Such harvest ensures stable growth of agricultural production, securing its contribution to real GDP growth.

Thus, the current acceleration in economic growth in Ukraine can be explained by the fact that expected risks did so far not materialise. The robustness of growth remains questionable, as additional gas shock or another reverse of external demand trends may provoke one more period of real GDP growth deceleration.



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Quarterly Trends

National accounts **		Q4 03	Q1 04	Q2 04	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06
GDP	UAH bn	77.1	64.7	79.0	100.5	100.6	84.3	97.5	119.4	123.6	102.0	...
GDP (real)	% yoy	12.1	12.7	13.7	14.0	8.5	4.9	3.4	1.4	1.7	3.2	...
Households consumption (real)	% yoy	13.6	14.6	16.8	13.1	16.2	14.3	17.7	17.0	17.1	19.7	...
State consumption (real)	% yoy	9.0	3.3	1.0	5.0	10.1	6.1	0.0	1.0	4.0	2.0	...
Gross fixed capital formation (real)	% yoy	9.0	18.4	6.5	4.6	12.9	-2.3	-0.5	0.2	0.3	8.2	...
Exports of goods and services (real)	% yoy	11.6	18.1	19.9	10.5	8.6	-0.6	-14.0	-12.7	-15.5	-19.9	...
Imports of goods and services (real)	% yoy	17.7	13.8	7.3	6.7	7.8	2.8	3.2	3.9	-0.9	5.6	...
Agriculture, hunting, forestry (real)*	% yoy	6.7	-4.4	0.9	35.7	9.9	5.8	8.3	2.6	-7.4	4.1	...
Manufacturing industry (real)*	% yoy	20.1	23.9	16.3	12.5	9.4	7.0	1.8	-1.1	2.0	-2.9	...
Construction (real)*	% yoy	16.9	29.9	30.6	16.4	3.9	-8.4	-11.3	-8.5	-7.5	2.6	...
Trade, repair services (real)*	% yoy	29.6	23.6	35.0	2.7	13.7	-2.1	-10.7	-11.7	-11.9	4.1	...
Transport (real)*	% yoy	11.7	10.1	8.0	12.3	10.5	6.6	5.7	2.8	7.8	3.4	...
Balance of payments												
Current account balance	USD bn	0.4	1.4	2.3	2.1	1.1	1.6	0.6	0.4	-0.1	-0.7	...
Current account balance	% of GDP	2.8	11.1	15.7	10.9	5.7	10.1	3.2	1.7	-0.4	-4.0	...
Trade balance in goods	USD m	-381	933	1552	774	482	1020	-236	-1131	-788	-1288	...
Trade balance in services	USD m	409	133	198	749	157	188	392	1035	191	176	...
Current transfers	USD m	584	475	758	720	623	626	694	745	780	616	...
Direct investment (FDI)	USD m	329	333	614	420	344	247	365	477	6474	662	...
Portfolio investments	USD m	-293	449	149	1313	156	397	923	90	1347	0	...
Gross international reserves	USD bn	6.9	7.9	9.6	12.1	9.5	12.0	13.1	14.3	19.4	17.3	...
Fiscal indicators												
Consolidated fiscal revenues	% of GDP	28.6	27.2	26.9	26.3	25.9	32.1	35.1	31.5	31.0	35.3	34.7
Personal income tax	% of GDP	5.1	4.4	4.1	3.8	3.8	4.3	4.4	3.9	4.2	4.9	5.0
Enterprise profits tax	% of GDP	5.0	3.9	4.0	4.1	6.1	4.8	5.9	5.3	6.3	3.8	5.0
Value-added tax	% of GDP	4.8	6.2	5.7	5.1	4.1	8.6	9.2	7.9	7.3	10.4	10.1
Excise tax	% of GDP	2.0	2.1	2.1	2.0	1.8	2.0	2.0	2.0	1.7	2.0	1.8
Consolidated fiscal expenditures	% of GDP	28.8	25.3	26.5	26.8	35.2	28.3	36.4	28.1	41.7	35.0	36.1
Current expenditures	% of GDP	24.3	22.4	22.7	21.7	27.2	26.5	33.6	24.0	34.2	32.8	32.6
Capital expenditures	% of GDP	4.4	2.9	3.8	5.1	8.0	1.8	2.7	4.1	7.5	2.2	3.5
Consolidated fiscal balance	% of GDP	-0.2	1.9	0.4	-0.5	-9.3	3.7	1.0	-5.0	6.2	-0.4	-1.2
Privatisation receipts	% of GDP	0.8	1.5	3.7	3.5	1.0	0.2	0.6	0.6	16.0	0.1	0.1
Labour market												
Average wage (real)	% yoy	14.9	19.9	18.6	14.7	15.4	15.0	19.0	19.6	26.4	23.8	22.6
Household income (real)	% yoy	8.7	11.7	16.3	11.3	16.6	24.0	28.0	19.4	18.9	22.1	...
Unemployment rate (ILO methodology)	%	9.0	9.3	8.3	8.1	8.7	8.7	7.1	5.2	7.8	7.9	...
Banking system												
Monetary aggregate M0	% yoy cum	25.3	29.1	25.6	37.1	27.9	28.2	39.1	31.1	42.2	36.2	25.3
Monetary aggregate M2	% yoy cum	47.6	45.4	44.8	51.5	32.3	38.9	37.4	31.3	53.9	39.2	36.6
Household deposits in national currency	% yoy cum	66.1	69.4	67.3	67.9	26.2	28.3	31.6	30.4	90.8	54.6	41.1
Household deposits in foreign currency	% yoy cum	77.5	67.0	61.7	55.2	54.3	51.8	45.4	46.4	59.1	54.5	66.2
Com. bank credits in national currency	% yoy cum	61.7	56.8	52.1	44.3	29.4	28.3	32.6	43.4	58.7	59.8	53.7
Com. bank credits in foreign currency	% yoy cum	60.9	63.6	56.2	43.5	32.2	33.1	36.8	47.1	66.3	72.0	82.1
Long-term com. bank credits	% yoy cum	157.9	141.7	102.7	82.7	57.1	49.5	53.0	70.1	84.6	87.6	86.7
Long-term com. bank credits	% of total	45.0	47.4	49.3	50.9	54.2	54.4	56.1	59.7	61.8	63.1	63.4
Average lending rate on national cur. credits	% p.a.	17.7	17.2	16.6	17.0	17.6	17.0	15.4	15.4	16.4	15.8	15.5
Average lending rate on foreign cur. credits	% p.a.	10.9	12.2	12.1	12.6	12.2	12.1	11.0	11.3	11.7	11.5	11.3

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

** preliminary

Notes:

yoy year on year change

p.a. per annum