Macroeconomic Forecast Ukraine

- Real GDP growth is forecast to reach 12,8% in 2004, but is expected to decelerate to 8.1% in 2005.
- Private consumption is expected to be a key contributor to economic growth in both 2004 and 2005.
- Real state consumption will not increase in 2004 and 2005.
- Investment growth is forecast to shrink to 10.2% in 2004, but accelerate to 14.5% in 2005.
- While export growth remains one of the key factors of economic growth in 2004, import growth is expected to surpass it in 2005, contributing to lower GDP growth.
- Consumer price inflation is expected to reach 12.2% by the end of 2004, and decelerate to 9.1% by the end of 2005.

No.2 (6)
November 2004

Forecast Period:
Q4-2004 to Q4-2005

Forecast Variables:
GDP and components, inflation

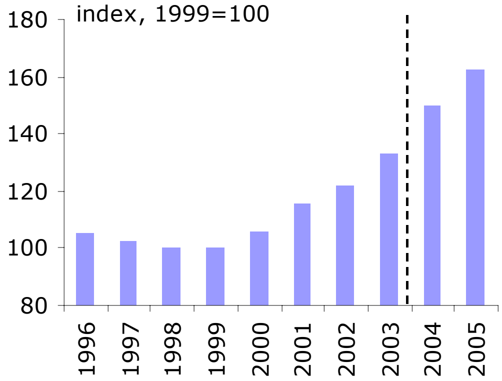
GDP: Real GDP growth in 2004 reaches 12.8%

The forecast of real GDP growth for 2004 was revised upwards to 12.8% from 8.9%. In line with our prior expectations, the major driving force behind growth has been household consumption, which is forecast to grow by 15.6% in real terms, supported by lower personal income tax rate and increased social transfers to population on the eve of elections. External demand has become the second key factor for the high GDP growth in 2004. Exports of goods and services are forecast to increase by 14.5%, and imports by 10.4% in real terms. The contribution of investments to growth is expected to diminish compared with 2003.

In 2005 real GDP is forecast to increase by 8.1% against the background of a remarkably good performance in 2004. Growth of private consumption will slow to 12.2% in real terms. At the same time investments are forecast to accelerate next year thanks to continued high investment demand and likely stabilisation of political situation after elections. Backed by investment demand, imports are forecast to grow faster than exports in real terms in 2005.

Population: 48 m
Industry/GDP: 28.8%
Agriculture/GDP: 10.9%
Investment/GDP: 19.1%
Export to: Russia 17%, EU25 33%
Import from: Russia 35%, EU25 32%

Gross Domestic Product



Source: Derzhkomstat, own calculations

Private Consumption: Household consumption leads growth

As forecast, the reduction of the personal income tax rate from a progressive 10-40% to a flat 13% increased household disposable income, stimulating consumption. Another factor that boosted household propensity to consume was increasing pension payout minimums, social payments, and wages throughout the economy. Hence, real household consumption is forecast to growth by 15.6% in 2004.

However, growth in real household consumption will slow to 12.2% in 2005. The main reason for this deceleration is an anticipated growth of consumer prices during the first half of 2005, which will partially offset the increasing nominal income of the population, which is expected to continue next year.

Assumptions on which the forecast is based

- The results of the presidential elections will be widely accepted, and will not cause serious social unrest.
- International demand for metals remains high.
- The monetary policy remains prudent.
- The VAT rate remains at 20%.
- WTO accession will not take place before the end of 2005, thus having no impact on foreign trade in 2005.

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Government Consumption: Real government consumption will not grow next year

In line with our prior expectations, final government consumption decreased by 2.7% yoy in real terms during the first half of the year, and is forecast to reach a zero growth level by the end of the year. The enterprise profits tax and the personal income tax rate reductions, which came in force in 2004, partially explain the low level of fiscal revenues, thus, low state consumption growth. More important factor negatively affecting state consumption is increased government-to-household transfers on the eve of the presidential elections, in particular the increase in social aid to pensioners that doubled the minimum pension payouts.

Next year's government consumption will be determined by the ability of the new government to meet its election promises. It is expected that the VAT rate will not be changed in 2005, thus the high revenues envisaged in the first draft of the 2005 Budget are quite likely to be met. Still, these revenues are very likely to be insufficient to meet all the promised expenditures. The social payments established on the eve of the elections are expected to add a significant burden to the budget, requiring transfers to the population at the expense of other expenditures. Hence the real state consumption will not grow in 2005.

Investment: Acceleration in 2005

While gross fixed capital formation grew by 23.3% yoy during the first quarter of 2004, the second quarter growth rate was far more moderate at 4.3% yoy. This significant deceleration of the investment boom can likely be explained by the recent involvement of manufacturers in the election campaign, which usually causes enterprise funds to be redirected from productive investments to other activities, such as payments or repayments of wage and/or social arrears. Also, several large investment projects have recently been completed, causing investments to slow down during the second half of the year. As a result, it is expected that gross fixed capital accumulation will increase by 10.2% in 2004.

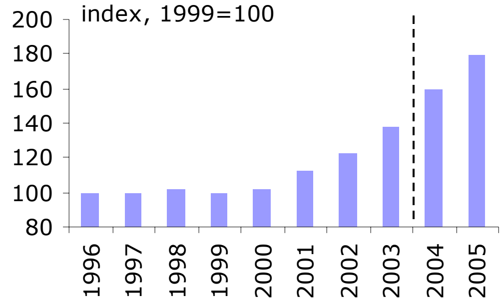
For next year we forecast higher investment's growth at 14.5%. Among the major causes for accelerated investment activity are a continuing high investment demand, a stabilised political situation, and further development of the financial markets that are essential for long-term borrowings.

External Sector: Exports in 2004 are much higher than expected, significantly contributing to GDP growth

Actual growth in exports of goods and services in 2004 was far stronger than previously expected. The very favourable world demand for ferrous metals and chemical products, as well as increased machinery and transport equipment exports are expected to ensure 14.5% growth of exports in real terms, and almost 42% growth in dollar terms by the end of 2004. The increase in imports of goods and services lagged behind exports despite the rise in imports of mineral products and machinery and transport equipment. It is expected that imports will grow by 10.4% in real terms, and by 33% in nominal dollar terms for the whole of 2004. This significant gap between the growth rates of exports and imports will ensure a high trade surplus of USD 4.5 bn. At the same time, the current account surplus will reach USD 6.4 bn (10.3% of GDP) thanks to net exports and significant net-inflows of current transfers into the country.

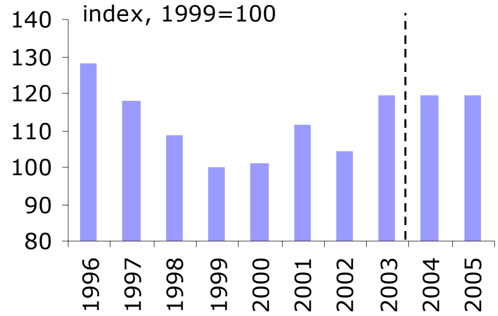
It is expected that exports will return to a more modest pace of growth next year, partly due to a real effective appreciation of the hryvnia. Real export growth is expected to slow down to 5.4%, while imports are forecast to grow by 8.1%. It is assumed that Ukraine will not join the WTO in 2005, thus no major changes are expected in the trade regime.

Households' Consumption



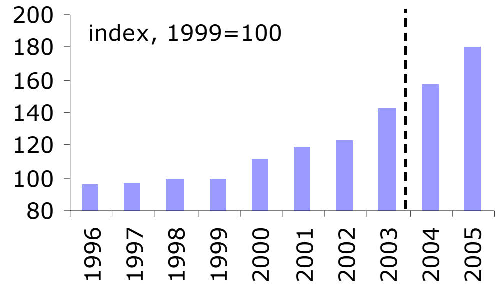
Source: Derzhkomstat, own calculations

State Consumption



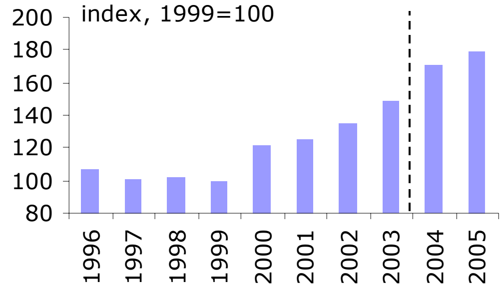
Source: Derzhkomstat, own calculations

Gross Fixed Capital Accumulation



Source: Derzhkomstat, own calculations

Exports of Goods and Services



Source: Derzhkomstat, own calculations

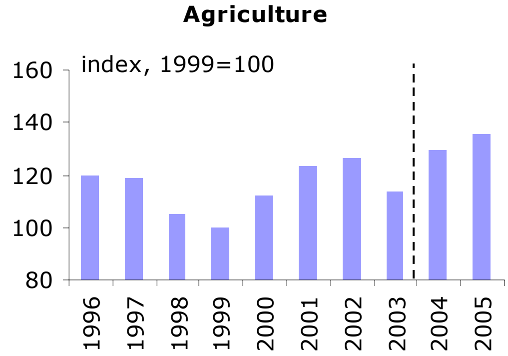
Production: Agriculture recovers in the second half of 2004

In line with prior expectations, a good grain harvest led to increased value added in *agriculture* after the sharp decline observed between the second half of 2003 and the first half of 2004. We expect that value added in agriculture will increase by 14.0% in 2004, due to a significant base-year effect, and will continue to grow at a moderate rate of 4.8% in 2005.

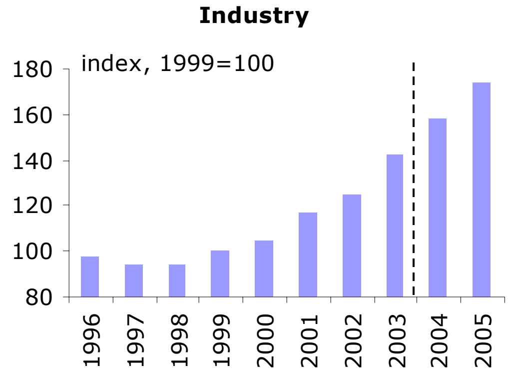
On the production side, *manufacturing* remained the most important driving force of real GDP growth. We forecast it to grow by 15.2% in 2004, backed by stable developments in machine building, metallurgy, and the food industry. Growth in machine building is especially high, due both to external and internal demand. Next year it is expected that industrial growth will continue, albeit at a more moderate pace. Value added in manufacturing will increase by 12.5%.

Value added in *construction* continued to grow at a high rate, reflecting the high investment activity in the country. It is expected that construction will increase by 25.0% in 2004, and by 20.5% in 2005.

Among the service sectors, the highest growth rates are observed in *wholesale and retail trades*, value added in which increased by 29.8% yoy during the first half of 2004. It is forecast that the growth of this sector value added will be 23.8% in 2004 thanks to high demand, and an increasing role of trade intermediaries. In 2005 it is forecast that trade will grow by a modest 15.9%. Value added in *transport* is expected to grow by 9.0% in 2004, down from 12.4% in 2003. Growth of 9.2% is expected for 2005.



Source: Derzhkomstat, own calculations

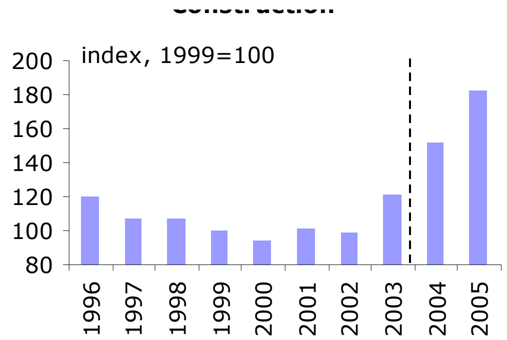


Source: Derzhkomstat, own calculations

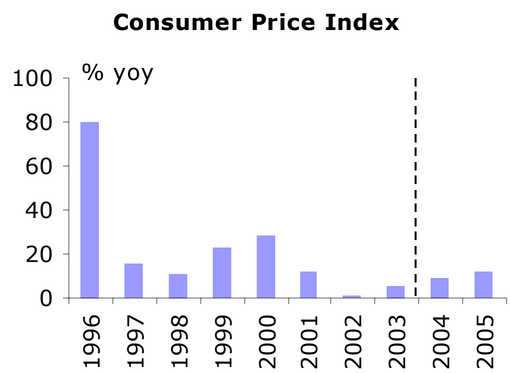
Inflation: CPI inflation is forecast to reach 12.2% by the end of 2004

During the first three quarters of 2004 the growth rate of consumer prices was higher than had been expected and reached 10.7% yoy. This development is to a large extent attributable to supply side factors, in particular, to the gasoline price upsurge this summer. Although the introduction of administrative regulations on the gasoline and other markets helped to withhold the accelerating inflation, additional inflationary pressure will result from imprudent fiscal policies, indicated by the September 2004 budget amendments. In particular, the sharp increases in pensions; stipends and other social benefits resulted in rising consumer products demand and already stimulated consumer price growth.

It is expected that the same factors will determine the development of consumer prices through the end of 2004 and in first half of 2005. Administrative regulations are likely to slacken significantly right after the presidential elections, resulting in sharp jumps in prices for products that have been affected. Domestic gasoline prices are expected to increase, which, in turn, will raise transportation costs and drive the overall price level up. Moreover, new legislation on housing and utility services that comes into force in 2005 may cause tariff increases for these services, since the tariff-setting authorities will be obliged to compensate the service providers for the mismatch between low tariffs and high costs. The excess demand for goods and services generated by the higher social payments will continue to contribute to inflation as well. Also, the strong price growth may spur inflationary expectations. It is expected, however, that the monetary policy will remain prudent enough to avoid creating additional inflationary pressures, and that the most striking fiscal imbalances will be eliminated in the second half of 2005. As a result, inflation is forecast to reach 12.2% yoy by the end of 2004, while returning to a more moderate 9.1% at the end of 2005.



Source: Derzhkomstat, own calculations



Source: Derzhkomstat, own calculations

Table 1. Growth of the Real GDP by Expenditures: Forecast (% yoy)

	2001	2002	2003	2004 E	2005 F
Private consumption	9.6	9.5	12.4	15.6	12.2
State consumption	10.4	-6.7	14.8	0.0	0.0
Gross fixed capital formation	6.2	3.4	15.8	10.2	14.5
Exports of goods and services	3.5	9.1	10.3	14.5	5.4
Imports of goods and services	6.0	3.7	16.4	10.4	8.1
Gross Domestic Product	**9.2**	**5.2**	**9.4**	**12.8**	**8.1**
Gross Domestic Product (UAH bn)	***204.2***	***225.8***	***264.2***	***333.7***	***402.7***

Note: E – estimate; F – forecast

Table 2. Growth of the Real GDP by Sector: Forecast (% yoy)

	2001	2002	2003	2004 E	2005 F
Agriculture, hunting and forestry	10.2	2.0	-9.9	14.0	4.8
Extractive industry	10.8	2.4	5.5	5.5	5.8
Manufacturing industry	14.0	9.5	18.1	15.2	12.5
Production/distribution of electricity, gas, water	3.8	1.7	4.7	-0.5	2.8
Construction	7.8	-2.6	23.1	25.0	20.5
Wholesale and retail trade, repair services	43.0	19.6	19.6	23.8	15.9
Transport	5.1	12.4	12.4	9.0	9.2
Education	5.1	1.9	1.9	6.1	2.8
Health	8.4	2.8	2.8	4.8	2.5
Gross Domestic Product	**9.2**	**5.2**	**9.4**	**12.8**	**8.1**

Note: E – estimate; F – forecast

Technical note

This forecast is based on iterative-analytical techniques, grounded in the system of national accounts, using different methods of GDP determination.

There are three basic methods for calculating GDP: GDP by production, GDP by income and GDP by expenditures (final uses of income). Two methods are used in this forecast – production and expenditures.

The calculations are conducted on a quarterly basis. Annual data are derived by aggregating the quarterly dynamics.

The forecasting procedure involves the following steps:

- For each method, the level of disaggregation of the GDP components is selected. The final result of the GDP forecast is based on forecasts for each component.
- The evolution of each component is forecast on the basis of historical data as well as the set of assumptions supplied with the forecast. Whenever possible, a forecast is based on a suitable leading indicator. Major work is focused on the dynamics of each component in real terms.
- The real GDP growth (for each method separately) is determined by summation of the contributions of each component. Here, contribution means the real growth of each component weighted by its share in the GDP structure in the corresponding period of the previous year (see Box 1 for details).
- The real values of GDP - determined by the two methods - are compared, and if a discrepancy is noted, another component forecasting iteration is initiated.

The forecast is built on a system of build-in indicators (proportions), which are expected to stay fairly constant. These indicators partially connect components of the GDPs by production and by expenditures. As additional instruments in component forecasting, econometric equations and input-output tables are used. The iterations continue until the two methods of GDP determination produce identical results.

Box 1. Calculations

To identify the contribution of each GDP component to total real growth, the following formula for growth of GDP $\hat{Y}$ can be used (1):

$$\hat{Y} = \left(\frac{Y^*_t - Y_{t-1}}{Y_{t-1}} \right) = \left(\sum_{i=1}^{I} \frac{X^*_{it} - X_{it-1}}{X_{it-1}} \cdot \frac{X_{it-1}}{Y_{t-1}} \right)$$

for each period t,

where Y is the GDP, and X is a component of the GDP, I is the number of components, and the sign * indicates inflation adjustments to the respective data.

Consequently, a contribution $\Theta_t^{X_i}$ of component X_i to real growth can be calculated as (2):

$$\Theta^{X_i}{}_t = \frac{\left(\dfrac{X^*_{it} - X_{it-1}}{X_{it-1}} \right)}{\hat{Y}} \cdot \frac{X_{it-1}}{Y_{t-1}} \cdot 100$$

for each period t.

In formula (2), the ratio of real growth rates of component X_i to GDP is weighted on the basis of the previous-period's share of this component in the nominal GDP.

Note: yoy year-on-year