



Macroeconomic Forecast Ukraine

- Real GDP growth is forecast to decelerate in 2005 and 2006 compared to previous years.
- In 2005 the real GDP is expected to increase by 7.0%, while in 2006 its growth is forecast to slow down to 6.4%.
- In the short run, final household consumption will remain the key contributor to real GDP growth on the demand side.
- The fiscal expansion is expected to stimulate final consumption by both households and government in 2005.
- Investment activities will remain at a very moderate pace in 2005 and the first half of 2006.
- The trade liberalisation and the revaluation of hryvnia are expected to foster imports in 2005.
- Ukraine's accession to the WTO is forecast to stimulate both exports and imports in 2006.
- Consumer prices are expected to increase by about 14% in 2005, however their growth will slow in 2006.

GDP: Economic growth is forecast to remain moderate in 2005 and 2006

Economic growth is expected to be moderate in 2005 and 2006. Private consumption will be the key demand factor behind the short-term growth, supported by a continuous expansion of household incomes. The latter is attributed to further increases in the minimum wage as well as the government's expansionary social policy. The growing demand for consumer goods will be partially satisfied by higher consumer goods imports, eased by the revaluation of the national currency and ongoing trade liberalisation. However, an expansion of the social component in the state's spending will come at the expense of investments. Uncertainty about re-privatisation and legislative changes will also contribute to lower investment activity in the country. In sum, higher imports and lower investments will result in a slowdown in the real GDP development in the short-run. Hence in 2005 real GDP growth is forecast to increase by 7.0% that is 5.1 percentage points below the previous year's figure. Unless investments recover, this will hurt the prospects for long-term economic growth. In addition, expansionary fiscal and social policies will contribute to higher inflation that is forecast to reach about 14% in 2005.

The real GDP growth for 2006 is forecast at 6.4%, primarily due to continuing increases in final household consumption. Investment activity is expected to remain sluggish during the first half of the year due to political factors like the parliamentary elections and the planned constitutional reform. Ukraine's accession to the WTO, anticipated at the end of 2005, is likely to foster both imports and exports, whereas further revaluation of the hryvnia will be more favourable for imports, the demand for which will be backed by a strong growth of final consumption.

Assumptions:

- The Government continues its expansionary social policy in 2005 and 2006.
- Import tariffs will be reduced for nearly all tariff lines.
- The average nominal exchange rate will be 5.1 UAH/USD and 4.9 UAH/USD in 2005 and 2006, respectively.
- Ukraine's WTO accession will take place by the end of 2005, thus affecting foreign trade flows in 2006.

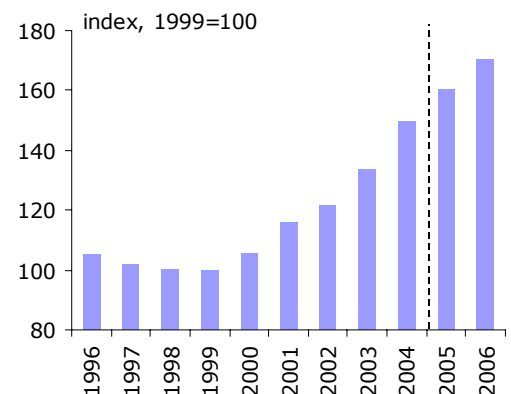
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Forecast Period:
Q1-2005 to Q4-2006

Forecast Variables:
GDP and components, inflation

Population: 47.3 m
Industry/GDP: 28.7%
Agriculture/GDP: 10.8%
Investment/GDP: 20.1%
Export to: Russia 17%, EU 33%
Import from: Russia 35%, EU 32%

Gross Domestic Product



Source: Derzhkomstat, own calculations

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Private Consumption: Key factor for economic growth

The real final household consumption is forecast to increase by 13.6% in 2005, remaining a key demand contributor for GDP growth. The growth of private consumption is stimulated by further increases in the minimum wage, introduction of a unified wage tariff scale for employees in budget sector, as well as a continuing expansion of the social transfers to the population that started during the fourth quarter of 2004. Growing private demand will be partially satisfied by higher consumer goods imports, as well as by developing consumer-oriented domestic industries and services.

In 2006, on the eve of the parliamentary elections, it is expected that the fiscal and social policy of the government will remain expansionary causing household incomes to rise. As a result, private consumption is expected to grow by 11.6% in real terms.

Government Consumption: Spending on wages and salaries will increase government consumption

The revised data for 2004 show that government consumption increased by 5.4% in real terms, primarily due to higher spending on wages and salaries. This trend is expected to continue this year, and real government consumption is forecast to grow by 6.4%. The sources for financing this high level of spending include broadening the tax base through elimination of tax privileges and subsidies, as well as a revision of the fiscal relationships with state monopolies.

No significant changes in the tax legislation are assumed for 2006 except for the introduction of 10% VAT rate on agricultural goods and an increase in the social privilege relating to personal income taxation. Thus, it is expected that the government will be able to sustain both its high volume of state-to-households social transfers and the growth in wages and salaries. As a result, government consumption is expected to increase by 4.6% in 2006.

Investment: Investment activities will decelerate in 2005 and the first half of 2006

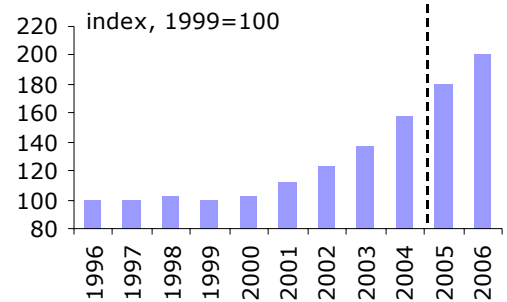
The uncertainty that accompanies the recent changes in the political constellation and the changes in the business climate will shape the investment activities in 2005 and in the first part of 2006. On the one hand, the expected reduction in corruption and progress with establishing the rule of law will positively contribute to the investment climate. On the other, the sudden changes in the tax legislation, in particular the elimination of special economic zones and territories of priority development, the changes in the trade regime, and talks about re-privatisation will temporarily impede investment. Yet other sources of uncertainty are: a forthcoming constitutional reform that will completely change the relationship between the President, Parliament and the Cabinet of Ministers, and parliamentary elections in the spring of 2006. Also, expansionary fiscal and social policies, stimulating consumption, will come at the expense of investments. As a result, it is forecast that investment activity will considerably decelerate in 2005, and the gross fixed capital accumulation will reach a very moderate 5.6%.

Investment activity in the first half of 2006 will be influenced by the same factors as in the year 2005. Still, investments are expected to revive during the second half of the year. Thus, fixed capital accumulation is forecast to increase by 6.4% in 2006.

External Sector: Trade liberalisation and revaluation of hryvnia will foster imports

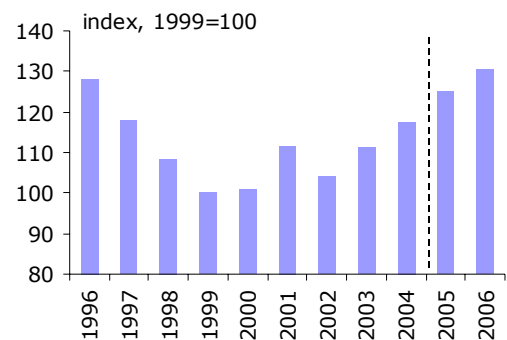
Trade liberalisation, revaluation of hryvnia, and the world market conjuncture for raw materials are expected to determine the pace of foreign trade in 2005. The dynamics of commodity exports in dollar terms will still depend on a favourable conjuncture for metals, although the revaluation of the national currency made metallurgy worse off. The sluggish real output growth in metallurgy points to a decreasing capacity of metal producers to expand their real exports.

Household Consumption



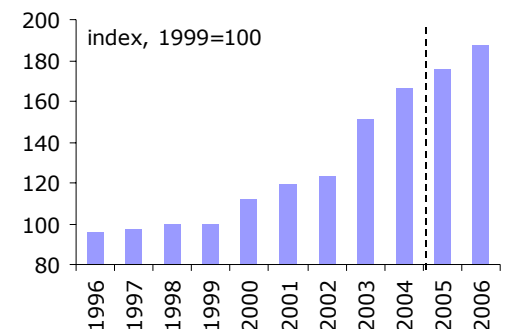
Source: Derzhkomstat, own calculations

State Consumption



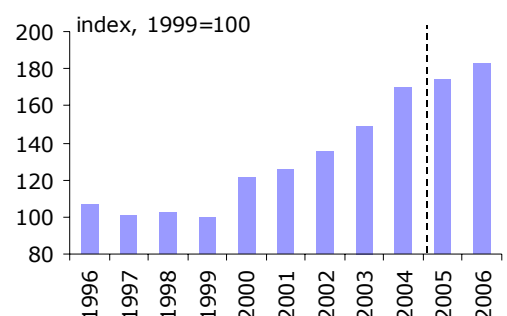
Source: Derzhkomstat, own calculations

Gross Fixed Capital Accumulation



Source: Derzhkomstat, own calculations

Exports of Goods and Services



Source: Derzhkomstat, own calculations

Strong government interventions in the petroleum products market, including a ban on exports of petroleum products during the sowing and harvesting seasons, negatively affect exports. On the other hand, expanding final household consumption, the revaluation of the national currency, and the reduction of import tariffs will stimulate commodity imports in 2005. As a result, the forecast growth of exports is 2.5% in inflation adjusted hryvnia terms, while the increase in imports is forecast at 7.7% in 2005.

Ukraine is very likely to become a WTO member by the end of 2005, which will influence trade flows in 2006. It is expected that both exports and imports of goods and services will intensify as a result of the changes in the trade regime. However, a likely further revaluation of the hryvnia will stimulate the internal demand for imports, fostering their growth. It is forecast that in 2006 exports of goods and services will grow by 5.3% in inflation adjusted hryvnia terms, while imports will expand by 10.2%.

Production: The growth of value added in most sectors is forecast to slow down

After a record figure of value added growth in *agriculture* reached in 2004, the increase in value added in 2005 is forecast to return to the moderate pace of 4.5%. Government interventions in the agricultural products market, in particular meat, will create disincentives for investment in agriculture. An additional shock is expected to come from trade liberalisation in 2005 and 2006 that will increase the level of competition at the domestic market. Thus, it is forecast that the growth of the sector will further decelerate in 2006, reaching 3.1%.

Although the *manufacturing industry* still remains a key contributor to a value added growth in the economy, its role has been gradually diminishing. It is forecast that the value added in manufacturing will grow by nearly 9.0% in 2005 and 2006, basically due to expansion of consumer-oriented industries like food production. At the same time, growth of value added in the *extractive industry* is expected to rise to 5.9% and 5.2% in 2005 and 2006 respectively due to a higher demand for raw materials.

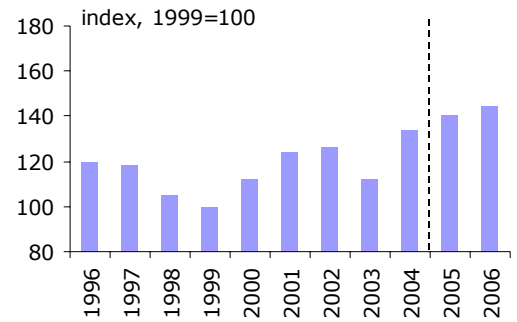
After several years of remarkable growth of value added in *construction*, it is forecast to decelerate to the very moderate pace of 4.3% due to the completion in 2004 of several large construction projects and the overall sluggish investment activity in the country. In 2006 the value added in construction is forecast to slightly accelerate to 5.6%.

Inflation: Consumer prices are expected to grow by 14% in 2005

The acceleration of consumer price inflation stimulated by the expansionary social policy in late 2004 will continue in 2005 thanks to demand and supply factors. On the demand side, consumer prices are being pushed upwards by the further expansion of social transfers to households. On the supply side, the main contributor to inflation will be increasing prices of petroleum products. These will fuel consumer price inflation through higher transportation costs and by increased public transportation tariffs, which are likely to increase as fuel costs rise. The structural imbalances on the meat market that had a great influence on inflation during the past 6 months are expected to be cured soon. Price growth is likely to be restrained to some extent by trade liberalization and the revaluation of the hryvnia, which will both make imported goods cheaper. As a result, it is forecast that the CPI will have increased by around 14% by the end of the year.

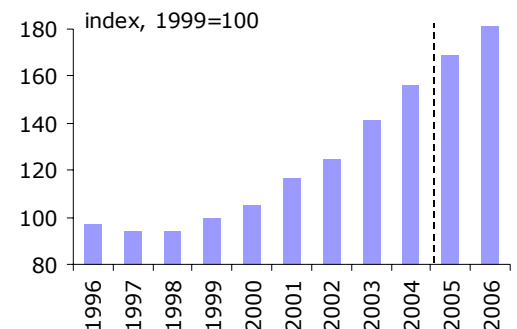
In 2006 prices will grow more moderately. While the social policy is likely to remain expansionary, no sharp increases in social payments are expected. Also, increases in the tariffs on gas for consumers, on electricity, as well as on transport tariffs are expected after the parliamentary elections. Thus, the consumer price inflation is forecast to reach 9% in 2006.

Agriculture



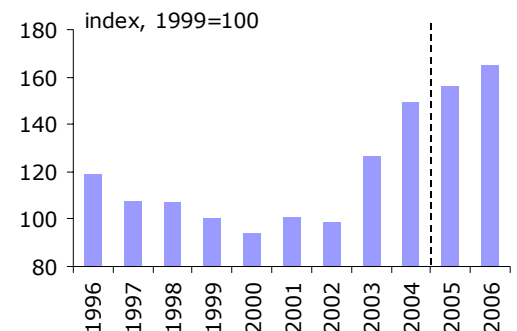
Source: Derzhkomstat, own calculations

Industry



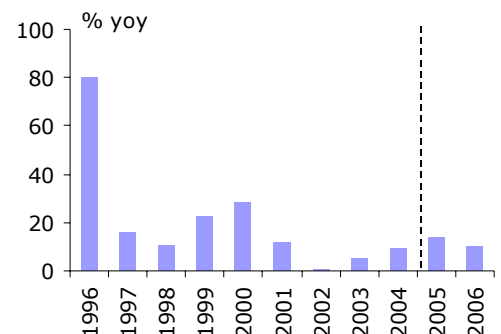
Source: Derzhkomstat, own calculations

Construction



Source: Derzhkomstat, own calculations

Consumer Price Index



Source: Derzhkomstat, own calculations



Table 1. Forecast growth of the real GDP by expenditures (% yoy)

	2002	2003	2004	2005E	2006F
Private consumption	9.5	12.4	15.1	13.6	11.6
State consumption	-6.7	14.8	5.4	6.4	4.6
Gross fixed capital formation	3.4	15.8	10.2	5.6	6.4
Exports of goods and services	9.1	10.3	13.8	2.5	5.3
Imports of goods and services	3.7	16.4	8.6	7.7	10.2
Gross Domestic Product	5.2	9.4	12.1	7.0	6.4
Gross Domestic Product (UAH bn)	225.8	264.2	344.8	428.8	505.7

Note: E – estimate; F – forecast

Table 2. Forecast growth of the real GDP by sector (% yoy)

	2002	2003	2004	2005E	2006F
Agriculture, hunting and forestry	2.0	-9.9	19.5	4.5	3.1
Extractive industry	2.4	5.5	4.2	5.9	5.2
Manufacturing industry	9.5	18.1	14.7	9.1	8.7
Production/distribution of electricity, gas, water	1.7	4.7	-1.0	5.2	2.8
Construction	-2.6	23.1	18.4	4.3	5.6
Wholesale and retail trade, repair services	19.6	19.6	17.8	5.7	12.3
Transport	12.4	12.4	10.3	7.4	7.0
Education	1.9	1.9	6.7	7.5	6.8
Health	2.8	2.8	5.5	7.3	8.2
Gross Domestic Product	5.2	9.4	12.1	7.0	6.4

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 Θ^{X_i} of component X_i to real growth can be calculated as (2):

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

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