



Macroeconomic Forecast Ukraine

- The real GDP is forecast to grow by 5.6% in 2003, and by 5.4% in 2004.
- While the year 2003 is marked by high investment, the year 2004 is expected to be a year of private consumption.
- Implementation of tax reform is expected to stimulate private consumption, while hurting state consumption due to lower fiscal revenues in 2004.
- Improvement in investment climate and financial sources encourage investments in 2003, while political uncertainty may hamper them in 2004.
- Although imports grow faster than exports, the forecast balance of goods and services remains positive.
- The poor grain harvest leads to negative growth in agriculture in 2003, significantly reducing the overall economic growth.
- High growth rates in construction reflect increases in investment demand in 2003.
- Inflation will reach 7% in 2003, but should decelerate in 2004.

GDP: The forecast growth for 2003 is 5.6%

The growth rate of the real GDP in 2003 is expected to reach 5.6% relying on substantial investment growth. Although the real GDP grew by 7.5% yoy during the first half of the year, it has significantly slowed since July due to the poor grain harvest.

The forecast growth of the real GDP for 2004 is 5.4% mainly due to growing private consumption. The significant reductions of the personal income tax rates, as well as reforms in the pension sphere, are expected to raise household consumption. The speed of gross fixed capital accumulation will be lower in 2004 than this year due to higher political uncertainty associated with the presidential elections scheduled for the fall of 2004.

Private Consumption: Tax reform will stimulate private consumption next year

Although the beginning of 2003 was marked by a high growth rate of household consumption, this rate is expected to slow for the rest of the year 2003. The food market panic associated with the poor grain harvest caused prices to rise, consequently depressing the purchasing power of households.

Private consumption is forecast to be the leading cause of real GDP growth in 2004. The growth rate of 8.5% yoy is expected to be caused by the reduction of the progressive personal income tax rate of 10-40% to a flat rate of 13%, and by the pension reform, which promotes increase of pension levels. The increase in the minimum wage will also have a positive impact of nominal incomes.

Assumptions for the forecast

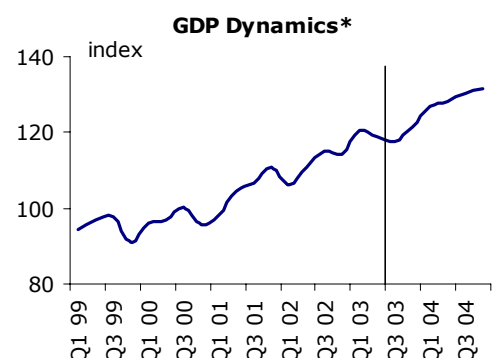
- The minimum wage will increase to UAH 237/month and remain constant at this level in 2004.
- Tax reforms in 2004: An enterprise profits tax rate of 25% and a flat personal income tax rate of 13%.
- Presidential elections will take place in 2004 causing higher political uncertainty.
- A constant real exchange rate throughout 2003 and 2004.
- Completion of WTO accession requirements by the end of 2004 will have no influence on trade flows next year.

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Forecast Period:
Q3-2003 to Q4-2004

Forecast Variables:
GDP and components, inflation

Population: 48 m
Industry/GDP: 30.5%
Agriculture/GDP: 13.4%
Investment/GDP: 20.3%
Export destinations: Russia 17%, EU 20%
Import origins: Russia 35%, EU 23%



Source: Derzhkomstat, own calculations
*seasonally adjusted, 1996 Q1 = 100

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State Consumption: Decline in real state consumption is forecast in 2004

Economic growth, better tax collection and successful external borrowing will result in a good fiscal performance in 2003. This in turn will permit the repayments of the state’s foreign debt to be made in a timely fashion. However, state expenditures for agricultural enterprises harmed by adverse weather conditions may limit the government’s ability to meet its budgeted expenditures in other areas. Still, state consumption is expected to grow by 4.6% in 2003.

The personal income and the enterprise profits tax rates will be reduced next year. This should lead to almost unchanged tax revenues compared to 2003, if the tax rates reductions are offset by implementing broadening of the tax base, economic growth, de-shadowing of the economy, and better tax collection. Therefore, the expected nominal fiscal revenues of 2004 will remain at almost the level of 2003, which will not allow expenditures to grow. Adjusted for inflation the real state consumption will slip to a negative 4.1% yoy in 2004.

Investment: After a year of mediocre growth, investment boomed

The year 2003 is marked by high growth of fixed capital accumulation. In the first quarter of the year it grew by 15% yoy, and the estimated growth of this GDP component for the whole year is 16.5% as compared to 4.9% last year. Political stability, intensification of reforms, and development of infrastructure against a background of significant postponed investment demand in 2002 created a favourable environment for this growth. Also, all sources of finance for investments – enterprise profits, bank credits and the stock market – improved. For instance, net profits of enterprises increased by a factor of 2.5 from January to May compared to the same period of 2002. Also, an acceleration of foreign direct investment is expected.

On the production side, the growth of investments reveals an increase in construction activity (for the first seven months of the year construction grew by 23% yoy) and in machine building (31% yoy growth from January to July).

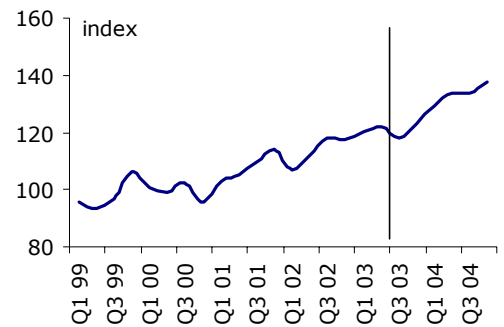
Next year two opposing forces will determine the pace of investments. On the one hand, tax reform is expected to have a positive impact on investments, freeing-up enterprise and household funds. On the other hand, the higher political uncertainty associated with the presidential elections of the fall of 2004 may negatively influence the investment activity in the country. As a result of these forces, the growth of gross fixed capital is expected to be 8%.

External Sector: Import growth exceeds export

The growth rate of exports of goods and services was 9.8% yoy in hryvnia terms during the first quarter of the year, while imports grew by 13.6% yoy. The major driving forces for goods exports were metallurgy and re-exports of gas (previously banned), while the major goods imports were oil, machinery and transport. This trend is expected to be maintained till the end of the year, i.e. imports are expected to exceed exports, but the balance will remain positive, and amount to USD 1.9 bn for the whole year.

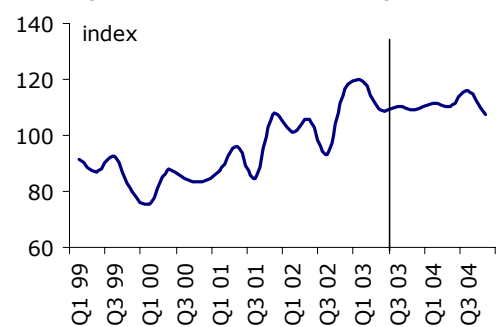
For 2004 the growth of imports is forecast to continue to exceed exports due to increased consumption and to investment demand. Still, both trade flows are expected to grow at lower rates than in 2003: exports are expected to increase by 4% in hryvnia terms and imports by 4.7%. The accession of several countries to the EU is not expected to have short-term negative impacts on Ukraine’s foreign trade, since trade flows of these countries are already EU-oriented.

Dynamics of Private Consumption*



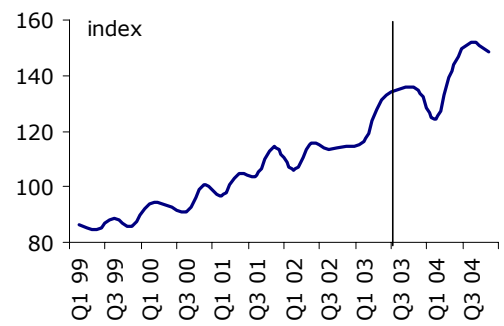
Source: Derzhkomstat, own calculations
* seasonally adjusted, 1996 Q1 = 100

Dynamics of State Consumption*



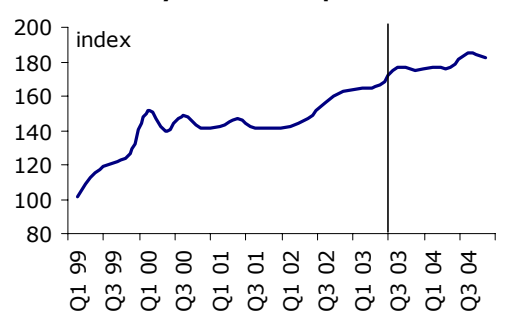
Source: Derzhkomstat, own calculations
* seasonally adjusted, 1996 Q1 = 100

Dynamics of Investments *



Source: Derzhkomstat, own calculations
* seasonally adjusted, 1996 Q1 = 100

Dynamics of Exports*



Source: NBU, Derzhkomstat, own calculations
* seasonally adjusted, goods and services, 1996 Q1 = 100

Taking into account the acceleration of the WTO accession activity, Ukraine is likely to complete negotiations by the end of 2004, provided the planned establishment of a Common Economic Area between Ukraine, Russia, Belarus, and Kazakhstan does not impede the process. Thus, Ukraine may become a member of the WTO early in 2005. Accession process is not expected to influence trade flows in 2004.

Production Side: The poor harvest slowed the overall GDP growth

The growth rate of value added in *agriculture* became one of the key factors of overall economic performance of the country. Despite the stable positive development of animal breeding, the weak performance of plant growing (namely, the poor grain harvest) caused the negative (-7.2 yoy) growth rate in agriculture in the first half of the year. The value added in agriculture is expected to decline by 14.5% in 2003. The sector is expected to perform more favourably next year. Taking in account the low statistical base of this year, the growth in 2004 is forecast at 5.7%.

The first half of the year was marked by high growth rates in the *manufacturing industry*, especially in machine building, metallurgy, chemistry, and the food industry. The value added in this sector is expected to increase by 15.2% this year, that is, to reach the growth rate of 2001 – the previous most successful year for manufacturing. In 2004 the growth is forecast to reach 9.1% yoy.

After a slight decline (-0.7%) in 2002, *construction* boomed this year. In the first half of the year the growth of value added in this sector reached almost 22% yoy. The annual growth figure for construction in 2003 should reach 23%, mirroring the investment growth. Next year, due to an expected deceleration of investment activity, the forecast growth rate for construction is lower, at 8.6% yoy.

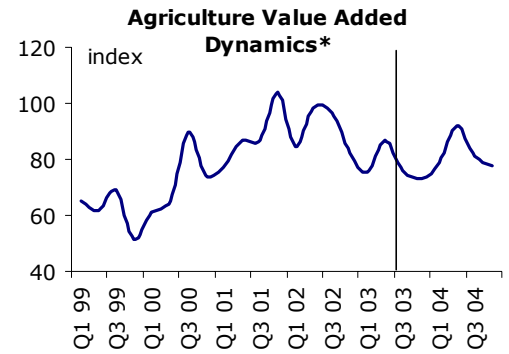
The growth of value added in the *wholesale and retail trade* will remain at approximately last year's 8.5%. However, in 2004 the acceleration of private consumption is expected to stimulate growth up to 10.4%.

The sector that has recently started growing is *transport*. While in 2001-2002 it grew at about 5% yoy, the growth of its value added during the first half of 2003 accelerated to 9.2%. This pace is expected to be maintained till the end of the year, with an annual growth near 9%, while the forecast figure for 2004 is 7%.

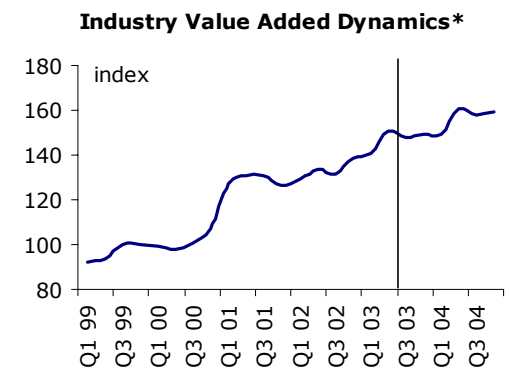
Inflation: Price increases will be mainly supply-side driven

The more rapid than expected growth of consumer prices at the beginning of this year was to a large extent determined by demand-side factors, in particular, by consumer expectations of a poor agricultural harvest, which caused panic buying. For the remaining months of the year the CPI is expected to grow at approximately the same pace as to date, reaching about 7% yoy growth by the end of 2003. It is forecast that the future inflation development will be supply-side driven, despite the strengthening government control over producers and distributors of food products. The effect of the poor grain crop on the domestic and international markets will be to drive grain prices up, which will spill over to the price dynamics of related products, such as flour, bread, and pasta. As a consequence of the shortage of fodder, increases in the prices on meat, meat products, and eggs are expected to add to inflation.

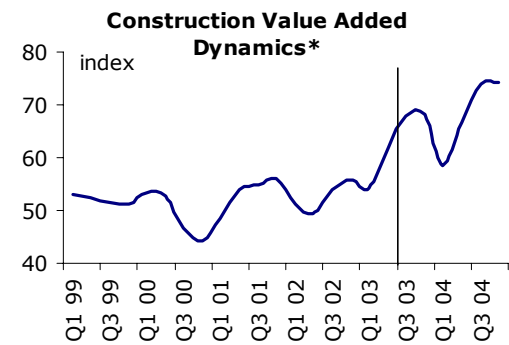
The same factors will continue to affect inflation dynamics in 2004. Also, the rise in the nominal income due to a further increase in the minimal wage and the reduction of the personal income tax rate may cause further upward pressures on prices. However, with presidential elections coming, strong administrative forces will be directed to keep food prices from rising too fast, which will slow the inflation to a moderate 5% yoy.



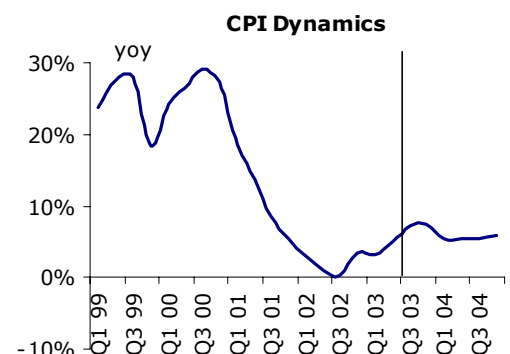
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Table 1. Growth of Real GDP by Expenditures: Forecast (% year-on-year)

	2000	2001	2002 P	2003 E	2004 F
Private consumption	2.5	9.6	5.6	5.8	8.5
State consumption	1.0	10.4	-0.7	4.6	-4.1
Gross fixed capital formation	12.4	6.2	4.9	16.5	8.0
Exports of goods and services	21.5	3.5	9.1	15.4	4.0
Imports of goods and services	23.8	6.0	3.7	17.8	4.7
Gross Domestic Product	5.9	9.2	4.8	5.6	5.4

Note: P – preliminary, E – estimate; F – forecast

Table 2. Growth of Real GDP by Sector: Forecast (% year-on-year)

	2000*	2001	2002 P	2003 E	2004 F
Agriculture, hunting and forestry	5.9	10.2	3.6	-14.5	5.7
Manufacturing industry	12.8	14.0	8.9	15.2	9.1
Construction	1.6	7.8	-1.4	23.1	8.6
Wholesale and retail trade, repair services	5.4	43.0	8.1	8.5	10.4
Transport	1.4	5.1	5.8	8.8	7.0
Gross Domestic Product	5.9	9.2	4.8	5.6	5.4

* In 2000 the GDP components were re-classified, thus the data shown are approximate

Note: P – preliminary, 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.

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 \bar{Y}_t can be used (1):

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

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):

$$\Theta_t^{X_i} = \left(\frac{X_{it}^* - X_{it-1}}{X_{it-1}} \right) \cdot \frac{X_{it-1}}{Y_{t-1}} \cdot 100$$

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