

UKRAINE- Reasons of GDP Growth Slowdown in 2005

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Ukraine demonstrated an excellent macroeconomic performance over 2000-2004. Real GDP grew by 12.1% year-over-year (yoy) in 2004, one of the best GDP growth rates among all transition economies, and even in the world. The major sectors that drove economic growth were industry, agriculture, and wholesale and retail trade. However, since the beginning of 2005 it experienced the dramatic slowdown of economic growth to 2.8% yoy over January-August. In August alone, for the first time during the last six years, GDP showed 1.6% yoy contraction. This note presents an in-depth analysis of the primary reasons of such drastic growth slowdown in 2005 and suggested measures to recover recent macroeconomic gains.

The growth slowdown as compared to 2004 by 9.3 percentage points (pps) (see Table 1) to 2.8% yoy in January-August 2005 was primarily due to the following factors:

- (a) The drop of the Processing Industry contribution to GDP growth by 2 pps (from 3.15 pps in 2004 to 0.72 pps in 2005). Out of the overall slowdown in GDP growth of 9.3 pps, 2 pps (or about 22%) were due to decelerating processing industry. Nevertheless, the Processing Industry in 2005 still grew by a moderate 3.5% yoy. The major reason for the growth deceleration in the sector was poor performance of metallurgy and machine-building. The decline was partly related to lower international prices for steel, high base effect and rising energy prices. However, another very important reason is considerable slowdown in investment activities. Analysis of the GDP growth by expenditure method (table 2) reveals that contribution of gross fixed capital formation in 1 quarter (1Q) 2005 turned into negative 0.5 pps, down from 3.9 pps in 1Q 2004 and 2 pps in 2004. Political uncertainties and stalled privatization process related to the lack of government's privatization program for this year and the whole issue of re-privatization caused by lower investments in machinery and equipment by local firms. According to the State Statistics committee, the share of expenditures on machinery and equipment in total fixes capital investments declined from 54.6% in 2003 to 49.6% in the first half of 2005.
- (b) Agriculture's contribution to GDP growth declined by 1.75 pps (from 2.06 pps to 0.31 pps). In 2005, agriculture still performed well (growing at 3.1% yoy), but the growth in the sector was much less than the extraordinary growth in 2004 (almost 19.5% yoy), which in turn is attributed to a low base effect in 2003.
- (c) Construction also reduced its contribution to growth in 2005 by about 1 pp. From a rate of growth of 18.4% in 2004, construction experienced a decline of 7.7% over January-August 2005. Therefore, its contribution to GDP growth in 2005 turned into negative. The reduction in the volumes of contract work in the sector was observed for all kinds of construction activities such as preparation of building plots, rigging works, rent of construction equipment but construction of buildings. At the same time,

residence construction continued to grow, expanding by 7.2% yoy over 1H 2005. Partly, this year's decline in construction sector may be explained by high base effect due to explosive 30% yoy increase in the first half of 2004. The other reasons may be low investment activities of local firms and completion of large infrastructure and repair works. Thus, in 2004 the lion share of construction and repair works was the works related to repair, construction and modernization of electric power stations, construction of highways (Kiev-Odessa and Kiev-Chop) and repair of other roads, pipelining, rebuilding and reconstruction of non-ferrous, machine-building and other industrial enterprises. The share of public investments (investments that were financed from state and local budgets) declined from about 15.5% of all fixed capital investments in 2004 to 7.9% in 1H 2005.

- (d) The deceleration in industry and poor export performance also affected negatively the "Wholesale and Retail Trade" sub-sector. This sub-sector had made the third largest contribution to GDP growth in 2004; but in 2005, it turned into a negative one. In fact, of the overall decline in GDP of 9.3 pps, this sub-sector was responsible for the largest decline in the contribution to GDP (2.53 pps decline, or almost 30% of the total). The main reason for this decline was a deduction in wholesale trade (rather than in retail trade, which actually expanded). Wholesale trade was negatively affected by the fact that domestic firms and construction companies were buying less machinery, equipment and construction materials from wholesalers, due to economic and political uncertainties.

For the entire year 2005, GDP growth is likely to be around 4-5%. The slight increase in growth (up from 2.8% yoy registered over January-August) may be induced by better performance of agriculture and a likely revival of investments once the re-privatization issue is resolved.

Table 1. Contribution to the GDP growth in 2004-2005, by production method

Value added growth by sectors, cum, %	Jan-Aug 2004, yoy	contributions to GDP	2004, yoy	contributions to GDP	Jan-Aug 2005, yoy	contributions to GDP	difference to Jan-Aug 2004	difference to 2004
Agriculture	29.5	2.84	19.4	2.06	3.1	0.31	-2.53	-1.75
Extractive industry	6.7	0.30	4.1	0.18	3.1	0.13	-0.17	-0.05
Processing industry	16.6	3.15	14.6	2.75	3.5	0.72	-2.42	-2.02
Production and distribution of electricity, gas and water	-1.7	-0.08	-1	-0.05	2.9	0.11	0.19	0.16
Construction	24.6	0.89	18.4	0.67	-7.7	-0.31	-1.21	-0.98
Wholesale and retail trade	21.3	2.39	17.7	2.01	-4.3	-0.52	-2.91	-2.53
Transport	10.5	1.28	10.3	1.22	6.3	0.74	-0.53	-0.48
Education	6.4	0.30	6.6	0.31	5.2	0.22	-0.08	-0.09
Health care	5.2	0.16	5.5	0.17	4.7	0.13	-0.03	-0.04
Net taxes on production and imports	14.8	1.67	9	1.43	2.8	0.30	-1.37	-1.13
Other activities	5.5	0.70	12.7	1.34	7.6	0.96	0.26	-0.38
GDP total (cum), yoy	13.6	13.60	12.1	12.10	2.8	2.80	-10.80	-9.30

	Jan-Aug 2004, yoy	contributions to GDP	2004, yoy	contributions to GDP	Jan-Aug 2005, yoy	contributions to GDP	difference to Jan-Aug 2004	difference to 2004
Processing	16.6	3.15	14.6	2.75	3.5	0.72	-2.42	-2.03
Food	13.4	0.60	12.4	0.55	14	0.69	0.09	0.13
Textile/Apparel	13.7	0.05	13.6	0.04	3.1	0.01	-0.03	-0.03
Coke- and oil-refining	1.9	0.04	3.4	0.07	-8.6	-0.19	-0.22	-0.25
Chemicals	15.8	0.27	14.4	0.24	11.4	0.21	-0.06	-0.03
Metals and metal processing	14.9	0.78	12	0.63	-3.2	-0.18	-0.97	-0.81
Machine-building	33.6	1.07	28	0.89	6.6	0.23	-0.84	-0.66

Table 2. Contribution to the GDP growth in 2004-2005, by expenditure method

	1q04	contributions to GDP	2004	contributions to GDP	1q05	contributions to GDP	difference to 1q04	difference to 2004
GDP, yoy	12.3		12.1		5.0		-7.30	-7.10
Final consumption	9.8	7.9	13	10.0	13.2	10.3	2.32	0.25
Final household consumption	15.5	8.8	16.3	8.9	16.4	9.3	0.49	0.38
NPISH final consumption expenditure	-4.3	-0.1	-0.4	0.0	0.0	0.0	0.09	0.01
General government final consumption	-3.6	-0.8	4.7	1.0	5.2	1.0	1.80	0.04
Individual final consumption (GG)	-2.3	-0.3	7.6	0.9	7.7	0.9	1.22	-0.03
Collective final consumption (GG)	-5.5	-0.5	0.6	0.0	1.1	0.1	0.56	0.03
Gross fixed capital formation	23.3	3.9	10.2	2.0	-2.6	-0.5	-4.37	-2.49
Exports of goods and services	16.5	10.7	18.1	10.6	0.1	0.1	-10.66	-10.51
Imports of goods and services	14.5	-8.4	13.6	-7.6	6.6	-4.1	4.32	3.53
Change in inventories, UAH million	-4,377		-3,630		-4,829			
Share of inventories in GDP	6.8		1.1		5.9			

By expenditure method, the growth slowdown in 2005 should be primarily attributed to:

- (a) drastic deceleration of the merchandise exports growth to 0.1% yoy in 1Q 2005, down from impressive 18.1% yoy increase in 2004. Although exports of metallurgical products continued increasing, the growth paces sharply decelerated from above 50% yoy in 2004 to slightly above 18% yoy in January-July 2005 (table 3). Another discouraging tendency is deteriorating exports of Ukraine's high-value added exports. In particular, over the first seven months of 2005, growth rates of exports of machines and equipment and vehicles turned into negative 14.7% yoy and 24% yoy, down from 30.5% yoy and 110% yoy in 2004, respectively. Such poor export performance this year may be explained by falling international prices on steel, low investment activities of domestic firms, and decelerating production.

Table 3. Merchandise exports, yoy growth, by commodity group

	Share	January-December 2004	January-July 2005
Total exports	100	41.64	7.60
Cereals	3.48	50.00	80.00
Foods	3.49	26.15	3.42
Minerals	13.23	23.55	21.50
Chemicals	8.51	43.16	14.87
Woods	1.58	29.00	8.96
Textiles	2.7	15.32	7.51
Metals	39.94	50.00	18.58
ferrous metals	32.96	60.00	22.23
Machines and equipment	9.28	30.54	-14.71
Vehicles	6.24	110.00	-23.96

Source: State Statistics Committee

- (b) negative growth rate of investment activities (table 2). Partly, the situation is explained by high base effect (in 2004, fixed capital formation grew at a rather high 10.2% yoy). However, as it was mentioned above, the primary reason of the contraction was political turbulences at the end of 2004/beginning of this year and the followed-up drastic change in the country's management with sometimes controversial steps like the re-privatization issue.

According to the State Statistics Committee, in 1H 2005 investments into fixed capital, accounting for 86.2% of all capital investments, actually increased by 8.5% yoy (in nominal terms) compared with 1H 2004. However, the pace of growth declined considerably from 28% yoy in 2004. The largest investments were into extractive, processing industries and redistribution of electricity, gas and water (40.4%), with processing industry accounting for 65.2% of this amount. In particular, the growth leaders in attracting investments were light industry, chemical industry and production of rubber and plastic goods. Continue increasing investments into transportation (about 10% yoy growth) and residence construction (about 10.4% yoy compared with 1H 2004). At the same time, majority of sectors showed growth deceleration compared to respective period last year and even contraction if deflated by inflation.