Ukraine - Economic Situation

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Economic Growth.

As anticipated in previous reports, the rate of growth of GDP slowed down during the month of September 2001. During this month, GDP increased by only 0.1% compared with the previous month. Nevertheless, given the strong performance during the previous eight months, real GDP in January-September grew by 9.3% compared with the same period of 2000.

The slowdown in GDP growth in September was due to a decline in agricultural production during the month. This was principally due to the fact that most of the harvest this year occurred in August while last year it was more evenly spread over August and September.

The industrial sector has continued to perform well. In September 2001, industrial output grew by 1.3% -- compared to August 2001 -- and by 13.6% -- compared to September 2000. Over the nine months from January to September 2001, industrial production rose by 16.6% in real terms. The fastest growing industries were coke and petroleum production - 55.7% year-to year, timber production - 31.3%, machine building - 23.0%, pulp and paper industry - by 22.2%, food industry - 21.2% and light industry - 17.3%.

GDP growth is likely to continue to slowdown in the fourth quarter of 2001 due to a weakening in external demand, the introduction of various trade restrictions by Ukraine's major trade partners, as well as the appreciation of the national currency. Nevertheless, Ukraine's rates of economic growth should continue to be positive during the foreseeable future. The Government now expects GDP to grow by about 7% to 8% this year, compared to a GDP growth of 5.8% in 2000. This outcome would still be among the best in the world. GDP is expected to growth at about 5% - 6% p.a. during next year.

Fiscal Policies.

The fiscal budget for year 2001 continues to be affected by the shortfall in privatization revenues. As of October 1, budget incomes from privatization of state property were only UAH 2.05 billion, or 50% of the planned amount of UAH 4.1 billion for January-September 2001. For the entire year, the Government now estimates that privatization proceeds will amount to about UAH 3.3 billion, 44% less of the target amount of UAH 5.9

billion. Originally, the Government was planning to obtain the bulk of the privatization revenues from the sale of 18 energy companies and Ukrtelecom. However, the Government sold stakes in only six energy companies this year before privatization of the next 12 companies was postponed until next year. The Government also postponed a tender to sell a stake in Ukrtelecom until next year.

Despite these shortfalls in privatization revenues, the consolidated fiscal budget is proceeding satisfactorily and is in surplus, as agreed with the IMF. This is due to higher local revenues and good control of expenditures. For the period January to September 2001, the consolidated fiscal budget showed a surplus of UAH 1.3 billion, or about 0.9% of GDP. The Government is concerned, however, that the slowdown in economic activity expected during the last quarter of this year will have a negative impact on Government revenues and bring the fiscal budget out of balance. By mid-November, the Government expects to introduce adjustments to the budget to ensure its balance. This will include further reductions and deferrals in planned expenditures and increases in utility prices, principally electricity. The implementation of these adjustments is a condition for the next disbursement of the IMF/World Bank programs.

Monetary Policies.

Ukraine continues to show low inflation rates, with a monthly inflation rate of only 0.2% in October 2001. During the ten-month period from the beginning of the year, the rate of inflation has been only 3.9%.

Inflation has remained low despite the fact that money supply has been increasing at a faster pace. During the ten-month period from January to October 2001, money supply (M3) increased by 27%, substantially above the initial target of 19% for the entire year. So far, money supply increases have not been reflected in higher inflation rates due to increases in money demand associated by high rates of economic growth. The National Bank of Ukraine projects that Ukraine will have a rate of inflation of 6% during the entire 2001 year, significantly below initial inflation forecast of 12.3% for the year.

Since the beginning of the year, the hryvnia has continued its mild appreciation vis-à-vis the dollar. It has strengthened by 2.5% this year, bringing the exchange rate for the dollar to UAH 5.29/$ by the end of October. This strengthening has allowed the NBU to buy about $1.8 billion of foreign exchange from the beginning of the year, to serve foreign debt and increase its level of international reserves.

As of the end of October, total foreign exchange reserves stood at $3 billion, their highest level since independence (equivalent to about 2.2 months of expected 2001 merchandise imports). The reserves have almost doubled since the beginning of this year due to good export performance and large foreign exchange purchases by the NBU.

Government Debt.

In October 2001 the Ukrainian and Russian governments signed an agreement to restructure $1.4 billion debt of Naftogaz Ukrainy to RAO Gazprom of Russia. The terms of the agreement were set along the lines of the Paris Club deal reached by Ukraine last July, i.e. 12-year period, 3-year grace, and interest rate at LIBOR plus one percent. Naftogaz will issue eurobonds to cover the debt. Furthermore, the sides agreed that this debt is a private corporate obligation. It should not have a negative effect for the existing Ukrainian Government Eurobonds. Ukraine is also continuing its negotiations to restructure its estimated USD 270-280 million gas debts with Turkmenistan.

As reported earlier, these bilateral agreements under the umbrella of the Paris Club should ensure the capacity of Ukraine to serve its foreign obligations without recourse to excessive money creation.

International Trade and Capital.

During the eight-month period from January to August 2001, Ukraine achieved a foreign trade surplus of $626 million compared to a surplus of $148 million for the same period last year. During this period, exports of goods totaled $10,701 million, which represented an increase of 16.8% year-to-year. Imports totaled $10,076 million, an increase of 12.3% year-to-year. Although largely diminished from previous years, Russia remained Ukraine's main trading partner accounting for 24.3% of exports and 37.6% of imports in January-August 2001. The improvement on exports was due to increased sales of machinery and equipment and agricultural products, rather than metallurgy products, which were the fastest-growing exports in year 2000.

The future evolution of Ukrainian exports will depend on the satisfactory resolution of a number of trade disputes. A number of countries, including the US, Russia, Canada and the EU, have initiated anti-dumping procedures against Ukraine's export commodities, particularly ferrous metals, metal products and chemicals. In addition, on November 1, the US was ready to apply trade sanctions to Ukrainian exports that may have produced losses of about $400 million. This action was due to inadequate protection by Ukraine of intellectual property rights, particularly lack of action on unauthorized CD production and export. Following the visit to Washington by Prime Minister Anatoliy Kinakh, the US Government has decided to wait until November 15, when the Ukrainian Parliament is expected to pass a bill on intellectual property protection.

Economic Reforms and International Programs.

In addition to sound fiscal and monetary policies, since the beginning of 2000 the Ukrainian Government has implemented an impressive number of important economic reform measures. They include a land reform that transferred land ownership to individual farmers; the elimination of Government intervention in the agricultural market and its commercialisation; a significant reduction of barter in public utilities and international trade; elimination of Government pension arrears; simplification in business inspections and registration requirements; introduction of European import certification standards; approval of the Land Code, the Banking Law, the Criminal Code and the Budget Code; successful external debt restructuring including the Paris Club and the gas debts to Russia and Turkmenistan; and the renewal of lending programmes by the IMF, World Bank, EBRD, and European Commission.

These economic reform measures have had the positive economic results outlined in this report. However, the level of investments remains low. Therefore, the sustainability of Ukraine's economic recovery will depend on the revival of investment. Domestic investments are recovering from a low base. During the period January-September 2001, total domestic investments increased by 25% compared to the same period in 2000. However, this level is still inadequate, representing only about 20% of GDP. Direct foreign investments are also low.

The Government is aware that in order to accelerate the pace of investments, it will need to take further measures to improve Ukraine's business climate, particularly by improving its legal environment, further deregulating business and improving corporate and public governance. Under the umbrella of a July 2001 Presidential decree, the Government is developing a program to achieve these results.

To implement successfully its economic reforms, Ukraine is also dependent of the support of international bilateral and multilateral agencies. Last September, the World Bank approved a Programmatic Adjustment Loan (balance-of-payment support) of $250 million conditioned on a number of structural economic reforms. At that time, $150 million were disbursed, with the remaining $100 million planned for disbursements in November 2001. Although most conditions for disbursements have been met, before proceeding, the World Bank expects the Government to (i) increase electricity tariffs as agreed with the private companies that recently purchased six state electricity distribution enterprises; (ii) make progress in reinitiating the privatization of the remaining 12 electricity generation companies; and (iii) complete the audit of Naftogaz Ukrainy. The Government expects to implement these measures in the second half of November.

Following the renewal of IMF lending last September, the next tranche of $380 million under the IMF's Extended Fund Facility was planned to be released in December 2001. For this, the Government will need to take action required by the World Bank on the power and gas sectors. In addition, during November the Government should take measures to cover the shortfall in privatization receipts for the 2001 fiscal budget. It should also get a satisfactory 2002 fiscal budget approved by Parliament. It is unlikely however that these matters will be resolved in November. The most likely outcome is that the next IMF disbursement will take place around January/February 2002. This is unlikely to cause problems to the country, given its high level of international reserves.