Ukraine - Economic Situation

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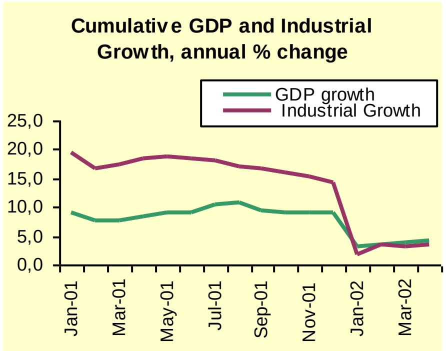
Economic Growth

In April 2002, Gross Domestic Production (GDP) slightly improved compared to previous months. In April, GDP growth reached 5% compared to the same month last year, while during January-April 2002, real GDP grew by 4.1%. During this four-month period, the highest growth rates in gross-value-added were registered in those sectors oriented towards the domestic market. In fact, domestic demand continued to be the main source of GDP growth, balancing weaknesses in external demand. The rise in gross-value-added took place in wholesale and retail trade (19.8% compared to the same period last year), agriculture and forestry (10.6%), and processing industries (4.0%). On the other hand, negative rates of growth were experienced in health care (-1.0%), utilities (-0.9%) and mining (-0.2%). The Government maintains its forecast for GDP growth at 6% for this year, compared to 9.1% GDP growth achieved in 2001. Other non-government forecasts are somewhat less optimistic, placing GDP growth for 2002 at 5% (IMF), 3.0% (CASE), 4.5% (ICPS) and 4%-6% (World Bank). In any case, the rate of GDP growth in Ukraine in 2002 is likely to outperform most emerging market economies, which have been affected more severely by the current worldwide economic slowdown.

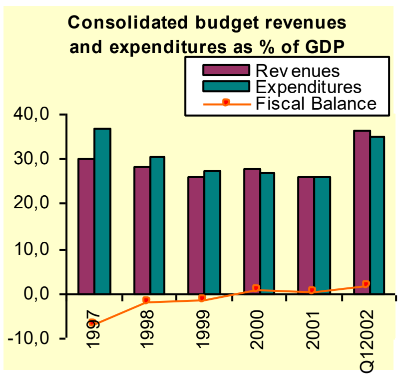


Source: State Statistics Committee

Industrial output continues to grow at lower pace than last year. In April, industrial output grew by 3.8% compared to the same month last year, bringing industrial growth for the first four months of the years to 3.5% year-to-year. During the same period last year, industrial output had increased by 18.4%. In January-April 2002, metal production and processing -- which accounted for the largest 21.4% share of total industrial production -- declined by 6.6% compared to the same period last year, mainly due to poor external market conditions and numerous trade barriers imposed by Russia, USA and other trade partners. The second largest industry – electricity, gas and water (18.1% share) also showed negative performance, with an output decline of 0.8%. These declines were overcompensated by positive rates of output growth in domestic-oriented industries, including wood processing (31.2% output growth), food and agricultural processing (13.5% growth), oil refining and coke (19.6% growth) and machine-building (8.7% growth).

Fiscal Policies

The consolidated fiscal budget figures for the first quarter of 2002 give optimism that the fiscal deficit for the year would be under control, despite earlier fears that the economic slowdown would bring substantial declines in fiscal revenues. During January to March, the consolidated fiscal budget showed a surplus of UAH 658 million ($125 million) or 1.5% of GDP. Consolidated budget



revenues reached UAH 12.6 billion or 29.6% of GDP. In nominal terms, this amount was 14.2% higher than the figure for the same period last year. These revenue increases were due to large tax revenues from VAT and excise taxes, which increased by 28% and 12%, respectively, compared to the same period of 2001. On the other hand, there is concern that the increase in VAT revenues may just be the result of an increase in VAT arrears which have not been refunded to exporters. About $380 million of VAT arrears are now overdue. Another concern is that another key tax, corporate profit tax, declined by 6% year-to-year, due to the general slowdown in industrial activities.

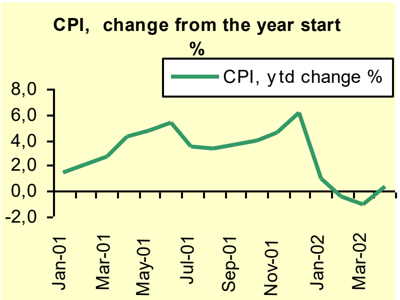
Although in the first quarter of the year fiscal budget revenues were higher than in the same period of 2002, they are considerably below the ambitious levels originally planned by the Government. The positive fiscal balance of the first quarter was achieved principally by a non-payment of VAT refunds and other reduction in Government expenditures from its original targets. Consolidated expenditures over the period totaled UAH 11.9 billion or 28.1% of GDP.

For the first time this year, the Government budget does not included privatization receipts as Government revenues. They were included as the main item to finance the anticipated fiscal deficit of 1.7% of GDP (in accordance with the IMF methodology). Privatization receipts were expected to reach about $1.1 billion (2.4% of GDP) and provide ample financing for the planned the fiscal deficit of $800 million (1.7% of GDP). Unfortunately, privatization receipts during the period from January to April 2002 amounted to only $53 million or only 5% out of the target for the year. It is now evident that the privatization targets will not be met. Without these privatization receipts, the Government should either find other non-inflationary sources of budget financing or just reduced its planned fiscal deficit to a lower figure consistent with expected privatization receipts.

A recent IMF mission visited Ukraine to agree with the Government on the resolution of the VAT arrears issue and other Government expenditure reductions needed during the rest of the year to maintain a healthy fiscal position. The Government is likely to comply with these expenditure reduction conditions, since its original budget had already identified expenditures that may be cut later in the year if fiscal revenues were not to materialize. However, the resolution of the issue of delays in the refunding to exporters of VAT arrears is still outstanding (see below under International Programs).

Monetary Policies

Following two months of deflation, in April 2002, the Consumer Price Index increased by 1.4% (led by foodstuff prices increases of 2.2% and utility price increases of 6.7 %.) From January to April, the inflation rate was only 0.3%. As noted earlier, these results have led the Government to reduce its inflation forecast for the year from 9.8% to 7%.



Source: National bank of Ukraine

In April, the National Bank of Ukraine continued with its expansionary monetary policies. During the month, money supply (M3) increased by 2.1% bringing the total increase in money supply since the beginning of the year to 11%. This is a large increase compared to the original Government target of an 18%-20% increase in M3 for the entire year.

Officials of the NBU has recently stated that the growth in money supply is intended to maintain a high demand for domestic consumption, which has been the main driver for GDP growth during this year. The NBU believes that these money supply increases are unlikely to be reflected in high inflation rates since the demand for money appear to be increasing at a similar pace. It has stated its intention to tighten monetary policies, if inflationary pressures were to develop.

From the beginning of 2002, the Hryvnia exchange rate has been quite stable, in the range of UAH/$ 5.30 (at the beginning of the year) to UAH/$5.33 (in mid-May). Given this stability in the exchange rate, the Government has announced that it has adjusted its foreign exchange forecast for 2002 from the original rate of UAH/$ 5.60 to UAH/$5.45. For 2003, the Government plans to use for its 2003 fiscal budget calculations an average annual exchange rate of UAH/$ 5.54, reaching UAH/$ 5.63 by the end of 2003.

The level of international reserves has also been steady at about $3.2 billion. Although this is one of the highest levels achieved by Ukraine since independence, it only covers two months of imports, compared to an international standard for international reserves of about three months of imports. The Government intends to increase gross international reserves gradually, reaching $ 3.5 billion by the end of the year 2002.

Government Debt

From January 1st to May 1st, 2002, the Government and NBU spent about $460 million to serve its external debt. These foreign exchange funds were partly secured by the NBU by purchasing about $360 million of foreign exchange in the inter-bank market during this period. For the entire year 2002, the Government is expected to spend about $1.4 billion on servicing its external loans. The Government was planning to finance these payments from disbursements of around $950 million from the IMF. So far, however, no IMF disbursements have taken place this year.

At $9.5 billion (including $1.8 billion due to the IMF), Ukraine's foreign debt is not high. It only represents about 21% of expected 2002 GDP (compared to ratios of 40% for all emerging market economies). It also represents a low share of the country's exports (50%, compared to 135% average for all emerging markets). However, debt service payments at about $1.4 billion for 2002 and $1.6 billion for 2003 do represent a substantial load for the country, given its relatively low level of international reserves. If inflation were to revive in Ukraine, to serve this debt, the NBU may not be able to purchase foreign exchange in the inter-bank markets, since this would expand money supply and put further inflationary pressures. The Government has stated that it will not attempt to negotiate the restructuring of this foreign debt. But it will seek next year to issue about $500 million of external debt obligations (either bank loans or Eurobonds) to fund part of its private debt service obligations.

Under the Paris Club agreement of last year, $580 million due by Ukraine to the Paris Club lenders and Russia would be restructured into 12-year obligations with three years of grace. The bilateral agreement with Germany has been signed already. A Government delegation is visiting Tokyo to sign the agreement with Japan. The bilateral agreement with the US is also expected to be signed shortly. Other bilateral agreements with the other Paris Club members have been agreed in principle and will be signed by the end of June 2002.

International Trade and Capital

Despite the slowdown in the world economy, lower prices for commodities, and the numerous restrictions on Ukrainian exports imposed by a number of trading partners, including the US and Russia, Ukraine's international trade improved somewhat during the first quarter of the year compared to the same period last year. The Committee on Statistics reported that during the first quarter of 2002, Ukraine showed a positive trade balance in goods and services amounting to $950 million, compared to $830 million in the same period of 2001. The $950 million surplus in the trade balance was due to a surplus of $326 million in goods and a surplus of $624 million in services. Exports of goods and services grew by 1.7% compared to the same period last year and amounted $4.8 billion, while imports declined by 1.2% to $3.8 billion. These results show the ability of the country to diversify its exports markets.

The shares of traditional products have declined. While raw ferrous metal continue to be the main export product from Ukraine, in the first quarter of 2002 its share in merchandise exports declined to 29% (from 31% in the same period last year). The share of ferrous metals products also declined from 3.3% from 5.6%.

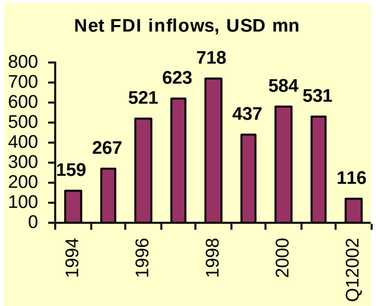
The shares of traditional buyers have also declined. While Russia remains the main buyer of Ukrainian exports, its share in total merchandise exports continued to decline reaching only 17% in the first quarter of 2002, compared to a share of 25% in the same period last year. In part, this drop in Russia's share was due to the protectionism policy carried out by the Russian Government. Antidumping investigations against Ukrainian goods and the introduction of new VAT collection methodology led to the search of new markets by Ukrainian companies. Among other main countries buying from Ukraine in the first quarter of 2002 were Turkey (7.7% of total exports), Italy (5%), China (4.5), Germany (4.2%) and Hungary (3.4%).

Source: State Statistics Committee

On the import side, Ukraine mainly imported from Russia which supplied 36.8% of Ukraine's total merchandise imports (compared to a larger share of 40.2% last year). On the other hand, imports increased from Turkmenistan (14.8% against 11.24% last year) and Germany (8.4% against 7.7 %.)

The level of foreign direct investments (FDI) in Ukraine continues to be below its potential. During the first quarter of 2002, the net inflow of FDI was only $115 million. Although this was 14% above the level received in the same period last year, it is significantly below the levels received by other similar countries. The total stock of the net FDI in Ukraine since 1991 is only $4.5 billion.

During January-March, the gross inflow of the FDI in Ukraine totaled $238 million; while gross outflow amounted to $117 million.



Source: State Statistics Committee

The Government is aware of the major contribution that FDI could make to GDP growth and has developed a program to improve Ukraine's business climate to attract FDI. The program includes a number of reforms to further liberalize, make the legal environment more predictable, improve banking services, modernize public administration, remove international capital and trade restrictions, and improve business taxation.

During 1991, the USA has been the largest investor in Ukraine – $763 million or 16.8% of total, followed by Cyprus - $485 million or 10.7%, Great Britain – $426 million or 9.4% and Netherlands – $ 383 million or 8.5%. The most attractive fields of economy for foreign investors have been the food industry and agricultural products processing – $807 million or 17.8% of total, wholesale trade – $673 million or 14.9%, and financial operations – $375 million or 8.3%.

International Programs

As reported last month, the IMF sent a mission to Kiev in the second half of May to review the possibility of re-initiating disbursements under the EFF program, which were suspended in January 2002. After the completion of the mission, the IMF reported that it was optimistic about the possibility of reviving disbursements, provided that the Government carries out, during the next four weeks, measures in two areas. First, the Government must implement fiscal budget measures to contain a likely fiscal deficit for 2002, since fiscal revenues are not to materializing at the levels originally planned. Second, the Government must implement changes in the mechanism for VAT reimbursements to avoid future arrears and implement a plan to repay current arrear over time. The IMF and the Government are considering alternative sources to finance such repayment of arrears. If these discussions are successful, the IMF may disburse between $550 million and $740 million in July 2002. This IMF review is the last opportunity for the Government and IMF to consider disbursements under the EFF, since this operation will expire in September 2002.

After the expiration in September 2002 of the current EFF program, the Government wishes to continue collaboration with the IMF, since it believes that such collaboration would improve international credibility for Ukraine. This collaboration could take several forms, including another EFF lending program with new conditionality, or only a “precautionary” arrangement (under which disbursements would take place only in case of need), or just a monitory IMF program, which would not involved any disbursements but would imply a seal of approval by the IMF of the macroeconomic policies of the Government. These arrangements may be important in connection to the planned borrowing by Ukraine in the international capital markets in 2003.

A World Bank mission also visited Kiev in the second half of May to review progress in the preparation of the second Programmatic Adjustment Loan for $250 million. This balance-of-payments loan is expected to be approved in the second half of 2002. At the completion of the mission, the World Bank stated that the key conditions for the loan include the resolution of fiscal problems (excessive tax benefits and tax arrears), the privatization of regional energy distribution companies, the restructuring of the state Savings Bank, and the establishment of an agency to register land property.

In mid-May, the European Union decided to extend a loan of Euros 110 million to Ukraine by the end of 2002. Although the EU indicated that it was pleased with the country’s economic performance, in order to receive these funds, the Government had to reach satisfactory agreement with the IMF. The last loan provided by the EU to Ukraine was in 1998.