

Ukraine - Economic Situation

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Economic Growth

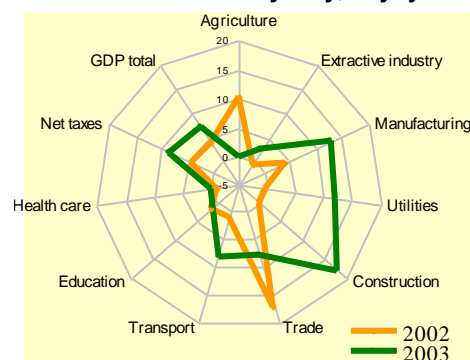
A broad-based growth of Ukrainian economy posted a marked acceleration in May 2003 driven by strong external and domestic demand. In May, real GDP growth picked up by 8.3% year-over-year (yoy) bringing the cumulative January-May figure to 7.3% yoy. The major contributors to GDP growth were processing industry (12.8% yoy), construction (17.5% yoy) and utilities (11.5% yoy). At the same time, value added in agriculture has shown zero growth during January-May.

Industrial production expanded rapidly responding to favorable external conditions and growing domestic demand. Growth of export-oriented metallurgy slowed down to 12.5% yoy in January-May primarily due to decelerated pipe production. Chemicals output also decelerated to 13.3% yoy indicating weakening external demand. At the same time, domestic market-oriented industries kept demonstrating high rates of growth driven by strengthening domestic demand. In January-May, growth in food and wood processing industry picked up to 17.7% yoy and 22.2% yoy respectively. Higher utility requirements of rapidly growing energy-intensive industries contributed to the growth in utility generation that remained at a still high 11.5% yoy during the period. Growing demand for transport services encouraged further expansion in machine building that reached 26.6% yoy in January-May. Unfavorable weather conditions threaten agricultural harvest this year, thus contributing to fears of deteriorating macroeconomic indicators till the end of the year. According to the official forecasts, GDP growth should reach an expected 5-6% in 2003 (based on optimistic scenario) that seems realistic assuming strong external demand for key export commodities remains in place till the end of 2003. In a base case scenario, the Ministry of Economy assumes 4.7% of GDP growth in 2003. In 2004, the government expects Ukrainian economy to grow at 4.8% based on a conservative scenario of economic development, and a high 8% rate of GDP growth is envisaged by optimistic scenario that assumes successful implementation of structural reforms and strong external demand for Ukrainian exports.

Fiscal Policy

Rapid economic growth made for healthy fiscal surpluses since the beginning of the year. In January-May, the state budget surplus constituted UAH 1.2 billion (\$225 million), or 1.4% of the period GDP. Given the targeted deficit of 0.8% of GDP, the current fiscal performance looks quite positive. Over the period, the state budget revenues made up UAH 20.1 billion (\$3.8

Real GDP and Value Added Growth by Sector in January-May, % yoy



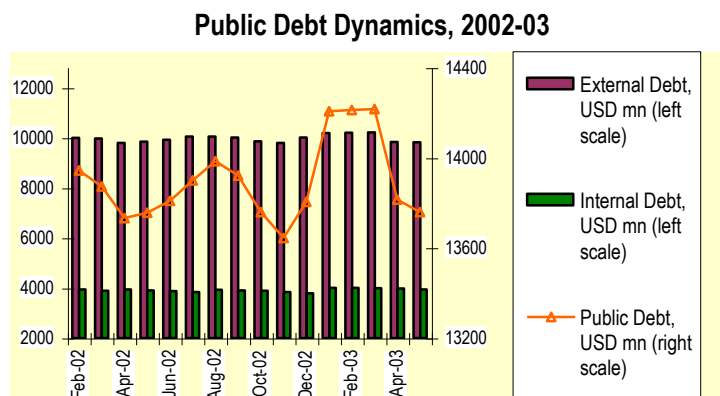
Source: State Statistics Committee

billion), and expenditures reached UAH 18.9 billion (\$3.6 billion). According to the Ministry of Finance, tax revenues came 2.1% above levels targeted for January-May, primarily on the account of plentiful corporate profit and personal income tax collections. Growth rates of fiscal revenues substantially exceeded the rates of the overall economic growth indicating also improved administration of taxes. However, the problem of VAT refund arrears that has yet to be resolved still undermines tax discipline. Together with improved tax enforcement, there have been positive shifts in privatisation performance. In January-May, proceeds from privatization of state property, an important source of budget-deficit financing, constituted \$187 million or more than 45% of the annual target. A significant increase in privatisation proceeds during May took place following transfer of payments for the state share in Ukrainian Mobile Communication (some \$80 million) and Nikopol Ferroally Plant (about \$40 million) to the budget. Despite brighter prospects over execution of the 2003 privatization plan, government has to rely on external sources of fiscal gap financing. Recent approval of amendments to 2003 Budget envisaging an increase of state budget revenues and expenditures by about \$550 million each creates additional challenges for the current year budget execution.

Meanwhile, the Parliament approved the 2004 Budget Resolution envisaging fiscal gap at 0.5% of GDP next year. Consideration of the main directions of the fiscal policy for 2004 took place following an adoption of the set of important tax laws that will come into force starting January 2004. As an indication of substantial progress in tax reform, three major tax laws have been recently adopted by the Parliament: law on taxation of personal income (PIT), corporate profit tax law and law on VAT. In particular, new PIT law foresees 13% flat tax rate starting 2004 instead of current progressive scale of 10% to 40% (in 2007 PIT will be increased to flat 15%). Law on corporate profit tax, adopted earlier, stipulates for the reduction of corporate profit tax from 20% to 15%. Starting January 2004, VAT will also be lowered from 20% to 17%, and a new, more effective, mechanism of VAT refund to exporters will be introduced. Significant decrease of the major tax rates would considerably reduce budget revenues next year. However, Ukrainian authorities expect that abolishment of tax privileges and de-shadowing of wage payments will compensate for the prospective loss. The other important component of the tax reform is the adoption of the law on single social tax, envisaging a reduction of the rates of deductions to various social security funds, including Pension Fund, from 37% to 25%. The government hopes for the Parliament's approval of the law on tax amnesty in 2004 that would also help to compensate for the revenues lost as a result of tax rates decrease. An adoption of the Tax Code is expected till July 13 when members of the Parliament leave for summer break. This step, if performed, would be highly praised by international financial institutions.

The total public debt fell by \$442 million during January-April, and reached \$13.76 billion equivalent as of end-April. External debt made up \$10.2 billion equivalent (or 22.8% of GDP expected in 2003). At the same time, domestic debt constituted only 9.2% of expected GDP and amounted to \$4 billion equivalent.

Taking an advantage of favorable macroeconomic situation in the country, the government placed \$800 million worth of Eurobonds at a record low rate of 7.65% early in June. The maturity of the new Eurobonds is 10 years. Lower-than-expected yield came as a result of strong investors demand that reached some \$4.5 billion. Such an outcome could be partly attributed to higher interest of



Source: Ministry of Finance

investors to transition economies due to slowdown of economic growth in the EU and the USA, on the one hand, and a new 144-A procedure of Eurobonds issue that allowed expanding the potential investors base to the US market also, on the other. Facing uncertainty over the World Bank's financing and questionable execution of privatization plan, Ukrainian government increased the size of the issue from the originally planned \$600 million to \$800 million.

Monetary Policy

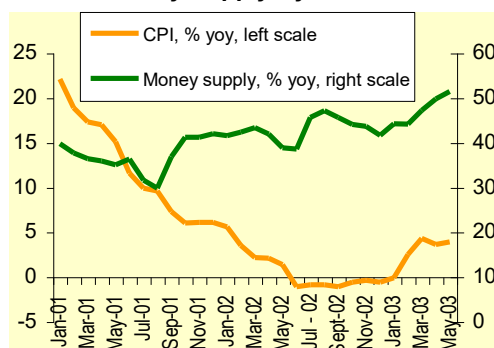
In May 2003, the annual growth in consumer prices picked slightly up to 3.9% yoy despite zero monthly growth of consumer prices during May. Since the beginning of the year Consumer Price Index (CPI) grew by 4.5% year-to-date (ytd). Food prices, the major determinant of consumer inflation dynamics, increased by 6.3% ytd in January-May. Over the same period, non-foods and services prices picked up by a relatively small 0.2% and 1.4% respectively. Although summer is usually a period of falling prices for foodstuffs, growing fears over extremely low agricultural harvest this year are likely to drive up inflationary expectations. Therefore, consumer prices are expected to grow further unless authorities implement more active measures to contain inflation. So far, the NBU announced that it is going to preserve its discount rate at a low 7% till September, thus signaling about its intentions to put off inflation targeting for a while.

Monetary aggregates continued rapid expansion in May. Annual growth of money supply accelerated to a high 51.4% yoy due to a weighty increase of cash in circulation, which expanded by 37% yoy. Over the month, money supply (M3) growth amounted to 2% month-over-month as cash in circulation and monetary base grew by 0.7% and 0.9% respectively during the month. Steady increase of lending activity, high growth of deposits, and continued accumulation of international reserves by the NBU contributed to money supply expansion. In May, the NBU forex reserves picked up by \$241 million to a new record of \$5.3 billion as of end-May. However, an increase in reserves is attributed to not only exports proceeds inflow but also depreciation of the US dollar against other currencies included in foreign reserves (including euro). By the end of the year the NBU expects its gross reserves to reach \$6.0-6.2 billion.

Commercial banks' lending speeded up in May as average lending rate went slightly down. During the month, the growth of commercial banks loans reached 54% yoy, while average lending rate fell to 15.1% annually. High growth of household deposits fuelled by rapid wage increase also contributed to the expansion of lending activity. In May, total deposits grew by 63% yoy primary on the account of household deposits increase. The average deposit rate went down to 6.5% annually in May compared to 6.6% in April.

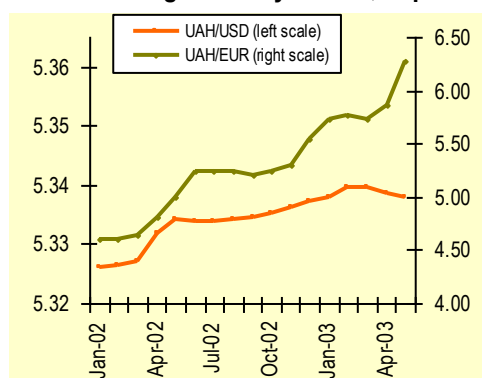
The official Hryvnia exchange rate stayed virtually unchanged at 5.33 UAH/USD as of May 31 (appreciated by a tiny 0.01% month-over-month). Continuing appreciation of Euro in the international markets contributed to depreciation of UAH/EUR exchange rate by 7.2% during May to 6.27 UAH/EUR. Since the year start, Hryvnia depreciated by 13.3% ytd against Euro.

CPI and Money Supply Dynamics, 2001-03



Source: State Statistics Committee, NBU

Exchange Rate Dynamics, eop



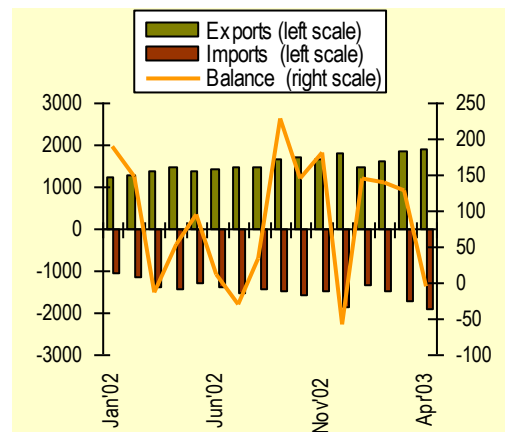
Source: National Bank of Ukraine

The NBU council made a second revision of its forecast for average hryvnia rate in 2003. Hryvnia exchange rate is expected to reach UAH/USD 5.36 instead of the previously set UAH/USD 5.39.

International Trade and Capital

According to the NBU balance of payment report, current account surplus rose by 31% yoy to \$1.1 billion in the first quarter of 2003. To a great extent an increase is attributed to substantial growth of merchandise trade surplus that posted more than twofold increase during the year. Services trade surplus demonstrated 54% yoy growth in January-March. Over the period, net FDI increased by almost 150% yoy to \$300 million, primarily on the account of investments from non-CIS countries. At the same time, about \$820 million of portfolio investment flew out of country. The NBU forecasts deterioration of current account balance till the year-end due to higher growth of imports expected in the second half of the year. According to the NBU expectations, current account surplus may fall by 50% yoy to \$1.6 billion in 2003.

Merchandise Trade Dynamics, USD mn



Sharp acceleration of imports in April 2003 contributed to a modest growth of merchandise trade surplus in January-April. Over the period, trade of goods surplus increased by 8.5% yoy to \$407 million or 3.2% of period GDP. In January-April, exports growth preserved at 28% yoy, while imports grew at 29% yoy. Ferrous metals exports remained among the largest contributors to the overall merchandise exports growth; these items' trading volume expanded by more than 40% yoy in January-April, while its share in the total exports made up 32%. Refined oil and gas exports were also on a rise as their share in the total exports went up from 9.3% in January-April 2002 to 14.5% during the same period this year. On import side, imports of raw energy resources posted more than twofold yoy increase to about \$2.7 billion (or 42% of all imports). On regional breakdown, Europe accounted for about 40% total merchandise exports during January-April, while Asia and CIS countries – for 26% and 23% respectively. At the same time, 56% of all goods imported to Ukraine came from CIS countries, whereas European countries' share constituted 36%. Still, demand for Russian goods grows much faster than for European products largely due to heavy reliance on Russian energy resources and relatively low income level in Ukraine.

International Programs

Positive macroeconomic developments in Ukraine along with a visible progress in tax reform should improve the chances of the government for resumption of international financing programs. So far, the situation with lending programs of IMF and the World Bank remained uncertain. Although Ukraine is currently in no immediate need of the IMF financing, renewal of active cooperation with this institution will significantly improve the country's international image, and also facilitate the resumption of the World Bank adjustment lending. Recently, IMF mission headed by the Director of the European II Department John Odling-Smee arrived to Ukraine to assess the possibility of launching a precautionary stand-by program in Ukraine. The mission will work in Ukraine until end-June, so the decision on the issue could be expected by end-July at best. Within pre-cautionary stand-by program, Ukraine may receive up to \$800 million in 3-5 years upon request of Ukrainian government in emergency cases. The IMF mission has to decide whether the government efforts on implementing structural reforms were sufficient to justify resumption of suspended cooperation. There are four issues outstanding: repayment of VAT refund arrears, completion of Naftogaz audit, further elimination of tax privileges, and also restructuring of state-owned Oschadbank. Although IMF representatives may be pleased with

recent adoption of the new tax laws by the Parliament, their primary concerns lie in the area of VAT refund arrears and abolishment of tax privileges. Lately, the government proposed to voluntarily exchange VAT refund debt for special government securities as alternative way of resolving VAT debt issue. However, it remains to be seen whether such measure will properly address the issue, and how the IMF will like it.

Resuming IMF funding would also unlock the World Bank financing within Programmatic Adjustment Loan (PAL-2) program, envisaging disbursement of \$250 million this year. The World Bank decision on PAL-2 was postponed till September when the World Bank Board of Directors will consider the country assistance strategy (CAS) for Ukraine in 2004-2007.

Other Developments

Following positive evaluation of Ukraine's actions on preventing money laundering by the Financial Action Task Force on Money Laundering (FATF), the government expects that Ukraine will be excluded from the list of non-cooperative countries in February 2004. Soon the FATF will propose Ukraine to work out a detailed action plan for effective introduction of the financial monitoring system, thus revealing the FATF's intentions to initiate Ukraine's exclusion from the black list of non-cooperative countries. According to FATF Chairman Jochen Sanio Ukraine will get a strong chance to leave the black list, if it properly implements its legislation on preventing money laundering. Recently, Finance minister Mykola Azarov and Nancy Lee, the US deputy assistant secretary for Eurasia and Latin America of the US Treasury, signed an agreement on provision of the US technical assistance to the State Department for Financial Monitoring of Ukraine. According to the US representative, an advisor, who has worked at the similar project in Russia, will assist in effective functioning of the Ukraine financial monitoring agency.