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Ukraine

Macroeconomic Situation

AUGUST 2003

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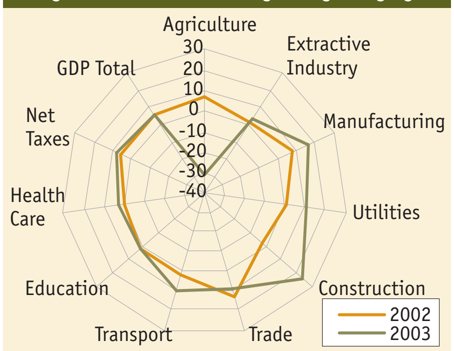
Economic Growth

During the month of July, a substantial decline in agriculture output contributed to a sharp reversal of GDP growth dynamics. During the month, real GDP growth fell by 5.6% year-over-year (yoy) after a remarkable 8.2% yoy pickup in June. As a result, cumulative January-July GDP growth slowed to 5.1% yoy. Continuation of robust growth in processing (15.5% yoy), construction (23.5% yoy) and utilities (9.3% yoy) partly compensated for the negative contribution of agriculture to overall economic growth. Value added in agriculture dropped by 31.4% yoy in January-July mainly due to unfavorable weather conditions. Price regulations introduced by the government on the grain market at the end of June also played a role in the poor performance of agriculture.

Expectations of the total grain output this year got worse after the harvesting season began. Instead of the earlier expected 25-27 million tons, the government now forecasts grain production at 22-25 million tons. The expected agricultural result looks particularly poor against the plentiful 39 million tons produced in 2002. However, the share of agriculture in the total economic output of Ukraine is small, representing slightly more than 10%. Therefore, the negative developments in agriculture are unlikely to spoil the overall positive economic outlook for Ukraine.

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



Source: State Statistics Committee

Poor agricultural performance contrasts with the remarkably good performance of industry in 2003. Favorable external conditions and strong domestic demand contributed to rapid growth in all sectors of industry. Since the beginning of 2003, the growth leader in industry has been machine-building, which demonstrated remarkable growth throughout the year. In July, output in the machine-building sub-sector grew by 44.5% yoy. Growth of the export-oriented metallurgy sub-sector picked up to 13.5% yoy in July, indicating improvement of its position on the international metals market. Chemicals output accelerated to 22% yoy in July, indicating stronger external demand. At the same time, the domestic-market-oriented food and wood processing industries continued to expand rapidly, posting 25% yoy and 33% yoy in July, respectively.

According to conservative official forecasts, real GDP is expected to grow by 4.7% in 2003. This forecast seems realistic even taking into account the dismal performance in agriculture. In 2004, the government forecasts economic growth at 4.8%-8% based on a conservative and optimistic scenarios of economic development. However, the real figure will depend on the pace of structural reforms implemented by the government as well as conditions in Ukraine's export markets.

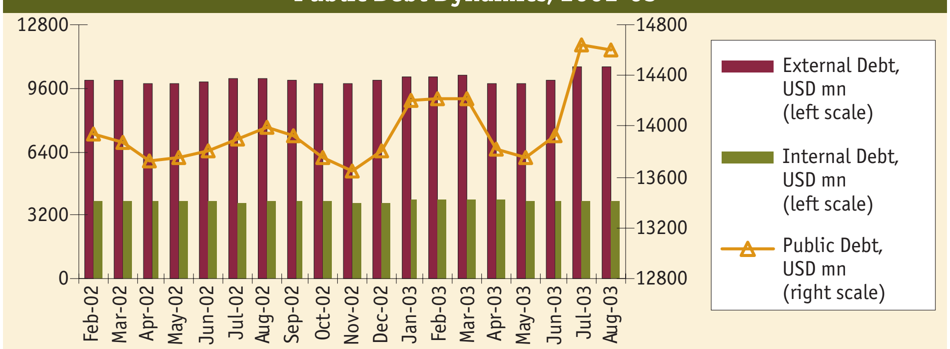
Fiscal Policy

During the course of 2003, fiscal performance has benefited greatly from the robust economic recovery. In January-July, the state budget surplus amounted to UAH 1.8 billion ($350 million), or 1.5% of the period's GDP. According to the budget execution report presented on the official website of the Ministry of Finance, instead of a surplus, the state budget was expected to run a deficit of about $350 million in January-July. Over the period, the state budget revenues reached UAH 29 billion ($5.5 billion), and expenditures made up UAH 27.2 billion ($5.2 billion). Plentiful corporate profit and personal income tax collections contributed to healthy budget surpluses that should allow the government to successfully meet its external obligations due in September. Growth rates of fiscal revenues substantially exceeded the growth rates for the overall economy, indicating improved tax administration. The main problem that still needs to be addressed by the government is the repayment of VAT refund arrears. This issue remains a major roadblock in Ukraine's relations with the international financial organizations.

Promising privatization performance gives rise to the hope that the government will be able to finance the expected fiscal deficit without additional external borrowings. In January-July 2003, proceeds from privatization reached almost $250 million - about 20% above the amount targeted for this period.

In 2004, the government plans a fiscal budget deficit of 0.5% of GDP. Following the approval of the draft budget by the Cabinet of Ministries, it has to be submitted to Parliament by September 15, 2003. Processing the state budget for the next year is likely to be difficult because of the important tax laws that will come into effect starting January 2004. As reported earlier, parliament passed three new laws that represented a major breakthrough in the ongoing tax reform. According to the new laws, as of January 2004 the personal income tax will be charged at a flat rate of 13% (15% starting from 2007), instead of the current brackets of 10% to 40%. The corporate profit tax rate will also be reduced from 20% to 15%, and the VAT will be reduced form 20% to 17%. Also, there will be elimination of a number of exemptions and double taxation. However,

Public Debt Dynamics, 2002-03



Source: Ministry of Finance

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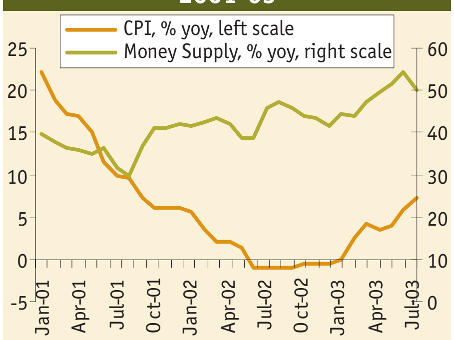
President Kuchma recently vetoed the new VAT tax law passed by parliament in June, on the grounds that not all tax privileges and exemptions had been abandoned.

During January-July 2003, the size of total public debt grew by $400 million or 2.1%, and reached $14.5 billion equivalent as of the end of July. The stock of Ukrainian public and publicly guaranteed debt increased in June following the placement of $800 million worth of Eurobonds that month. In July, however, the debt stock fell by $136 million primarily due to the reduction of internal public debt. In July, the sale of government securities yielded much less than the amount that was repaid to domestic creditors. Meanwhile, in July the stock of external debt remained virtually unchanged at $10.7 billion equivalent (or 23% of GDP expected in 2003). In forthcoming months, Ukraine's external debt is likely to decline due to weighty payments on external debt (about $400 million) scheduled for September. However, the size of the decline depends on whether the government implements its earlier decision to borrow some $100 million externally to purchase grain as compensation for the shortfall in grain production this year.

Monetary Policy

The annual rate of inflation continued to increase in July, with consumer prices picking up 7.4% yoy compared to 5.9% yoy growth in June. Such an increase is explained by unsatisfied demand for flour and cereals on the domestic market caused by the poor new grain harvest.

CPI and Money Supply Dynamics, 2001-03



Source: State Statistics Committee, NBU

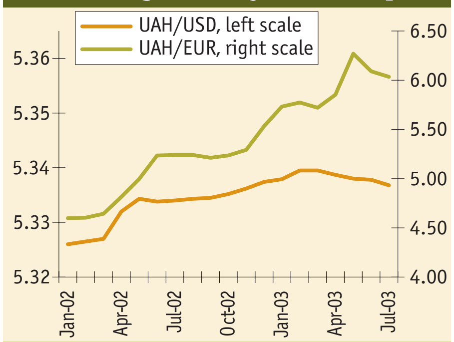
Price controls for grain introduced by the government at the end of June to stop the growth of prices for these items during the month only worsened the situation, since they may have driven up inflationary expectations of market participants. Since the beginning of the year, the Consumer Price Index (CPI) grew by 4.5% year-to-date (ytd) as consumer prices posted a seasonal monthly decline in July. Food prices, the major determinant of consumer inflation dynamics, increased by 6.2% ytd in January-July. Over the same period, prices for non-food and services picked up by a relatively small 0.3% and 2% respectively. However, the official inflation forecasts remained unchanged. The authorities still expect end of period consumer prices growth at 6% in 2003. Although the monetary authority forecast CPI inflation at 7-8%, the NBU has not resorted to the use of monetary tools to control inflation, as it still keeps its discount rate at a low 7%.

The growth of monetary aggregates decelerated slightly in July. However, in annual terms, money supply grew by a high rate of 50% yoy (from 54% yoy a month ago) due to a substantial increase of cash in circulation. In July, money supply (M3) growth amounted to 2.3% month-over-month, as cash in circulation and monetary base grew by 2.4% and 4% respectively. Continued high deposits growth contributed to money supply expansion. Also, the growth of the monetary base is linked to the NBU interventions in the foreign exchange market. In July, the NBU kept accumulating its foreign exchange reserves through buyout of excess foreign exchange on the inter-bank market. Thus, its foreign reserves increased by $335 million to a record high $6.51 billion as of late July.

The NBU interventions prevented the Hryvnia from appreciating against the U.S. dollar. In July, the official Hryvnia exchange rate remained unchanged at 5.33 UAH/USD at the end of the month. Weakening of the Euro on international markets contributed to slight appreciation of the UAH/EUR exchange rate during July to 6.04 UAH/EUR. Since the beginning of the year, the Hryvnia depreciated by 9.1% ytd against the Euro. The NBU council expects the official Hryvnia exchange rate to reach UAH/USD 5.36 instead of the previously targeted UAH/USD 5.39 in 2003.

Private sector lending by commercial banks continued to accelerate in July, while average lending rates picked up. This reflects a strong demand for credit money from a rapidly growing economy. In July, the growth of commercial bank loans increased to 61% yoy, while the average lending rate increased by 20bp to 14.8% annually. High wage growth contributed to rapid expansion of household deposits. In July, total deposits grew by 63% yoy primarily on account of an increase in household deposits. The average deposit rate went down to 6.2% annually in July compared to 6.4% in June.

Exchange Rate Dynamics, eop

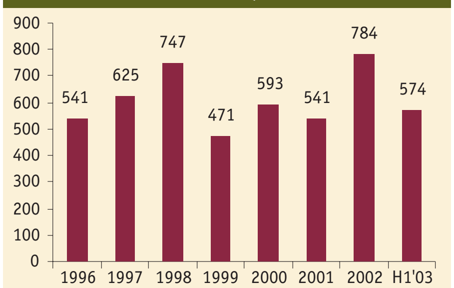


Source: National Bank of Ukraine

International Trade and Capital

In the first half of 2003, Ukraine's foreign trade surplus for goods and services increased 7% yoy to $1.86 billion. This improvement of its foreign trade balance indicates a strong demand for Ukraine's exports of goods and services. Also, this supports the view that Ukrainian economic growth is largely benefiting from the external sector.

Net FDI flows, USD mn



Source: : State Statistics Committee

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The trade balance for goods alone is not as favorable as the balance for goods and services. This is because growing investment demand is fuelling imports expansion. As a result, the merchandise trade surplus declined 8% yoy in the first half of 2003. Nevertheless, over the period, the surplus in trade of goods was still significant at $445 million or 2% of GDP for the period. In January-June, exports grew at 27% yoy, while imports expanded at 29% yoy. Ferrous metals exports remained among the largest contributor to overall merchandise exports growth. The trading volume of these items expanded by more than 31% yoy in January-June, while their share in total exports is still the highest at 32%. Chemicals exports were also on the rise, demonstrating 35% yoy growth over the first half of 2003.

On the import side, growth of oil and gas imports decelerated to 24% yoy (from 28% yoy in five month period), although these products still account for the largest share of Ukraine's imports (about 38%.) Increasing volumes of grain imports relative to the previous years' figures contributed to the import growth. Also, accelerating imports of machines and equipment (27% yoy growth) indicate the strengthening investment demand in the country.

On trade destination, Europe accounted for about 40% total merchandise exports during January-June, while Asia and CIS countries accounted for 25% each. At the same time, 50% of all goods imported to Ukraine came from CIS countries, whereas European countries' share constituted 32%. Still, demand for Russian goods is growing much faster than for European products, largely due to Ukraine's dependence on Russian energy resources and the relatively low purchasing power of Ukrainians.

Positive macroeconomic developments in Ukraine are having a positive impact on the flow of foreign direct investment (FDI) to Ukraine. In the first half of 2003, net FDI increased by almost 10.5% yoy to $574 million, reflecting growing investor confidence in the Ukrainian economy. Thus, the cumulative amount of foreign direct investment to Ukraine reached about $6 billion or $126 per capita. Nevertheless, this figure is still low compared to other transition economies. Based on cumulative figures, the largest amount of investment came from the USA with $998 million, followed by Cyprus with $631 million and the UK with $565 million. Judging by the amount of FDI attracted, the most attractive sectors for foreign investment are food processing and wholesale and retail trade, to which investors directed 15.2% and 14.4% of total FDI respectively. In 2003, the Ukrainian government expects $750 million in net FDI. However, recent data supports the view that the official forecast may be lower than the actual inflows in 2003.

International Programs

International financial organizations are still undecided on the resumption of their major lending programs in Ukraine. Following the failure of the Parliament to approve the law envisaging a restructuring of VAT refund debt, the IMF is likely to postpone its decision on the precautionary stand-by arrangement for Ukraine. Earlier, it was expected that the IMF Board would approve renewal of an active lending program with Ukraine in late August. At present, consideration of this issue is likely to be delayed until October. Under the precautionary stand-by program, Ukraine may receive up to $800 million over 3-5 years upon request by the Ukrainian government in emergency cases. The major issues that remain outstanding are repayment of VAT refund arrears, and the elimination of tax privileges. Therefore, Ukraine may expect a positive decision by the IMF only if it succeeds in addressing the above-mentioned issues during September. The renewal of cooperation with the IMF will also facilitate the resumption of World Bank adjustment lending.

The World Bank has also postponed the approval of the Second Programmatic Adjustment Loan (PAL-2) by its Board of Directors from September to the second half of October. Previously, it was announced that the World Bank would disburse $75 million of PAL-2 after approval of the loan in September, while the remaining $175 million envisaged by PAL-2 would be disbursed by the end of 2003, provided that Ukraine proceeds with the privatization of regional energy distributing companies. Elimination of tax privileges and restructuring of the state-owned Oschadbank are also among the conditions set by the World Bank for the loan disbursement. Consideration of the country assistance strategy (CAS) for Ukraine in 2004-2007 is quite likely to be put off until October as well.

Other Developments

The Ukrainian government is still expecting to join the WTO in 2004. So far, Ukraine has signed 14 of 22 agreements on mutual market access necessary to join the WTO, including one with the EU. In July, the government signed the market access agreement with Bulgaria. Also, Ukraine hopes for a prompt signing of the agreements on mutual market access with Poland and Brazil. However, the major obstacle to Ukraine's membership in the WTO remains the dispute with the USA over imports of the US poultry meat and protection of intellectual property rights. In addition, the recent regulations imposed on the grain market and the regulation of food prices may delay the recognition of Ukraine as a functioning market economy by the USA and the EU. This is also one of the important criteria for a country to become a member of the WTO.

Meanwhile, top officials of Ukraine, Belarus, Kazakhstan and Russia approved the draft agreement for the creation of the Common Economic Area (CEA) within the boundaries of these four countries. This, and other documents related to the creation of CEA, was agreed upon at the summit held in Yalta, Ukraine, on August 15, 2003. According to the mutually agreed definition of the CEA, it is assumed that the territories of participating states will have unified customs mechanisms and free movement of goods, services, capital and labor. They will also pursue a single foreign trade policy. The CEA is to be an open union, thus allowing for other states to join the union. Although the countries agreed to follow the rules and recommendations of the WTO in their integration efforts, most analysts view the creation of the CEA as a political rather than economic union. There are fears that it may result in substantial delays in the process of Ukraine's accession to the WTO.

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