

Ukraine - Economic Situation

Dr. Edilberto Segura

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Economic Growth

During September 2003, the exceptionally strong performance in industry and construction supported a record high GDP growth of 15% year-over-year (yoy). As a result, during January-September, Ukraine's GDP grew by 6.5% yoy, representing a solid increase as compared to the 5.3% yoy GDP growth reported in January-August.

In September, growth in industry reached 19.2% yoy. Since the beginning of the year, industrial output grew by 15.2% yoy, far exceeding the 6% growth rate observed in January-September 2002. The major contributors to September's industrial growth were food processing, machine building, metallurgy, and chemical industry. In September, strong external demand remained the main driver of growth in metallurgy and chemicals, whose output increased by 11% and 21% yoy, respectively. Metallurgy output was induced by a 34.5% yoy increase in the production of machinery. This solid growth in machine building throughout a year provides evidence of positive shift in the structure of industrial production towards higher-value added sectors. Other growth leaders included the domestic-market-oriented food processing industry that demonstrated 32% yoy growth in September. During this nine-month period, value-added in manufacturing, construction and transport surged by 17.2%, 25.7% and 10.5% yoy respectively.

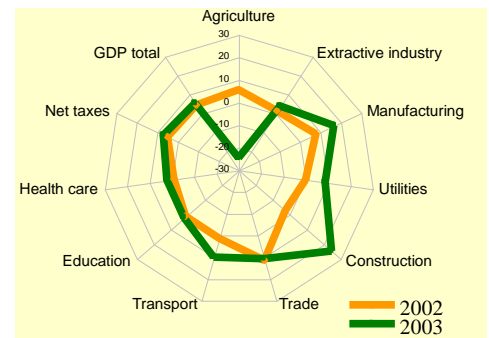
In September, the agricultural sector recovered to some extent, due to rich harvests of vegetables, potato, and sunflower seeds. As a result, the cumulative decline in agricultural value-added fell from 26% yoy in January-August to 16.7% yoy in January-September. Also, livestock farming demonstrated healthy rates of growth this year.

Due to the impressive performance of industry, the government has revised its growth forecast for 2003 from 6% to 6.5%. The IMF has also recently revised its forecast of Ukrainian economic growth in 2003 from 4.8% to 5.3%.

Fiscal Policy

Supported by robust economic growth, fiscal performance has been very good. In January-September, the state budget posted a surplus of UAH 703 million (\$132 million), or 0.4% of the period GDP. Over this period, state budget revenues reached UAH 39.3 billion (\$7.4 billion), and expenditures amounted to UAH 38.6 billion (\$7.2 billion). Both revenues and expenditures of the state budget have increased by 17% yoy in real terms. Such an increase can be attributed to rich tax receipts, primarily from corporate profit and personal income taxes driven by high rates of economic growth during the year. However, the problem of timely refunds of VAT arrears still remains unresolved, thus casting shadow over the generally positive fiscal picture. This was the main reason for the IMF to further

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



Source: State Statistics Committee

delay its financing program resumption for Ukraine. Presently, the amount of VAT refund arrears amount to UAH 6.5 billion (\$1.2 billion), which is too heavy a load for the budget to handle given the heavy external debt repayments due in 2003 and 2004.

The risk of under-execution of the privatization program this year has diminished. The State Property Fund has managed to sell UAH 1.735 billion (\$326 million) worth of the state property during January-September. This result is consistent with the annual target of \$400 million in privatization receipts. Despite this generally positive privatization performance, Ukraine's investment climate may be affected by the intention of the State property Fund to re-nationalize earlier privatized enterprises due to failure of investors to meet all agreed post-privatization requirements. This would affect two oblenegos - Khersonoblenergo and Kyrovogradoblenergo that were sold to a Slovakian power company.

With regard to the next year's budget, on October 24, the Parliament approved the 2004 Draft Budget on its first reading. Fiscal revenues would reach UAH 61.1 billion (\$11.5 billion), while expenditures would amount to UAH 64.6 billion (\$12.1 billion). Thus, the approved budget deficit for 2004 is targeted at UAH 3.34 billion or 1.2% of expected GDP. This expected fiscal gap will be financed out of privatization receipts, and domestic and external borrowing. This draft budget proposal was based on the removal of tax privileges, expansion of the tax base, and introduction of export duty for natural gas. During the same sitting, the members of the Parliament approved several tax laws necessary for successful budget execution, including those eliminating certain VAT privileges. Earlier, President Kuchma had vetoed an earlier law that envisaged a reduction of VAT rates without a compensatory elimination of tax privileges. It remains to be seen whether the newly adopted tax bills pass through the President's approval.

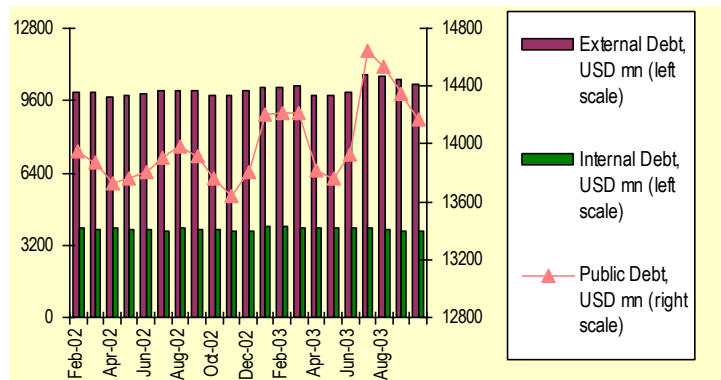
Following the repayment external debt payments in September, the total public debt fell by \$178 million or 1.2% during September. As a result, the public and publicly guaranteed debt reached \$14.2 billion equivalent at the end of September.

In September, the stock of external debt declined to \$10.3 billion equivalent (or 23% of GDP expected in 2003.) However, new placement of \$200 million worth of Eurobonds in October will make up for the September's reduction in the stock of external debt. The government decided to issue of Eurobonds in order to compensate for the suspended financing from the international financial institutions. Given a good demand for Ukraine's sovereign Eurobonds, the government managed to place the new issue at the same favorable terms as in June this year (at 7.65% rate and 10 years maturity). The newly Eurobonds got a B+ rating from Fitch rating agency. Overall, the government planned to borrow up to \$1.1 billion in 2003. So far, \$1 billion has been attracted from the external creditors including \$800 million in June and \$200 million in October.

Monetary Policy

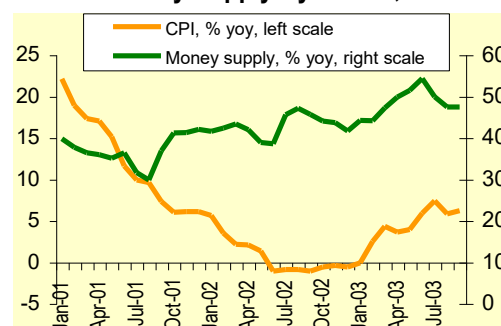
In September, increases in food prices led to an annual inflation rate of 6.2% yoy, compared to 5.8% yoy inflation rate a month before. Although growth of bread and cereal prices continued to decelerate in September (as administrative regulations were still in place), retail gasoline prices and some transport tariffs were on a rise, thus contributing to inflation pickup during the month.

Public Debt Dynamics, 2002-03



Source: Ministry of Finance

CPI and Money Supply Dynamics, 2001-03



Source: State Statistics Committee, NBU

Since the beginning of the year to the end of September, the Consumer Price Index (CPI) grew by 3.3% year-to-date (ytd). Being the major determinant of consumer prices, food prices increased by 3.9% ytd. Growth of non-food and service prices increased by 0.8% and 3% ytd, respectively. These developments led the government to revise its end-year inflation target. The official end-of-period (eop) inflation forecast was increased from 6% to 7-7.2% for 2003.

Despite the acceleration of inflation, monetary policies have been expansionary with high growth of monetary aggregates. In September, money supply (M3) grew by 50% yoy after a slight slowdown in August (47% yoy). Since the amount of cash in circulation and the monetary base declined in September, the increases in M3 (4.2% monthly pickup) can be explained by a growth in bank deposits. The reduction of the monetary base in September could be attributed to heavy external debt payments performed during the month. This was also the main reason for the reduction of the NBU's international reserves. At the end of September, the gross international reserves of the NBU declined by \$232 million to \$6.68 billion. However, the recent placement of sovereign Eurobonds by the government allowed NBU to replenish its reserves to a record high \$7 billion at the beginning of October.

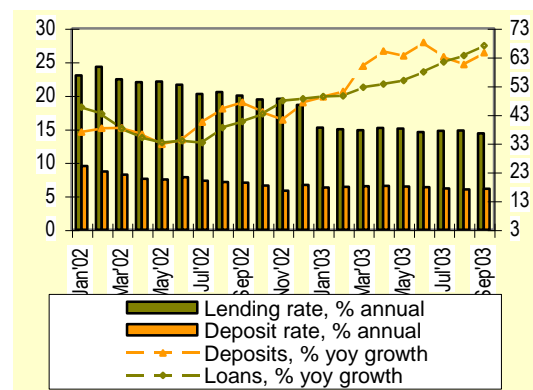
Active NBU's interventions on the local forex market allowed it to prevent hryvnia appreciation that could harm export competitiveness. During September, the official hryvnia exchange rate has remained unchanged at 5.33 UAH/USD as of end-month. At the same time, the hryvnia depreciated against Euro in September when the UAH/EUR exchange rate picked up 5.4% over the month to 6.08 UAH/EUR.

In September, Ukrainian commercial banks continued to expand their loan portfolios trying to make use of accelerated inflow of deposit money. During the month, the volume of private sector lending by commercial banks surged to 66% yoy following the reduction of the average lending rate. In September, the average rate on loans decreased by 45 basic points to 14.4% annually primarily due to substantial reduction in the cost of hryvnia loans. Steady income growth and the end of vacation season were the major drivers for deposit growth acceleration in September. During the month, total deposits growth increased to 64% yoy from 60% yoy reported in August. Also, an increase of the average deposit rate to 6.1% annually contributed to deposit growth over the period.

International Trade and Capital

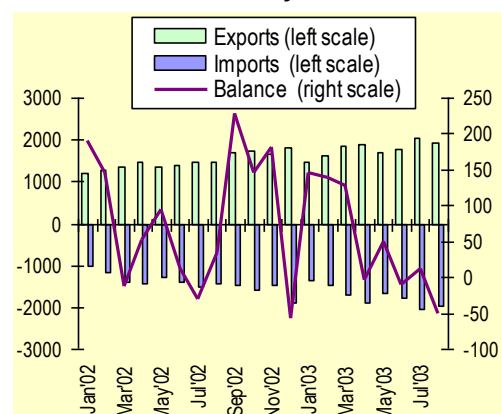
In January-August, the surplus in the Trade of Goods account declined 16% yoy to \$404 million as imports growth slightly exceeded exports increase. Over the period, exports grew by 29% yoy to \$14.3 billion, while imports increased by 31.2% yoy to \$13.9 billion. In August alone, substantial acceleration of imports caused a USD 52 million merchandise trade deficit, even though export performance remained strong. Higher oil prices and strengthening investment demand could be blamed for imports growth acceleration. Strong demand for traditional Ukrainian export items such as metals and chemicals provided for healthy

Loans and Deposits Growth and Interest Rates Dynamics



Source: National Bank of Ukraine

Merchandise Trade Dynamics, USD mn



Source: State Statistics Committee

export performance during the year. Also, machinery exports sped up from 17.3% yoy in January-July to 27.2% yoy in January-August reflecting strong trend towards diversification of Ukraine's exports. Meanwhile, geographical orientation of Ukraine's foreign trade remained virtually unchanged. Europe accounted for 39% of total merchandise exports during January-August, while Asia and CIS countries accounted for 24.5% and 25.7% of goods exports respectively. At the same time, slightly over 50% of all goods imported to Ukraine came from CIS countries, whereas European countries' share constituted 34%.

International Programs

Negotiations between the Government and the IMF in early October failed to produce positive results. As a result, it is unlikely that a precautionary stand-by arrangement would be approved in 2003. Despite satisfactory overall macroeconomic performance, the IMF mission concluded that the Ukrainian government had failed to make sufficient progress to resolve the VAT refund arrears problem.

The failure to reach an agreement with the IMF delayed disbursement of adjustment lending from the World Bank. The World Bank postponed the approval of the Second Programmatic Adjustment Loan (PAL-2) until December 2003. The World Bank Board of Directors also approved a new Country Assistance Strategy (CAS) for the period of 2004-2007. According to the CAS, the World Bank plans to extend \$2.4-3.0 billion of loans for implementation of structural reforms and sustaining macroeconomic stability. On October 20, 2003 the government and the World Bank has signed a loan agreement for disbursement of \$195 million for implementation of Rural Finance Project. The purpose of the project is to increase the transparency of land distribution in Ukraine through formation of cadastre system for agricultural land privatization and issuance of state acts on land ownership. The World Bank will disburse these funds as soon as the Parliament approves the project.

Other Developments

During the EU-Ukraine summit that took place in Yalta, the EU highest-ranking officials stated that Ukraine could become the EU candidate at some point in the future. This was the first time that such a favorable statement was made. However, the EU officials failed to discuss a possible date of Ukraine's accession to the EU. As noted in previous reports, Ukraine's participation in Common Economic Area (CEA) agreement with Russia, Belarus and Kazakhstan was perceived as a threat to Ukraine's European integration policy by the western community.

Ukraine's accession to the WTO is unlikely to take place earlier than late 2004. So far, Ukraine has signed 15 of the 22 agreements on mutual market access that are necessary to join the WTO. Ukraine has to sign an agreement on mutual market access with the US, which is likely to occur not earlier than 2004. Although Ukraine has agreed to lift its ban for poultry imports from the US, negotiations with the US can be expected to take several months. In addition, there are some issues in Ukraine-US bilateral relations that require US legislative action (e.g. the removal of Jackson-Vanik amendment), and thus could not be expected earlier than in January-February 2004. Also, Ukraine has to improve enforcement of intellectual property rights legislation in order to get a market economy status from the US.

During the recent plenary session of the Financial Action Task Force (FATF), Ukrainian officials presented its plan of bringing Ukrainian legislation on money laundering closer to international standards. The successful implementation of this legislation would facilitate Ukraine's removal from the black list of non-cooperating countries. The Ukrainian government expects to have the country removed from the list by February 2004.