Ukraine
Macroeconomic Situation

DECEMBER 2003

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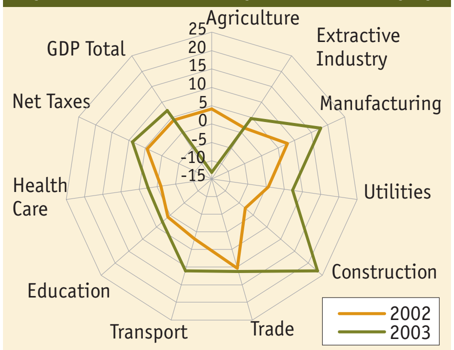
Economic Growth

Ukraine's excellent economic performance in the last three months of the year should ensure that it will be among the best performing countries in the world in 2003 in terms of GDP growth. In November 2003, Ukraine's real GDP grew by 12.1% yoy, following growth rates of 12.3% yoy in October and 15% yoy in September. During January-November, Ukraine's GDP grew by 7.7% yoy, supported by an expansion of 15.5% yoy in industrial output and a marked growth in construction of 23.0% yoy.

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



Source: State Statistics Committee

In November 2003, industry posted a 14.3% yoy growth, bringing the cumulative figure to 15.5% yoy in January-November. The major contributors to industrial growth have remained the machine-building industry, food processing, metallurgy, and chemicals. Since the beginning of the year, the machine-building industry has remained the growth leader, with production increasing by 34% in November, following an increase of 38% yoy in October. The food industry also expanded significantly, supported by a steady growth of household income. In November, food processing output increased by 21% yoy. Favorable external conditions allowed for further acceleration of growth in metallurgy and chemicals, whose output increased by 22.9% and 16.9% yoy, respectively.

Other contributors to GDP growth included service sectors. During the January-November period, value-added in construction and transport surged by 23.3% and 12% yoy, respectively. Meanwhile, the agricultural sector has continued to recover as the cumulative decline in agricultural value-added fell from 26% yoy in January-August to 11.9% yoy in January-November. The major reason for this development was the rich harvest of vegetables, potatoes, and sunflower seeds.

This impressive real sector performance led the government to adjust its year-end economic growth figure. In November, the Ministry of Economy revised its GDP growth forecast for 2003 from 6.5% to 7.9%, expecting continuation of solid industrial growth during the last months of the year.

Fiscal Policy

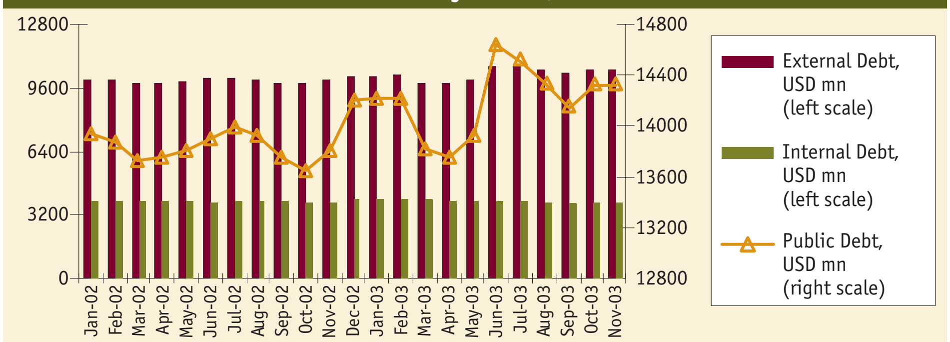
Fiscal performance has remained solid, supported by higher than expected rates of economic growth. In January-November 2003, the state budget showed a surplus, which reached UAH 762 million ($144 million), or 0.34% of the period's GDP (the original plan called for a consolidated fiscal deficit of 0.4% of GDP.) Over the January-October period, state budget revenues grew by 23% yoy to reach UAH 44 billion ($8.25 billion), and expenditures increased 26% yoy to UAH 43.5 billion ($8.15 billion.) Fiscal authorities were able to over-fulfill their tax collection targets due to an impressive growth in industry and other sectors of the economy. Receipts of corporate profit and personal income taxes were the major sources of state budget revenue. At the same time, the execution of the state budget on the expenditure side lagged slightly behind plan, as the government reduced expenditures due to uncertainties over deficit financing. Privatization receipts, one of the major deficit financing items, came in at about $320 million (or 80% of the annual target) in January-October. Recently, the State Property Fund announced that although this result was consistent with the annual targets of the government, it would be difficult to complete the remaining privatizations for 2003, due to a difficult pre-election political environment.

The prospects for the 2004 fiscal budget are also positive. The fiscal budget for 2004 was passed on November 27th, despite confrontations between the opposition and pro-presidential political groups. Two days later, President Kuchma signed the budget law. After going through two readings in the Parliament, the parameters of the draft budget have changed. Both revenue and expenditure in the part of the draft budget have been increased relative to those proposed by the government-by UAH 2.5 billion and UAH 4.4 billion, respectively. According to the approved version of the fiscal budget for 2004, state budget revenues should reach UAH 60.7 billion ($11.4 billion), while expenditures should amount to UAH 64 billion ($12 billion). Thus, the approved budget deficit for 2004 is targeted at UAH 3.4 billion or 1.2% of expected GDP. Next year's budget is based on the following forecasts: 4.8% GDP growth, 6.7% end-of-period inflation, and an average hryvnia exchange rate of UAH/USD 5.38-5.42. This expected fiscal gap will be financed out of privatization receipts and borrowings. Also, the 2004 Budget law envisages restructuring overdue VAT refund arrears into government securities. The total amount of VAT refunds to be restructured would amount to UAH 1.9 billion ($360 million.) This move would satisfy the IMF, as this issue has been the major stumbling block in negotiations on a proposed precautionary stand-by arrangement.

Although 2004 budget targets look quite manageable, a note of caution should be made on several issues envisaged by the document. First, the Parliament extended the tax privileges enjoyed by agricultural producers for one more year, until the end of 2004. This decision by members of Parliament was aimed at compensating the agricultural sector for the unfavorable condition in the sector in 2003. Second, the minimum wage increase has been reduced from the initially planned UAH 237 to UAH 205 starting December 1, 2003. This issue caused strong protests from opposition forces, who accused the government of creating a socially irresponsible budget. And finally, the 2004 budget foresees a significant increase in subsidies to coal mines.

A new placement of Eurobonds ($200 million) in October led to an almost equivalent increase of total public debt. In October, total public debt grew by 2.5% month-over-month to reach $14.34 billion equivalent at the end of October. During the month, the stock of external debt increased to

Public Debt Dynamics, 2002-03



Source: Ministry of Finance

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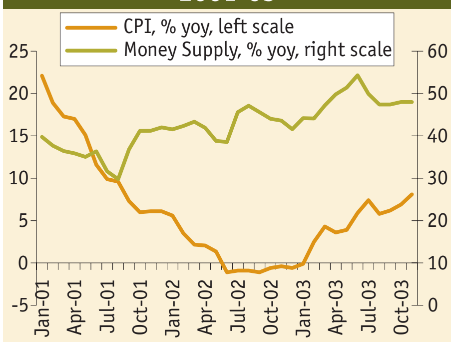
$10.5 billion equivalent (or 23.4% of GDP expected in 2003). In November, the stock of public debt ramained unchanged at $14.34 billion. In December, the stock of public debt should go down as the government has already fulfilled its borrowing plan for the year, judging by the current fiscal performance. Since the beginning of the year, Ukraine has borrowed $1 billion from the external market out of an initially planned $1.1 billion. At the same time, the government repaid $1.57 billion on its public debt obligations, including $1.19 billion to its external creditors. Timely payments on its external debt and the strong macroeconomic performance of the country contributed to the gradual improvement of Ukraine's sovereign credit rating. Recently, Fitch rating agency affirmed Ukraine's foreign currency rating at B+. However, it noted that the country's rating is constrained by political risks due to forthcoming presidential elections.

Monetary Policy

Consumer inflation accelerated significantly in November. During the month, consumer prices grew by 1.9%, thus bringing the inflation rate to 6.6% since January. In November, increases in food prices led to an annual increase of 11% yoy. Growth in food prices, especially for bread and cereals, continued to be the key determinants of the overall level of consumer prices. Despite regulating efforts by the government, the poor grain harvest led to a sharp increase in bread prices all over Ukraine. In November, bread prices increased to 26.6% yoy from 12.7% the month before. The cost of housing and utilities services also began increasing with the beginning of the heating season in October.

CPI and Money Supply Dynamics, 2001-03



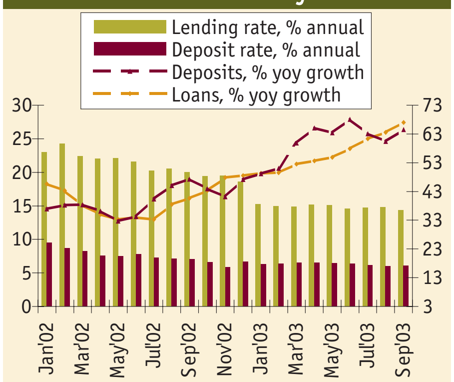
Source: State Statistics Committee, NBU

The Ministry of Economy anticipates that consumer inflation will reach 1.6 % in December. Such an outcome would bring the official end-of-period (eop) inflation rate to 8.3% for 2003 rather than the 7.5% forecasted by the Ministry of Economy.

The growth of monetary aggregates slowed slightly due to the accelerating inflation. In November, the growth rate of the monetary base declined to 30% yoy compared with 31% yoy growth a month before. The money supply (M3) growth remained unchanged during the month at 48% yoy. The decelerating trends in the growth of the monetary aggregates came as a result of less active NBU interventions on the local forex market. During October, the NBU turned from net purchaser to net seller of foreign currency, which resulted in a temporary increase of demand for hryvnia resources on the interbank market. Although bank deposits kept growing at a high pace, commercial banks experienced short-term liquidity problems during November. As a result, the NBU had to sharply increase its refinancing to commercial banks in November. At that, the level of international reserves kept by the NBU remained sound. At the end of November, the gross international reserves of the NBU amounted to $6.9 billion, having increased by less than $100 million during the month.

In November, the exchange rate for the Ukrainian hryvnia remained relatively stable against major currencies. During the month, the official hryvnia exchange rate remained at 5.33 UAH/USD (as of end-of-month.) At the same time, the hryvnia/euro rate increased by 1.4% over the month to 6.35 UAH/EUR. The hryvnia depreciation against the euro reflects fluctuation of the euro on the international markets.

Loans and Deposits Growth and Interest Rates Dynamics



Source: National Bank of Ukraine

With the support of the NBU through discount lending, Ukrainian commercial banks continued to expand their loan portfolios in November. During the month, the volume of private sector lending surged to a record high 69% yoy. At the same time, the average lending rate increased by 10 basis points to 14.8% annually in November, mainly due to the somewhat higher cost of hryvnia loans. Continuation of robust household income growth allowed commercial banks to attract 61% more deposits in November than over the same period a year ago. Also, further increase in the average deposit rate to 7.2% annually contributed to deposit acceleration over the period.

International Trade and Capital

During the first three quarters of 2003, the balance of foreign trade in goods and services saw a healthy surplus of $2.5 billion (or about 7.5% of period GDP.) Imports continued to grow faster than exports primarily due to higher demand for investment goods from abroad. Exports of goods and services increased by 24% yoy to $19.4 billion, while imports grew by 31% yoy to $16.9 billion. Traditionally, the balance of services trade account is significantly higher than the merchandise trade balance. In January-September, the surplus in the services trade account amounted to a substantial $2.1 billion, mainly due to robust growth of receipts from oil and gas transportation services provided to CIS countries.

At the same time, a surplus in the trade of goods account continued to decline. In the first three quarters of 2003, the merchandise trade surplus amounted to $375 million, almost half of the amount reported last year. The major reason for a declining merchandise trade surplus was a significant acceleration of imports growth relative to exports increase. The most likely explanation for such a development is increasing investment demand from rapidly growing industries seeking to renovate their outdated capital assets. Over the period, good exports growth slowed to 28% yoy to $16.3 billion, while good imports increased by 32% yoy to $16 billion. Nevertheless, Ukrainian export performance remained robust due to still strong demand for traditional Ukrainian export items such as metals and chemicals. In particular, machinery exports sped up from 27% yoy in January-August to 33% yoy in January-September, reflecting gradual diversification of Ukraine's export items. At the same time, the share of grain exports continued to decline due to the poor grain harvest, falling to 1.7% of total exports compared to almost 5% a year ago.

On the merchandise import side, imports of machines & equipment and energy resources were the two major items contributing to total imports growth. However, energy resources growth began to slow down (to 21% yoy), while machinery imports kept accelerating, posting 32% yoy growth in January-September. Meanwhile, the geographical breakdown of Ukraine's foreign trade saw only minor changes.

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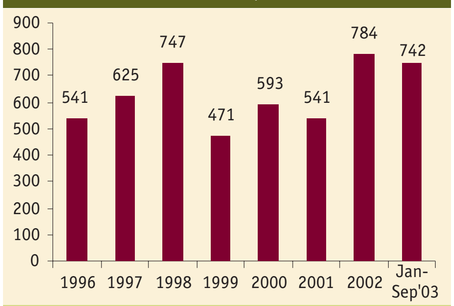
Although Russia still remains Ukraine's major trading partner (accounting for 35% of all imports and 18% of all exports), trade turnover with Europe has been growing faster than with Russia. During January-September, exports to European countries grew by 37% yoy in contrast to 34% yoy growth of exports to Russia. At the same time, demand for goods imported from Asian countries and Russia grew much faster than for European products, partly because of the relatively low income level in Ukraine.

Robust economic growth in the country stimulated an acceleration of foreign direct investment (FDI). In January-September, net FDI reached $742 million, which is 86% higher than over the same period last year. Since Ukraine's independence, the cumulative FDI stock has reached just over $6.2 billion. However, this figure is still low in per capita terms (only $130), compared to the corresponding figures in other transition economies. The largest amount of FDI came from the USA (16.4% of the cumulative figure), Cyprus (10.4%), and the UK (10.1%). The relatively large share of investments originating from Cyprus suggests that part of the earlier outflows of Ukrainian capital is gradually returning to the country. However, FDI dynamics may deteriorate in 2004 as presidential elections get closer, since foreign investors usually become more cautious when political risks rise.

Net FDI Flows, USD mn



Source: : State Statistics Committee

International Programs

Ukraine's relations with international financial organizations have improved. On December 9th, the World Bank approved the $250 million Second Programmatic Adjustment Loan (PAL-2). Disbursement of $75 million will take place immediately, with the remaining $175 million to be disbursed in 2004 based on Ukraine's policy performance. The World Bank cited the following achievements made by Ukraine, which led to the approval of the loan:

(i) better financial discipline with pubic sector wages and pensions being paid regularly and on time;
(ii) significant reductions in arrears on social protection payments;
(iii) better tax collection, with 2003 being the first year in which Ukraine's enterprise sector as a whole is staying current on tax obligations, including enterprises of the energy sector;
(iv) cash collection by energy companies for services rendered have increased further, reaching 91% for electricity services and 87% for gas services over the last 12 months;
(v) improved regulatory and institutional environment for the financial sector and investment;
(vi) acceleration of Ukraine's bid to join the World Trade Organization;
(vii) progress in the development and protection of property rights;
(viii) important progress on tax reform;
(ix) completion of the audits of three of Naftogaz's largest subsidiaries by an internationally reputable auditing firm, with progress being made toward a comprehensive audit of the entire company according to international standards for 2004.

In order to qualify for release of the second tranche of $175 million, Ukraine will need to meet a number of conditions. These include: maintaining no net increase in tax debts to the budget without the use of tax amnesty; requiring local governments to pay heat and hot water providers for the losses created if tariffs set by local governments are below normal costs; eliminating all electricity tariff privileges assigned to individual companies or sectors; enactment of a law on debt resolution in the energy sector; launching a tender to sale the remaining state-owned oblenergos; enacting a law that forms the legal basis for a unified system of registration for legal rights to land and real estate; adopting (by the Cabinet of Ministers) on internal financial audit and control to establish a modern system of internal accountability for the use of public funds; and further reducting tax exemptions.

All of the above reforms are meant to improve financial discipline, regulatory policies, property rights, public sector accountability, and management of social and environmental risks.

In meetings with the IMF on December 17th, the government expressed its strong interest in cooperating with the IMF under a precautionary stand-by program. The IMF program would be for 15 months. During that time, Ukraine could use funds of up to SDR514.5 million if the need arises. During the meeting, the IMF stated that it saw no major obstacles to the signing of the agreement in the near future.

Other Developments

On the international front, the Ukrainian government has made considerable progress towards WTO entry and hopes to be accepted by the end of 2004. So far, Ukraine has signed 19 of the 22 agreements on mutual market access that are necessary to join the WTO. Recently, Ukrainian officials reached agreements on mutual market access and signed corresponding documents with Brazil, Israel, Poland, and Estonia. A bilateral agreement with the US has yet to be signed. Recently, Ukraine sent official applications to the US Government and the EU requesting to be recognized as a functioning market economy. Market economy status would facilitate Ukraine's accession to the WTO and improve Ukraine's treatment in trade disputes. Among the major criteria for obtaining market economy status are overall macroeconomic stability, liberalized prices and trade, absence of significant barriers to market entry and exit, proper regulation of property rights and contract enforcement, and a sufficiently well-developed financial sector. In general, Ukraine meets these criteria, and thus may count on getting market economy status soon. However, Ukraine has to improve enforcement of its intellectual property rights legislation in order to obtain market economy status from the US.

As additional evidence of the government's strong commitment to entering the WTO, President Kuchma signed a decree calling for the government to abandon the practice of granting special privileges to individual enterprises and sectors, including tax, custom duties and others. According to the decree, the major reason for such a move was due to the various privileges extended to various sectors of the economy and the difficulties this caused the government during negotiations on WTO entry. The first industry that is likely to be influenced by the decree is the auto-making industry, where privileges granted to one producer created an unfair operating environment for other market participants.