Ukraine
Macroeconomic Situation

July 2004

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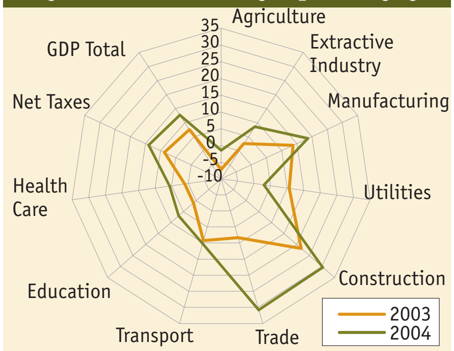
Economic Growth

The Ukrainian economy continued to show remarkable growth in June, underpinned by strong external and domestic demand. Real GDP growth leaped by 19.1% year-over-year (yoy) bringing the cumulative figure to 12.7% yoy.

The major sectors contributing to this growth were construction, domestic trade, manufacturing and transport. Growth in these sectors more than compensated for the continuing decline in agriculture.

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



Source: State Statistics Committee

Between January and June, the construction sector had outstanding performance with growth of 30.3% yoy. A sharp rebound in domestic demand led to a growth rate of 30.7% yoy wholesale and retail trade in contrast to 18.3% yoy in January-May. However, industrial output growth slowed in June after reaching its peak growth of 20% yoy in March. The major reason for the slowdown in industry was a sharp reduction in the growth rates of metallurgy and machine building, though they remained among the growth leaders. Nevertheless, industrial growth rates are still reasonably high; production of metals increased by 9.4% yoy in June and the machine-building industry increased its production by 23.6% yoy. These sectors are likely to maintain high growth due to the relatively diversified structure of machine building output. While production of agricultural machines and railway vehicles is slowing down, carmakers and producers of electric machines and equipment continue to expand their production at an accelerating pace. Routine repairs at the two biggest oil refineries in the country resulted in 2.5% and 5% yoy decline of output in the coke and oil-refining industry in May and June, respectively. Thanks to a favorable external environment, growth in chemicals surged 11.5% yoy.

For 2004, the government expects GDP growth to reach 9.5%. This is higher than the earlier forecasted 6.5% and may turn out to be optimistic, given the recent slowdown in industrial expansion and the acceleration of producer price growth. A sharp increase in world oil prices may result in further deceleration of industrial production growth due to the high energy-intensity of industrial output. At the same time, agricultural output is expected to grow considerably this year due to the low starting point of last year. Thus, Ukraine's economic growth outlook remains quite positive for 2004.

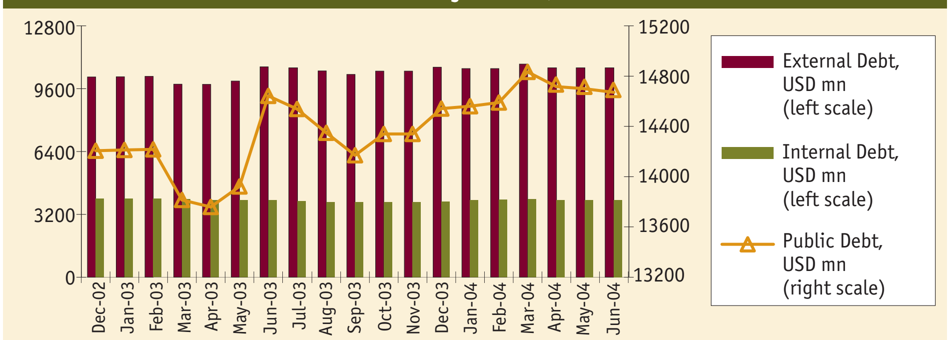
Fiscal Policy

The implementation of several large privatization deals has led to some fiscal policy softening and triggered a revision of the 2004 fiscal budget. The privatization of the large metallurgical plant Kryvorizhstal and the coal mine complex Pavlogradvuhillia provided the government with extra budget resources, allowing it to increase social expenditures, to support agricultural producers, and to raise minimum wages from UAH 205 to UAH 237 beginning September 1, 2004. At the request of the government, the Parliament of Ukraine has now adopted amendments to the 2004 Budget, which foresee an increase of state budget revenues by UAH 4.5 billion ($850 million) and expenditures by UAH 8 billion ($1.5 billion). As a result, the state budget deficit is now planned at UAH 7.4 billion ($1.4 billion), which is equivalent to about 2.2% of GDP expected in 2004. The higher budget gap is to be covered by privatization revenues and new borrowing.

The annual target for privatization proceeds has been revised from UAH 2.1 billion to UAH 5.2 billion ($978 million). The government increased its expected privatization revenues after the aforementioned two large privatization deals were completed.. So far the State Property Fund (SPF) has sold Kryvorizhstal to the Industrial Metallurgical Union for $804 million. However, this deal has been challenged in court by several bidders that were not permitted to participate in the tender. Pavlogradvuhillia has also been sold to a domestic investor affiliated with a Donetsk financial group, which offered UAH 1.4 billion for the stake. On this basis, privatization proceeds reached some UAH 6.5 billion ($1.2 billion) in the first half of 2004, an amount that is higher than the revised annual target. Meanwhile, the SPF hopes to unload another large mining enterprise, Ukrrudprom, and a 43% stake in the state telecom, Ukrtelecom.

During January-May, the state budget posted a UAH 432 million ($81 million) surplus, which is slightly less than 0.4% of period GDP. Budget revenues reached UAH 23.2 billion ($4.36 billion) over this period, while expenditures amounted to UAH 22.8 billion ($4.28 million). Rapid economic growth was the basis for the growth of tax revenues. During January-May, VAT and excise tax revenues increased the most by 15.6% yoy and 33% yoy, respectively. Over the same period, proceeds of corporate income tax grew by only 3.6% yoy as the rate was cut by 5 percentage points, effective January 2004. Due to the cut in the personal income tax (PIT) rate to 13%, collection of PIT turned out to be worse than a year ago as PIT revenue fell by 1.3%. Nevertheless, current fiscal performance indicates some success in the tax reform program, which shows that companies tend to bring their transactions out of the shadow economy when tax rates are reduced. At the same time, further changes in tax reform are uncertain. Parliament failed to adopt draft laws that called for the reduction of the VAT rate (from 20% to 15%) and the strengthening of VAT administration through the introduction of VAT accounts. However, many issues related to the functioning of VAT accounts were poorly thought out, and the introduction of those accounts could have increased transaction costs for businesses due to the freezing of funds on these accounts. As a result, the decision has met strong resistance from industry groups, and was postponed until September when members of Parliament return to work after summer break.

Public Debt Dynamics, 2003-04



Source: Ministry of Finance

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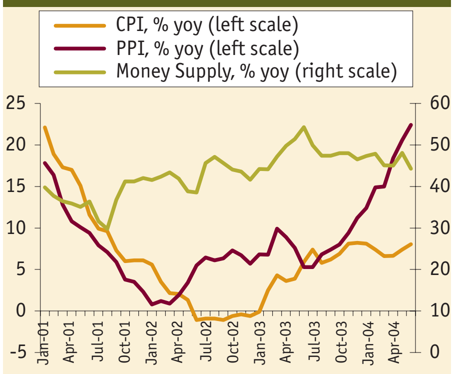
During the first half of the year, the amount of public debt increased slightly by 1.1% to $14.7 billion equivalent at the end of June. As a share of GDP, this is a relatively low level compared to other transition economies in the region. In June, the stock of external debt declined only marginally by 0.3% to $10.7 billion equivalent. In total, the 2004 budget envisages $1.2 billion in external borrowing and $1.53 billion in external debt repayment and service. Meanwhile, Parliament approved a bill allowing the Ministry of Finance to manage the state debt, thus allowing for opportunities to optimize borrowing and repayment schemes. In particular, the Ministry of Finance expects to reduce external debt servicing by 18% to $415 million.

Monetary Policy

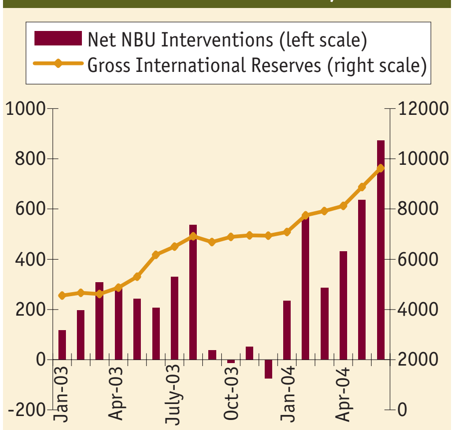
CPI and Money Supply Dynamics, 2001-04



Source: State Statistics Committee, NBU

The deceleration of consumer prices early in the year reversed in May, reflecting the spillover of producer inflation into the retail market. In May and June, the CPI increased by 1.4% indicating that hopes for summer deflation were not realized. As a result, annual growth of consumer prices jumped from 6.64% yoy in April to 8% yoy in June. Increases in food prices accelerated in June to 9.8% yoy from 8.9% yoy in April. Non-foods prices grew 4.3% yoy in June, almost double April's figure. The major reason for such an abrupt increase was growth of retail gasoline prices at the end of May, which soared more than 35% month-over-month. Gasoline producers correlated the price hikes to the increase in world oil prices. The government believes that the industry is oligopolist and responded to the situation in the gasoline market by introducing administrative price controls and rationing exports of refined oil. In addition, the government has developed regulations that would determine oil prices over the long term (about one year) and would set maximum profitability levels for gasoline market participants. These measures resulted in gasoline price stabilization, but prices remained much higher than in previous months. Thus, prices of other consumer goods may start to increase due to spillover effects. Services tariffs also followed an accelerating trend. In June, services tariffs growth picked up to 6.4% yoy, after 6.2% yoy growth a month before. The government expects full-year consumer inflation at 8% eop, up from the earlier forecasted 5.8-6.3%.

NBU's Forex Market Interventions and International Reserves, USD mn



Source: National Bank of Ukraine

The growth of producer prices continued to accelerate in June. Over the month, the producer price index (PPI) went up to 22.4% yoy from 20.6% yoy a month before. The highest growth of prices was registered in resource-intensive industries like metal processing, coke and oil refining, and mining.

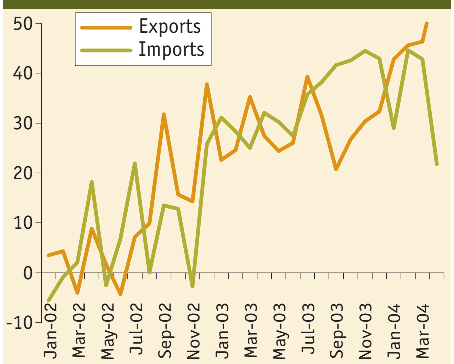
Monetary aggregates growth slowed down in June. Over the period, money supply (M3) growth fell to 44% yoy from 48% yoy in May. Mounting inflationary pressure made the National Bank of Ukraine (NBU) switch to stricter monetary policy, including a discount rate increase and tougher control over commercial bank lending. The NBU increased its discount rate from 7% to 7.5% annually, effective June 6th. So far, monetary aggregates growth remains in line with the NBU's annual growth targets of 26-32% yoy for the monetary base and 32-39% yoy for the money supply. Meanwhile, the NBU continued to accumulate its gross international reserves to about $8.9 billion at the end of May, due to the plentiful inflow of exports proceeds. Foreign exchange purchases by the NBU on the interbank market amounted to $636 million in May and $783 million in June, but part of the forex purchases were sterilized by the NBU though issue of deposit certificates. Thus, the NBU has already outperformed its year-end target for gross reserves of $8.5 billion. However, the NBU's reserves may shrink later in the year when large external debt repayments are due.

Excessive export-related foreign exchange inflow caused a small nominal appreciation of the hryvnia in June. Since the beginning of the year, the official hryvnia exchange rate appreciated by 0.2% to 5.321 UAH/USD at the end of the month. Over the same period, the hryvnia/euro rate also fell 2.8% year-to-date to 6.48 UAH/EUR.

Commercial banks continued the rapid expansion of their lending portfolios, fueled by the accelerating growth of deposits. In June, bank deposits grew by 56.4% yoy, while commercial bank lending increased by 57.6% yoy, slightly slower than last month's growth. The average cost of hryvnia loans decreased 80 basis points in June to 16.6% annually. Over the same period, the average rate on hryvnia deposits went up 220 basis points to 7.7% annually. Following the introduction of stricter reserve requirements by the NBU in June, banks' credit growth is expected to slow down further; therefore, the risks associated with high credit growth should decrease as well.

International Trade and Capital

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

In January-April, the foreign trade account showed a large surplus due to remarkably strong export growth. The surplus in the trade of goods account increased to $1.55 billion, which is almost four times more than the same period last year. In January-April, growth of merchandise exports soared 49% yoy to $10.1 billion, exceeding imports growth of 34% yoy to $8.6 billion.

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By product breakdown, the largest contribution to the overall growth of merchandise exports came from machinery and transport equipment. These items' trading volume expanded by more than 90% yoy in January-April, and their share in total exports made up 17%. Robust economic growth in CIS countries, which are the main consumers of Ukrainian produced machines, helped cause the remarkable growth of machinery exports. Over the same period, exports of metals and chemicals remained in great demand in the rest of the world and grew by 46% yoy and 45% yoy, respectively.

On the merchandise import side, imports of machines and transport equipment and of energy resources were the two biggest items contributing to total imports growth. In January-April, energy resources imports, which account for 37% of total imports, grew 17.9% yoy (up from 15% in February). On the other hand, machinery and transport equipment imports increased by 65% yoy, reflecting the strengthening investment demand in the country.

The geographical breakdown of Ukraine's foreign trade saw only slight changes. Due to Ukraine's dependency on energy imports from Russia, this country is Ukraine's biggest partner, accounting for 39.4% of all imports and 16.5% of all exports. The rest of Europe and the rapidly growing Asian countries are becoming more important on the export side. In January-April, the rest of Europe accounted for 41% of Ukraine's exports and 32.3% of its imports. The largest European partners for goods were Germany (9.8% of exports and 8.9% of imports) and Italy (4.6% of exports and 2.5% of imports). Over the same period, 23.6% of all exports went to Asian countries, primarily China and Korea.

International Programs

As reported earlier, the IMF resumed its cooperation with Ukraine under a Precautionary Stand-By Program at the end of March. The IMF program is for 12 months, during which time Ukraine can use funds amounting to $607 million or 30% of Ukraine's quota, but only if an urgent need arises. However, Ukraine's situation has improved substantially in recent years, and it is quite unlikely that the government will resort to IMF financing under the program. In May 2004, a regular IMF mission visited Ukraine to monitor the progress on structural reform. An important issue for IMF officials remains the progress in coping with VAT refund arrears. However, Ukraine still has not enacted legislation that improves VAT administration and VAT refund management.

Ukraine still has much to do in order to qualify for disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2) from the World Bank. After disbursing $75 million of the PAL-2 late in December 2003, the World Bank planned to unload the remaining $175 million of the loan in 2004 based on Ukraine's policy performance. In particular, the World Bank expects the Ukrainian government to strengthen the social and financial viability of the pension system, enhance the accountability of the state tax administration, implement an energy debt restructuring plan and resume the suspended privatization of remaining state-owned oblenergos, and establish unified registration for land and real estate ownership.

Other Developments

Ukraine again failed to obtain market economy status from the EU, which could substantially improve the treatment of Ukrainian exporters in anti-dumping investigations with EU members. In its official letter, the European Commission stated that Ukraine should resolve two important issues to be regarded as a functioning market economy. In particular, the European Commission is concerned with the non-market price regulation measures pursued by the government and deficiencies of bankruptcy legislation in Ukraine. In light of the recent development concerning the retail gasoline market and the beginning of the parliamentary holidays, these issues are not likely to be resolved in the next couple of months.

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