

Iryna Piontkivska, Edilberto L. Segura

Summary

Sharp acceleration in wholesale and retail trade and rapid recovery of agriculture supported robust GDP growth in the first seven months of 2004. In January-July, real GDP growth reached 13.5% year-over-year (yoy). This impressive macroeconomic performance led the government to improve the official GDP growth forecast from 9.5% to 10.5%. During the first half of 2004, fiscal performance has been satisfactory as the consolidated budget surplus made up 0.4% of period GDP. Good privatization performance has contributed to a positive fiscal outlook for 2004. In addition, the government issued \$500 million worth of Eurobonds at a record low rate of 5.36% per year at the end of July.

On the other hand, inflationary pressures have emerged. Consumer price growth continued to accelerate, while producer inflation slowed in July. Over the month, annual growth of consumer prices reached 8.1% yoy, while producers' inflation decelerated to 21.3% yoy. Increasing inflationary pressure caused the National Bank of Ukraine (NBU) to sterilize excess hryvnia liquidity by selling certificates of deposit (CDs). A huge foreign trade balance surplus allowed the NBU to further accumulate its gross international reserves to \$11.1 billion. In the first half (H1) of 2004, the trade of goods surplus reached \$2.4 billion, which is more than five times higher than that achieved during the same period last year. During the first half of 2004, net foreign direct investment (FDI) inflow amounted to \$574 million, an amount roughly equal to the level obtained during the same period last year. Ukraine's economic growth outlook remains quite positive for 2004 despite the risks associated with the upcoming presidential elections.

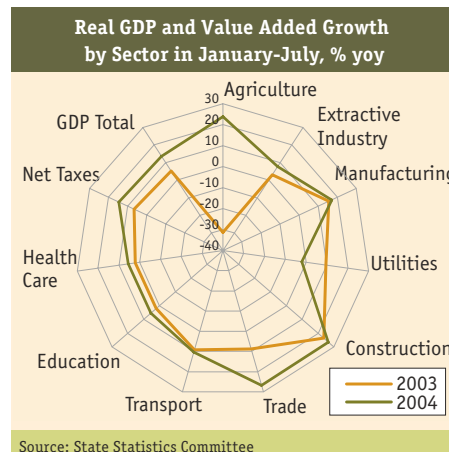
Economic Growth

Solid GDP growth continued over the first seven months of 2004, supported by continued growth in wholesale and retail trade as well as the recovery in agriculture. According to the State Statistics Committee report, real GDP growth reached 17.2% yoy in July. This brought the cumulative figure to 13.5% yoy. Deceleration of growth in industry, which continued for the fourth consecutive month, was more than offset by a recovery in agriculture. Other major sectors contributing to this growth were construction, domestic trade, and transport.

Value added growth in agriculture reached 23.7% yoy for January-July. This was after a 1.5% yoy decline in the first half of the year. The July surge in agricultural growth occurred because of the good harvest this year compared to the poor base of 2003.

During January-July, the construction sector performed remarkably well with growth of 26.4% yoy. Strong domestic demand supported a 26.7% yoy growth of wholesale and retail trade rate. Industrial output growth slowed to 8% in July compared with 11.2% yoy in June. Despite this deceleration, the cumulative

growth figure for industry remained at a reasonably high level of 14.7% yoy in January-July. The major reason for the slowdown in industry was a less favorable external environment for metals, which is one of the major contributors to total industrial output. Still, production of metals grew at a good rate of 8.2% yoy in January-July. In contrast to metallurgy, output in chemicals and machine building expanded by 17.6% yoy and 23.6% yoy, respectively. The industrial sector is likely to continue growing at a reasonable rate due to robust external demand for chemicals and the relatively diversified structure of machine building output. After routine repairs, the two biggest oil refineries in the country started to gradually increase their output, resulting in 2.3% yoy growth in the coke and oil-refining industry in January-July.

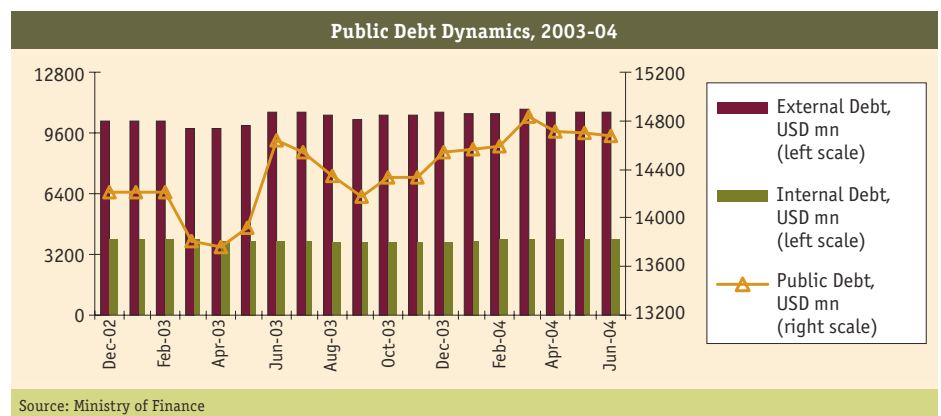


The impressive evolution of Ukraine's main macroeconomic indicators improved the government's expectations for year-end economic growth. For 2004, the official GDP growth forecast was raised from 9.5% to 10.5%. This is the second revision of the official forecast since the beginning of the year, when the government expected 6.5% year-end GDP growth. These projections have credibility as the IMF's own forecast is that Ukraine may demonstrate even higher economic growth in 2004 — up to 11.5%. Ukraine's economic growth outlook remains quite positive for 2004 despite the risks associated with the upcoming presidential elections.

Fiscal Policy

The robust economic growth since the beginning of the year has contributed to a successful fiscal budget performance. During the first half of 2004, the consolidated budget posted a surplus of UAH 560 million (\$107 million), which is about 0.4% of period GDP. Budget revenues amounted to UAH 38.4 billion (\$7.2 billion) over this period, while expenditures reached UAH 37.8 billion (\$7.1 billion). Despite considerably higher rates of economic growth than envisaged in the 2004 budget, corporate and personal income tax revenues grew by a relatively modest 5% yoy. Value added tax (VAT) revenue increased the most, by 21% yoy in the first half of the year. At the same time, budget expenditures lagged behind targeted levels. During January-June, the expenditure components were executed by about 90% of period targets. Under-financing of budget expenditures along with plentiful privatization receipts led to the accumulation of substantial budget funds on the State Treasury accounts. By July 1st, the State Treasury had accumulated UAH 8.5 billion, which is to be spent in the second half of 2004 in order to implement the recent budget amendments. However, a significant increase of expenditures in the run-up to the presidential election may trigger consumer price growth.

So far successful privatization performance has contributed to a positive fiscal outlook for 2004. In January-July, the State Property Fund (SPF) sold UAH 7.33 billion (\$1.4 billion) worth of state property. After completing the Kryvorizhstal and Pavlogradvuhillia privatization deals, the SPF managed to sell five constituents of the large mining company Ukrudprom in July. Thus, during one month, the aforementioned deal along with smaller privatization sales yielded some UAH 2 billion (\$380 million), which is comparable to last year's annual privatization receipts. However, significant acceleration of mass privatization during the election year raises concerns over the efficiency and competitiveness of privatization tenders. This was the likely reason for President Kuchma to recommend the delay of the Ukrtelecom and Odessa port plant privatization until after the presidential elections. The annual target for privatization proceeds has been revised once again from UAH 5.2 billion to UAH 8.1 billion (\$1.52 billion), excluding the two large privatization deals previously mentioned.



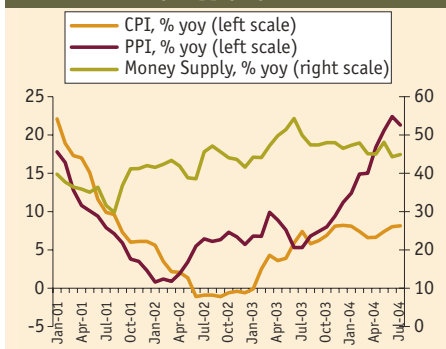
Macroeconomic Situation

During the first half of the year, the amount of public debt increased 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. Public debt will increase, since Ukraine issued \$500 million worth of Eurobonds at the end of July. The recent placement was successful, with a much lower yield than previous Eurobond issues. However, the newly issued Eurobonds have five years to mature with a floating yield equal to a 6-month LIBOR plus 337.5 basis points. At the end of July, the yield of Ukrainian Eurobonds was equal to a relatively low 5.36% annually. In total, the 2004 budget envisages \$1.2 billion in external borrowing and \$1.53 billion in external debt repayment and service.

Monetary Policy

During July, consumer price growth continued to accelerate, while producer inflation slowed. Annual growth of consumer prices reached 8.1% yoy in July, up from 8% yoy a month before. Prices of foods and non-foods grew 9.8% yoy and 4.2% yoy in July. An increase in gasoline prices early in the summer spilled over into service prices (transport in particular.) In July, service tariffs increased by 6.8% yoy due to significant acceleration of tariffs for transport services (up to 8.2% yoy from 5.3% yoy in June.) Taking into account current price dynamics, the government's expectations of full-year consumer inflation at 8% eop may turn out to be optimistic.

CPI and Money Supply Dynamics, 2001-04



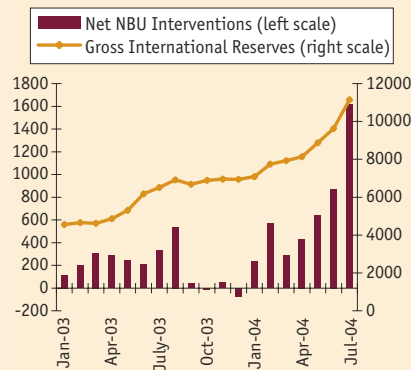
Source: State Statistics Committee, NBU

Meanwhile, producer price index (PPI) growth decelerated to 21.3% yoy in July from 22.4% yoy a month before. Lower PPI growth could be attributed to decelerating dynamics of raw materials prices (in particular, energy resources and agricultural output.) A slowdown in input prices was registered in resource-intensive industries like coke and oil refining, mining, and food processing.

Monetary aggregates growth accelerated slightly in July in spite of a stricter monetary stance by monetary authorities. Over the period, money supply (M3) growth picked up to 45% yoy from 44% yoy in June.

A huge foreign trade balance surplus and proceeds from the Eurobonds issue allowed the NBU to further accumulate its international reserves. In July, foreign exchange purchases by the NBU on the interbank market amounted to a record \$1.62 billion. At the end of July, the NBU's gross international reserves reached a remarkably high level of \$11.1 billion. Increasing inflationary pressure made the NBU sterilize excess hryvnia liquidity by selling CDs. During July, the sales of CDs amounted to UAH 3.29 billion, which is equivalent to 3% of the total money supply.

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



Source: National Bank of Ukraine

Despite the NBU's buyouts, export-related foreign exchange inflow caused a small nominal appreciation of the hryvnia in July. Since the beginning of the year, the official hryvnia exchange rate appreciated by 0.3% to 5.316 UAH/USD at the end of the month. Over the same period, the hryvnia/euro rate also fell by 4% year-to-date to 6.39 UAH/EUR.

Credit growth continued to slow in July following the introduction of stricter reserve requirements a month earlier. Commercial bank lending increased by 40 basis points in July to an annual rate of 17%. The rate on loans denominated in foreign currency also increased by 50 basis points to 12.7% per annum. Growth of commercial bank deposits slowed to 55% yoy as returns on deposits declined. In July, the average deposit rate fell 240 basis points to 6.9% annually, which is less attractive taking into account the 8% rate of annual inflation.

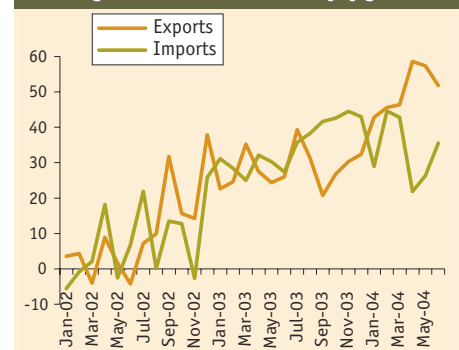
International Trade and Capital

Strong demand for Ukraine's main export commodities resulted in a large surplus in the trade of goods account in the first half of 2004. The trade of goods surplus reached \$2.4 billion, which is more than five times higher than the surplus achieved during the same period last year. In January-June, growth of merchandise exports surged 51% yoy to \$15.5 billion, exceeding imports growth of 33% yoy. However, exports dynamics reveal some deceleration for the second consecutive month, indicating a deterioration of the external environment. At the same time, imports

growth is on the rise, reflecting increasing consumption and investment demand for imports.

By product breakdown, Ukraine's exports are dominated by ferrous metals and chemicals. In January-June, metals and chemicals were still in great demand in the rest of the world, thus exports of these items grew by 60% yoy and 42% yoy, respectively. In addition, growth of machinery and transport equipment exports contributed heavily to the overall growth of merchandise exports, as their sales to foreign partners increased by more than 72% yoy in the first half of 2004, and their share in total exports was 16%. On the import side, energy resources and machines and transport equipment were the two biggest items in the structure of goods imports. In January-June 2004, energy resources imports, which account for 38.6% of merchandise imports, accelerated to 23% yoy in US dollar terms. Such an increase could partly be attributed to the higher price of energy resources rather than an increase in import volume. On the other hand, machinery and transport equipment imports grew by 60% yoy indicating robust investment demand in the country.

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

Ukraine's foreign trade partners remained virtually unchanged. On the export side, Ukraine's exports to Europe increased 47% yoy and accounted for about 40% of total goods exports in the first half of 2004. At the same time, exports to CIS and Asia grew by 60% yoy and 38% yoy, respectively. Russia remained Ukraine's single biggest partner, accounting for 39.8% of all imports and 17.6% of all exports. European countries' share in total merchandise imports constituted 33.4%.

Impressive rates of economic growth supported inflows of FDI to Ukraine. According to the State Statistics Committee, net FDI inflow amounted to \$574 million over the first half of 2004. This amount is roughly equal to the level over the same period last year. Of total inflow, the largest volume of FDI originated from Cyprus (about \$191 million.) Large inflows of capital also came from Western European countries (Germany, Austria, the Netherlands) and Russia. By sector breakdown, foreign investors preferred to invest in financial services, wholesale trade

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

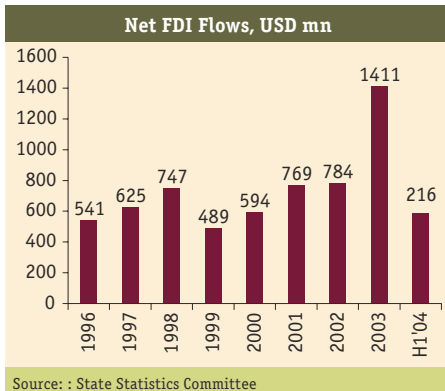
Kyiv Office, Ukraine

21, Pushkinska Street, Suite 40
Kyiv 01004, Ukraine
Tel: (380-44) 244-9487 Fax: (380-44) 244-9488
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine

Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: (380-57) 714 1180 Fax: (380-57) 714 1188
E-mail: kharkov.office@sigmableyzer.com.ua

and real estate services, which received about 52% of total FDI inflow in the first half of 2004. Food processing also remained quite attractive to foreign investors and absorbed about 10% of the total net FDI inflows. However, cumulative FDI remained at a relatively low level of \$7.3 billion, or about \$154 per capita. So far, the volume of FDI inflow has turned out to be better than expected for a presidential election year.



International Programs

A regular IMF mission that visited Ukraine at the end of July concluded that Ukraine is not carrying out some of its obligations under the stand-by program. Although the IMF positively assessed the country's macroeconomic performance, it was displeased by the approval of the 2004 Budget amendments and the insignificant progress in repayment of VAT refund arrears. In particular, the IMF is concerned with an increase of the fiscal deficit for 2004 from 1.75% to 2.75% of GDP, which does not comply with stand-by program obligations. A substantial increase of fiscal expenditures in the run up to the presidential election may cause additional inflationary pressure. At the same time, IMF representatives praised the monetary policy conducted by the NBU, especially its efforts to suppress money supply growth. 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 in case an urgent need arises.

In order to approve disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2), the World Bank expects Ukraine to make

further progress in implementation of an energy debt restructuring plan and in enhancement of the accountability of the state tax administration. 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.

Other Developments

On August 18, 2004, Russian President Putin signed a law abolishing the VAT on oil and gas exports to members of the Commonwealth of Independent States beginning January 1, 2005. The approval of the aforementioned law will benefit Ukraine to a great extent. Ukraine's economy depends heavily on Russian supplies of oil and gas due to the high energy-intensity of Ukraine's major industries. Currently, Russia levies an 18% VAT on oil and gas exports, which increases the price of these items on the border. In turn, Ukrainian authorities also charge the same tax for the energy imports from Russia. Thus, it is expected that Russian oil supplies to Ukraine will increase, while the price is likely to decline. Lower oil and gas prices may improve the competitiveness of Ukrainian output on external markets outside the CIS.