

Macroeconomic Situation

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Summary

Ukraine continued to enjoy broad-based economic growth in August, when real GDP growth reached 14.2% year-over-year (yoy). Some slowdown in manufacturing growth was compensated by a sharp recovery in agriculture and impressive development in the construction sector. Successful economic performance in the first eight months of 2004 supports government expectations of 12.4% year-end economic growth, revised upward from the previous 10.5% GDP growth forecast. The government continued to pursue pre-election fiscal loosening. In particular, the Cabinet of Ministers decided to provide support to retired people by increasing pensions to subsistence wage levels (currently set at around \$54 per month) starting in September. So far, the consolidated budget has posted a surplus of 0.5% of period GDP in January-July, but the situation for the rest of the year raises concerns. Budget expenditures continued to be under-financed and fiscal authorities kept accumulating funds on the budget accounts. However, a significant increase of expenditures in the run-up to the presidential election may create additional inflationary pressure.

Inflationary expectations worsened in August as annual inflation accelerated to 9.9% yoy while producer inflation picked up to 22% yoy. Money supply growth continued to accelerate in August because of a massive inflow of export-related foreign exchange and despite some appreciation of the national currency. However, rapid money growth was accompanied by fast expansion in money demand, which stemmed from the buoyancy of the domestic economy. Nevertheless, the National Bank of Ukraine (NBU) continued its efforts to curb monetary expansion. In particular, the NBU continued its sterilization activities and allowed a small nominal appreciation of the hryvnia in August. Boosted by a favorable external environment, the surplus in the trade of goods account surged to over \$2.56 billion in January-July. During the first half of 2004, the current account surplus grew to a record high \$4 billion, or 15% of period GDP. Ukraine continued to gradually proceed with the process of accession to the World Trade Organization (WTO). According to the Ministry of Economy, Ukraine has adjusted about 95% of tariff lines during bilateral negotiations with WTO members. Thus, it seems that 2005 is a feasible date for Ukraine's accession to the WTO.

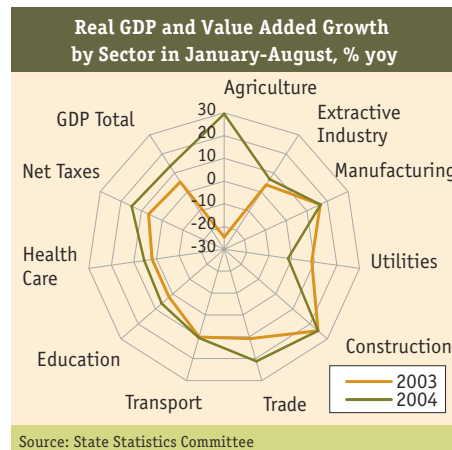
Economic Growth

During August, Ukraine continued to enjoy broad-based economic growth. Over the month, the sharp rebound in agriculture and strong performance in construction and trade supported 14.2% GDP growth. In the first eight months of 2004, GDP growth reached 13.6% yoy.

The good harvest significantly improved agricultural performance indicators this year. Value added growth in agriculture reached about 30% yoy in January-August after an almost 25% decline over the corresponding period last year. By the end of August, Ukrainian farmers

had harvested about 35 million tons of grain, which is more than a twofold increase compared to the same period last year.

Boosted by strong payable demand for new residential housing and industrial buildings, the construction sector demonstrated an impressive growth of 26.4% yoy during January-August. Value added in wholesale and retail trade and transport surged by 21.3% yoy and 10.5% yoy over the eight months, respectively.



Despite continuing deceleration, industry remained one of the major sectors contributing to GDP growth. In January-August, growth in industry slowed to 14.4% yoy from 14.7% yoy in January-July. However, industrial output growth accelerated slightly from 8% in July to 9.5% yoy in August. The increase is attributed to better performance in machine building and utilities compared to previous months. Though production of export-oriented metals and chemicals (major contributors to industrial growth) decelerated, the rates of output growth in these sectors remained at reasonably high levels of 15% yoy and 15.8% yoy respectively. In contrast to metallurgy and chemicals, output in machine-building surged by 33.6% yoy in January-August compared to a 2% yoy decline during the same period last year.

Successful economic performance in the first eight months of 2004 supports the government expectations of 12.4% year-end economic growth, revised up-

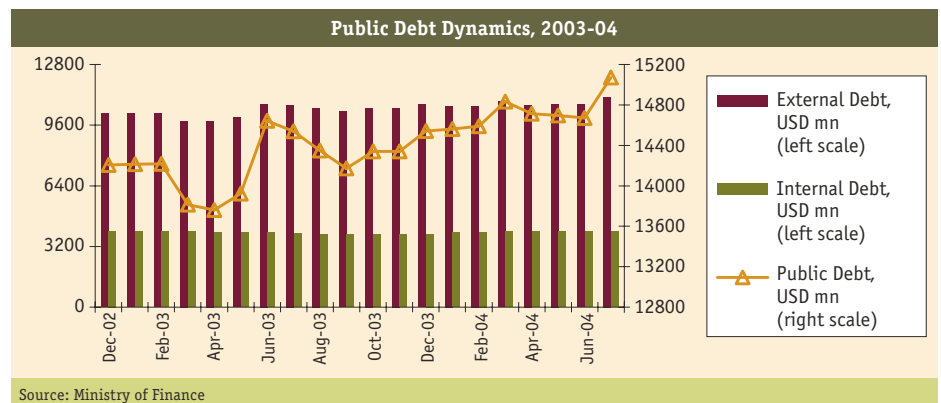
ward from a 10.5% GDP growth forecast. These projections are quite credible provided that agricultural growth continues.

Fiscal Policy

Plentiful privatization receipts and adequate fiscal revenue collection allowed the government to further expand its social expenditures. In particular, the Cabinet of Ministers decided to increase retirees' pensions to reach subsistence wage levels (currently set at around \$54 per month) starting in September. The approximate cost of this move for the state budget is about UAH 3 billion (\$560 million), equivalent to roughly 4% of this year's state budget expenditures. Having received UAH 8.2 billion (\$1.5 billion) from privatization as of August, the government will be able to finance the expected budget gap as well as implement additional social security payments (including pension increases).

In January-July, the consolidated budget posted a surplus of UAH 861 million (\$162 million), which is about 0.5% of period GDP. High rates of economic growth had a positive effect on overall fiscal revenue collection, though the collection rates of tax receipts could have been better. Budget revenues increased by 11% yoy (in real terms) to UAH 47.4 billion (\$8.9 billion). On the other hand, budget expenditures increased at a faster real rate of 17% yoy, reaching UAH 46.5 billion (\$8.8 billion). In January-July, corporate income tax revenues grew by a relatively modest 1.2% yoy, while personal income tax revenues fell 11% yoy over the same period. The biggest contribution to total revenue growth was made by value added taxes (up 15% yoy) and non-tax revenues (up 31% yoy). At the same time, budget expenditures continued to be under-financed as fiscal authorities kept accumulating surplus funds on the budget accounts. By July 31st, the State Treasury had accumulated UAH 10.6 billion (about 9% of the total money supply), which is to be spent until the end of 2004 in order to implement social payments promised by the government. Massive transfers of budget funds to the population in a short period of time may create significant inflationary pressure.

Regarding the state of the fiscal budget for 2005, the government approved its 2005 draft budget with reve-



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nues of UAH 87.88 billion (\$16.6 billion) and expenditures of UAH 92.8 billion (\$17.5 billion). Thus, the government plans a state budget deficit of UAH 4.97 billion, or 1.5% of GDP. The 2005 draft budget was passed to the Parliament of Ukraine for consideration, and the first reading is scheduled for October 20th. The budget was prepared on the basis of a conservative scenario of macroeconomic development assuming GDP growth of 8.6% and year-end inflation of 6.2% in 2005. The expected 2005 budget gap is to be financed by privatization revenue and state borrowing. For 2005, planned privatization revenues at UAH 4.5 billion (\$850 million) remain a major deficit-financing item.

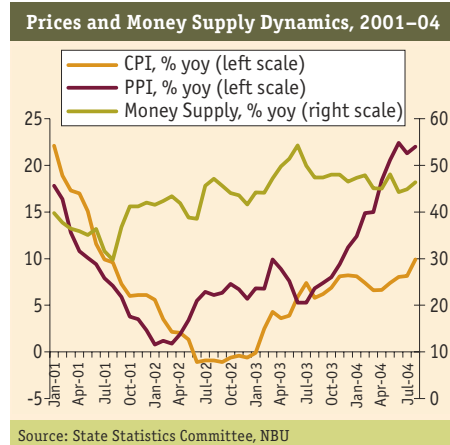
Total public debt grew by 3.6% during January-July, and reached \$15.1 billion equivalent at the end of July. The increase was due primarily to increases in external debt, as the government successfully placed \$500 million worth of Eurobonds at the end of July. The stock of external debt reached \$11.1 billion equivalent (or 22% of expected 2004 GDP.) In early September, the Ministry of Finance successfully met the due interest and amortization payments (EUR 125.5 million on bonds denominated in EUR and \$133.4 million on bonds denominated in US dollars) on the Eurobonds it issued in 2000. In total, the 2004 budget envisages \$1.2 billion in external borrowing and \$1.53 billion in external debt repayment and service. Regarding next year's borrowing, the government plans to attract about \$1.65 billion both externally and domestically. At the same time, Ukraine's sovereign debt payments due in 2005 amounted to \$2.38 billion.

Monetary Policy

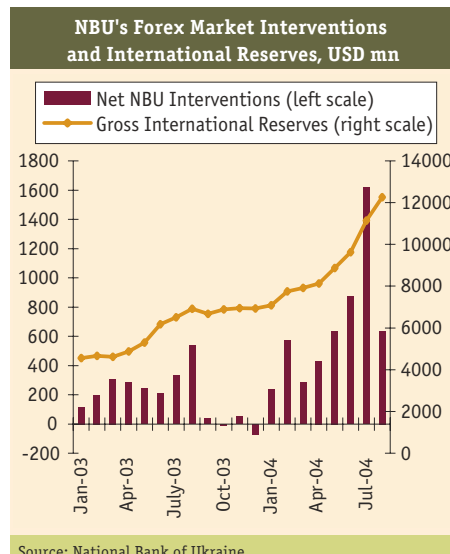
Inflationary expectations worsened in August as annual inflation accelerated to 9.9% yoy compared to 8.1% in July. This increase occurred despite 0.1% monthly deflation in August. Acceleration of consumer price growth took place due to higher foodstuff prices. In August, food prices grew 12.5% yoy, primarily due to meat and milk products, the prices of which went up 15.2% and 37% yoy, respectively. The good harvest led to a reduction of prices on potatoes, vegetables and fruits, but was insufficient to compensate for price growth on other components of the consumer basket. Substantial growth of gasoline prices (up 64% yoy) drove the non-foods price index up 4.5% yoy. While services tariffs growth slowed slightly to 6.7% yoy, tariffs of communication services remained unchanged compared to last year's level. Taking into account current price dynamics and the expected substantial increase of fiscal expenditures in the coming months, the government's expectations of full-year consumer inflation at 8% eop seems overly optimistic.

Meanwhile, producer price index (PPI) growth increased to 22% yoy in August from 21.3% yoy a month before. The upward trend of raw materials prices (in particular, energy resources) is the most

likely cause of higher growth of producer prices. The highest growth of input prices was in resource-intensive industries like coke and oil refining, mining, metallurgy and chemicals.



Money supply growth continued to accelerate in August because of a massive inflow of export-related foreign exchange and despite some appreciation of the national currency. Money supply (M3) growth picked up to 46.4% yoy in August from 44.9% yoy in July. So far, rapid money growth has not been fully reflected in the inflation rate, as it was accompanied by fast expansion in money demand stemming from the buoyancy of the domestic economy. Nevertheless, in light of the possible fiscal loosening before the presidential election, the NBU has continued its efforts to curb monetary expansion. In particular, the NBU increased the daily minimum mandatory reserve requirement from 60% to 70% in August. Taking into account the high liquidity of the commercial banks, the new regulation is unlikely to significantly affect credit activity in the country.

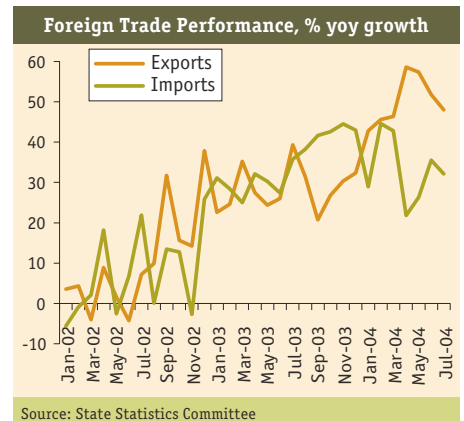


Robust export growth allowed the NBU to further accumulate its international reserves in August. The NBU's gross international reserves increased to an all-time high of \$12.3 billion at the end of August. However, to suppress monetary expansion, the NBU continued its sterilization activities by selling UAH 2.4 billion worth of certificates of deposit during August. The NBU also allowed a small nominal appreciation of the hryvnia. Over the month, the official hryvnia exchange rate appreciated by 0.1% to 5.312 UAH/USD. Over the same period, the hryvnia/euro rate picked up by 0.1% to 6.4 UAH/EUR.

Excessive liquidity of the banking system supported by rapid growth of deposits allowed commercial banks to further boost their lending activities. In August, commercial bank lending increased 49% yoy and the average cost of loans rose by 10 basis points to an annual rate of 15%. Growth of commercial bank deposits accelerated to 57% yoy despite returns on deposits falling 100 basis points to 5.9% annually. Such deposit dynamics may be attributed to uncertainties associated with the pre-election period, when households prefer low-risk ways to store their savings and enterprises avoid starting new investment projects.

International Trade and Capital

According to the NBU's balance of payments report, the current account surplus grew by 121% yoy to a record high of \$4 billion in the first half of 2004. This amount represents 15.5% of the period's GDP. A significant surplus in the trade of goods and services accounts as well as growth of remittances contributed to a highly positive current account balance. Based on the NBU's report, foreign direct investment growth accelerated 28% yoy to reach \$884 million in January-June. At the same time, large portfolio investments flowed out of the country. In the first half of 2004, net portfolio outflows were \$349 million, which may be explained by higher political risks due to the upcoming presidential election.



Boosted by a favorable external environment for the key exports of metals and chemicals and the competitiveness of the exchange rate, the surplus in the trade

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of goods account surged to over \$2.56 billion in January-July, more than five times higher than the surplus achieved during the same period last year. In January-July, merchandise exports grew by 48% yoy to reach \$18.3 billion, exceeding imports, grew to 31% yoy. Though export growth has been decelerating over the past three months, the rate of export growth remained at an exceptionally high level.

Ukraine's main export commodities remained ferrous metals, machinery and equipment, and chemicals. In January-July, metal exports grew by 50% yoy. Growth of machinery and transport equipment exports continued to contribute heavily to the overall growth of goods exports. The cross-border sales of these items increased by 82% yoy in January-July, and their share in total exports reached 16%. Enjoying robust external demand, chemicals exports accelerated to 43% yoy over the same period. On the import side, energy resources and investment goods such as machinery and transport equipment were the two biggest items in the structure of goods imports. In January-July, energy resources imports, which account for 38.8% of merchandise imports, accelerated to 31% yoy in US dollar terms. However, this increase may to a certain extent be attributed to the higher price of energy resources rather than to an increase in import volume. Boosted by robust investment demand in the country, machinery and transport equipment imports grew by 44% yoy, and their share in total goods imports increased to almost 25%, from around 22% over the same period last year.

The geographical breakdown of Ukraine's foreign trade was dominated by Russia, which accounted for 40.5% of all imports and 18% of all exports. In the first seven months of 2004, European countries' share of total merchandise exports and imports constituted 38% and 33.4%, respectively.

International Programs

Despite successful macroeconomic performance, Ukraine's relations with the international financial organizations may deteriorate as a result of deviations from the agreed-upon government policies, particularly fiscal policies. A regular IMF mission that visited Ukraine at the end of July concluded that Ukraine is not carrying out some of its agreements 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.

Although the Ukrainian authorities counted on the disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2) by the end of 2004, the World Bank is unlikely to approve it until the law regulating debt restructuring in the energy sector is adopted by Parliament. The Bank believes that this is a stumbling block to further progress with energy sector reform. After disbursing \$75 million of the PAL-2 late in December 2003, the World Bank postponed the transfer of the remaining \$175 million of the loan.

Other Developments

Ukraine continued to gradually proceed with the process of accession to the WTO. In August, Ukrainian officials reached an agreement on mutual market access and signed the corresponding document with Argentina. So far, Ukraine has signed 25 bilateral agreements within the framework of the WTO negotiations. Ukraine still has to settle disputes with the USA, China, Turkey, and Japan in order to sign the agreements on mutual market access necessary to join the WTO. Simultaneously, Ukrainian officials are preparing a draft report of the accession working party that indicates that Ukraine has entered the final stage of WTO accession negotiations. According to the Ministry of Economy, Ukraine has adjusted about 95% of tariff lines during bilateral negotiations with WTO members. Thus, it seems now that Ukraine may succeed in completing all the necessary steps for WTO entry in 2005.

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