

Macroeconomic Situation

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Summary

The startling rate of economic growth in Ukraine continued though September stimulated by robust external and domestic demand. In January-September, real GDP growth reached 13.4% year-over-year (yoy). Manufacturing, agriculture and trade were the main drivers of economic growth in the country. Rapid expansion of production in manufacturing is, to a great extent, being encouraged by a favorable external environment. The current economic performance makes the government's expectations of 12.4% year-end economic growth quite feasible.

Pre-election fiscal loosening and mounting inflationary pressures are the main areas of concern. During January-August, the consolidated budget maintained a surplus of 0.6% of period GDP. But an increase of social outlays after September is likely to result in a fiscal deficit of 2.75% of GDP compared to the previously planned deficit of 1.75% of GDP. The IMF considers the recent fiscal expansion inappropriate and recommended that measures be taken to bring the fiscal budget deficit to less than 2% of GDP.

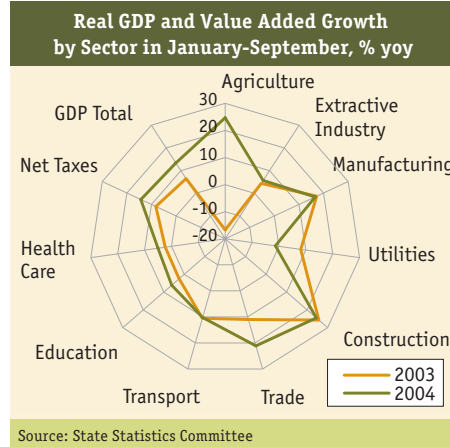
Following massive social payouts by the government during September, consumer inflation accelerated to 10.7% yoy by the end of that month. Money supply growth of almost 50% yoy also contributed to inflation. To reduce Hryvnia liquidity, the National Bank of Ukraine (NBU) intensified its efforts to curb monetary expansion. In particular, the NBU increased its discount rate to 8% and continued its sterilization activities by selling certificates of deposit. An additional sterilization effect was created as a result of the abrupt increase of demand for foreign exchange in September and October. During these months, net purchase of cash foreign exchange by the population increased to \$815 million, although it had been constantly negative throughout January-August. The sharp increase in demand caused a temporary shortage of cash foreign exchange on the retail market. To address this situation, the NBU sold net foreign exchange to commercial banks of about \$550 million in October.

Nevertheless, the NBU's gross international reserves remained at a record high of \$12.1 billion. Taking into account robust export performance, the situation may be stabilized in the near future. In January-August, the surplus in the trade of goods account reached almost \$3 billion, as exports grew 41% yoy compared to a 17% yoy import increase. Though still robust, external demand for the key export commodities like metals, chemicals and machinery revealed signs of weakness as export growth rates gradually decelerated over the last three months.

Economic Growth

Supported by robust external and domestic demand, the Ukrainian economy continued to demonstrate a high rate of economic growth in September. After reaching its peak growth of 19.1% yoy in June, GDP growth began to gradually decelerate. In September,

economic output picked up 11.5% yoy, bringing the cumulative figure to 13.4% yoy. The major contributors to economic growth are manufacturing, agriculture and wholesale and retail trade, growth of which accounts for more than 60% of the total figure.



Agriculture witnessed a value added increase of 24.7% yoy in January-September, which compares very favorably with the 17% decline during the corresponding period last year. Sustained high growth in wholesale and retail trade (21.1% yoy) indicates booming domestic demand. Construction also saw a tremendous increase of 24.5% yoy during January-September.

Favorable external demand encouraged the rapid expansion of production in industry. In January-September, growth in industry reached 14.4% yoy primarily on account of metallurgy, chemicals and machine building. Meanwhile, performance of export-oriented metals and chemicals remained quite impressive despite some deceleration. Output growth in these sectors constituted a high 14.4% yoy and 15.6% yoy, respectively. Production in machine-building soared 33.5% yoy in January-September, reflecting a continuation of spectacular growth since the beginning of the year.

The government expects real GDP growth of 12.4% for 2004. This is realistic, taking into account current economic performance. However, Ukraine's economic growth is susceptible to changes in the external environment due to the economy's high reliance on ex-

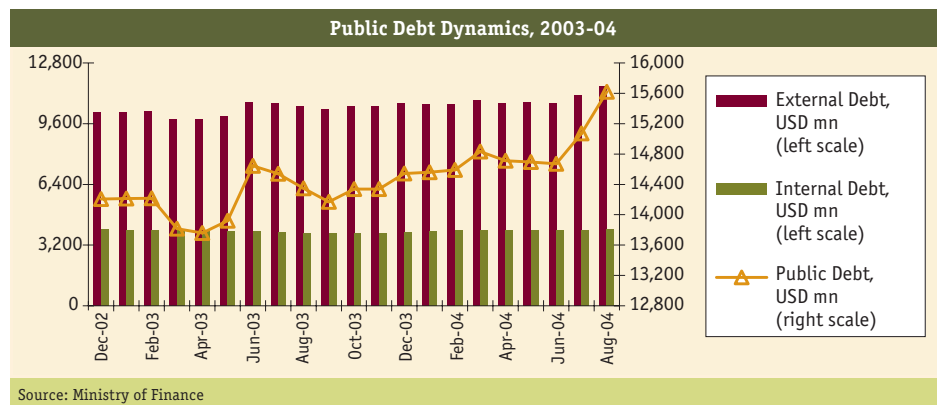
ports. A sharp decline in world prices for major export items coupled with expansionary monetary and fiscal policy may have detrimental effects for the country's economic stability.

Fiscal Policy

Recent fiscal policy loosening will result in a higher than expected budget deficit in 2004. Before the recent budget amendments calling for significant expenditure hikes came into force, the consolidated budget balance remained in surplus in January-August. Over the period, the consolidated budget posted a surplus of UAH 1.12 billion (\$211 million), which is about 0.6% of period GDP. In January-August, budget revenues grew by 10.4% yoy (in real terms) to UAH 56.1 billion (\$10.6 billion). On the other hand, budget expenditures increased at a faster real rate of 18.2% yoy, reaching UAH 54.7 billion (\$10.3 billion). Starting in September, however, the government increased retirees' pensions to subsistence wage levels (currently set at around \$54 per month) and public wages by 13%. As a result of the amendments to the budget, the expected budget deficit target for 2004 increased sharply, and is likely to reach UAH 9.4 billion (\$1.77 billion). Such a deficit might be equivalent to about 2.75% of GDP compared to the previously planned 1.75%.

So far, the government has enough resources to finance the expected fiscal deficit in 2004. In addition to external borrowings, the government received some UAH 8.55 billion (\$1.61 billion) from privatization of state property in January-September.

Being one-off fiscal receipts, privatization revenues can not be regarded as a reliable source of fiscal deficit financing for future periods. Facing large social security and wage bills and substantial external debt payments, the government will have to resort to a tighter fiscal policy next year in order to preserve macroeconomic stability. In fact, the recently approved expansionary fiscal policy may imply higher inflationary pressure beyond 2004 if other expenditures are not reduced accordingly. In fact, there is a risk that the fiscal deficit in 2005 may be in excess of 3%-4% of GDP, an unsustainable level. It is unlikely, however, that the new Government in 2005 would allow such a deterioration in fiscal policies.



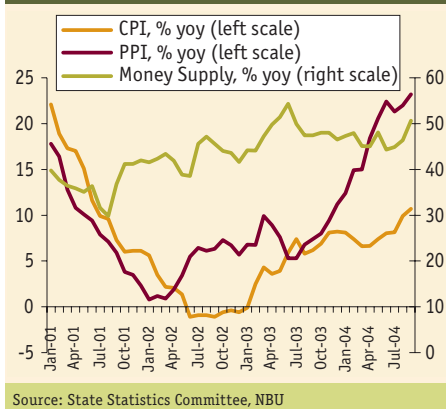
Macroeconomic Situation

Total public debt grew by 7.4% during January-August, and reached \$15.6 billion equivalent at the end of August. The increase was the result of a recent Eurobonds placement on the external market and the VAT refund debt restructuring to domestic creditors. The stock of external debt grew 8.2% year-to-date, and reached \$11.6 billion equivalent (or 22% of expected 2004 GDP.) In July-August, the Ukrainian government successfully placed \$500 million worth of Eurobonds and provided a guarantee to a Deutsche Bank loan (\$480 million) for construction of the Kyiv-Odessa highway. In total, the 2004 budget calls for \$1.2 billion in external borrowing and \$1.53 billion in external debt repayment and service. Over January-August, the government has successfully met its external debt payments in the amount of \$1.23 billion.

Monetary Policy

Mounting inflationary pressure has led the NBU to a more restrictive monetary policy. In September, annual consumer inflation further accelerated to 10.7% yoy, compared to 9.9% in August. Consumer price growth continued primarily due to surging meat and gasoline prices. In September, prices of foodstuffs increased 13.6% yoy, which is largely explained by 39.4% and 25.6% yoy growth of meat and bread, respectively. In response to the increase in food prices, administrative price regulation was introduced for certain groups of products like meat, bread and oil. However, the primary reason for the rise in consumer inflation was the recent massive social payments by the government. Meanwhile, the non-foods price index grew by 4.5% yoy following some deceleration of gasoline prices — from 63% yoy in August to 56.4% yoy in September — which took place as a result of government intervention. Services tariffs grew at a relatively modest 6.9% yoy, mainly on account of higher transport service prices. The government's year-end inflation expectations worsened — consumer inflation is projected to reach 8.5% eop, while the NBU predicts 9% eop inflation.

Prices and Money Supply Dynamics, 2001–04

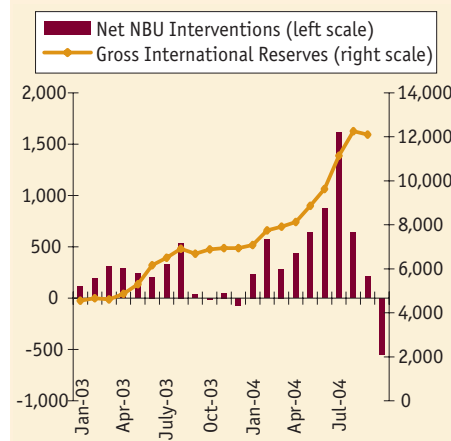


Source: State Statistics Committee, NBU

Growing world prices for metals and oil have contributed to an increase of producer inflation. The pro-

ducer price index (PPI) increased to 23.2% yoy in September from 22% yoy a month before. The highest growth of input prices was in resource-intensive industries like coke and oil refining, mining, metallurgy and chemicals.

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



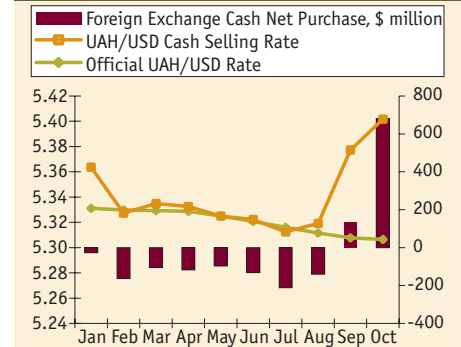
Source: National Bank of Ukraine

Growth of money supply soared in September following massive social payouts by the government. A surge of cash in circulation contributed to broad money (M3) growth, which picked up to 50.6% yoy in September from 46.4% yoy in August. To alleviate the effect of monetary expansion on inflation, the NBU continued its efforts to curb money growth. In particular, the NBU increased its discount rate from 7.5% to 8% effective October 7th. Also, the NBU continued its sterilization activities by selling UAH 2.7 billion worth of certificates of deposit during September. The high liquidity of the banking system allowed commercial banks to further expand their lending. In September, credit growth amounted to 44% yoy and the average cost of loans fell by 20 basis points to an annual rate of 14.8%. Growth of commercial bank deposits accelerated to a high 60% yoy as returns on deposits increased 10 basis points to 6% annually.

Accelerating price growth and political uncertainties threatened public confidence in the Hryvnia's stability as demand for cash foreign exchange expanded significantly in September and October. Many Ukrainians decided to convert their savings of foreign currencies on the short period of time, which resulted in an abrupt increase of the foreign exchange rate on the retail market. While the official Hryvnia rate has continued to gradually appreciate over the last three months, the retail UAH/USD rate picked up from 5.31 in August to 5.40 in October. Over September-October, net purchase of cash foreign exchange by the population increased to \$815 million, although it was constantly negative throughout January-August. The sudden demand swing caused temporary shortages of cash foreign exchange on the retail market. To address this sit-

uation, the net sale of foreign exchange by the NBU to commercial banks increased to some \$550 million in October. At the end of September, the NBU's gross international reserves remained at a record high of \$12.1 billion. The recent developments on the retail foreign exchange market are temporary effects of an abrupt increase of inflationary pressure and political uncertainty in the run-up to the presidential elections. Taking into account robust export performance, the situation may be stabilized after the elections.

Demand for Cash Foreign Exchange and Exchange Rates Dynamics in 2004

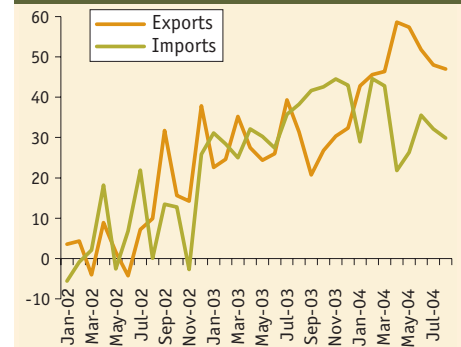


Source: National Bank of Ukraine

International Trade and Capital

Robust external demand for key export commodities such as metals, chemicals and machinery and favorable world prices for these commodities drove Ukraine's foreign trade surplus to record high levels. In January-August, the surplus in the trade of goods account reached almost \$3 billion, more than seven times higher than the surplus recorded over the same period last year. In January-August, merchandise exports grew by 41% yoy to reach \$21 billion, exceeding imports growth of 17% yoy to \$18 billion. Though export performance remains robust, decelerating rates of export growth indicate some weakening of external demand for Ukraine's main export commodities.

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

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Strong world prices for metals were the primary engines of merchandise export growth. In January-August, metal exports in dollar terms grew by 50% yoy. At the same time, metals production in absolute units has seen a modest growth since the beginning of the year. In January-August, Ukrainian metallurgical enterprises produced just 5.6% more of rolled metal than over the same period last year. Taking into account the sensitivity of metal products to price and exchange rate movements and their high share in total goods exports (39%), this represents the main source of Ukraine's external vulnerability. A sudden deterioration in the external environment may have detrimental consequences for the economy considering the inadequate adjustment mechanisms.



At the same time, the impressive dynamics of high-value added exports like machines and transport equipment is a positive development. Growth of machinery and transport equipment exports increased by 83.4% yoy in January-August, and their share in total exports reached 16.3%. On the import side, energy re-

sources and investment goods such as machinery and equipment remained the two biggest items in the structure of goods imports. In January-August, energy resources imports, which account for 38.6% of merchandise imports, grew by 31% yoy in US dollar terms. This increase, however, may be attributed to higher world crude oil price rather than to an increase in import volumes. Robust growth of machinery and transport equipment imports (44% yoy in January-August) reflects strong investment demand in the country. The geographical breakdown of Ukraine's foreign trade remains biased towards Russia, which accounted for 41% of all imports and 17.9% of all exports. In eight months of 2004, European countries' share of total merchandise exports and imports constituted 37.3% and 33.3%, respectively.

International Programs

The main areas of concern for the IMF are the recent fiscal loosening by the government and the growing inflationary pressures. In its latest report, the IMF stated that it considers the recent fiscal expansion inappropriate and urged Ukraine's government to follow a more prudent fiscal policy. In particular, the IMF recommended that the country save additional privatisation revenues until future periods in order to be able to perform counter-cyclical fiscal policies and avoid additional fiscal expansion, which would contribute to higher inflationary pressures. Also, the IMF stressed that exchange rate and monetary policies should be shaped accordingly in order to prevent substantial inflation hikes. 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.

The World Bank is unlikely to approve the disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2) 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 in 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

On October 22nd, representatives of Ukraine, Russia, Belarus and Kazakhstan met in Kiev for a regular meeting to discuss issues related to the creation of the Common Economic Area (CEA) within the borders of the above-mentioned countries. During the meeting, the participants considered the problems related to the adoption of the unified principles of VAT administration on foreign trade transactions between the participant countries, and also considered possible costs and benefits of the WTO accession of individual countries and the subsequent mechanism of negotiations with other participants of CEA. Earlier this year, the Parliament of Ukraine approved the multilateral agreement on the creation of the CEA. The agreement envisaged that the participating countries would gradually integrate their trade and economic policies, leading to the eventual creation of a customs union. However, it is unlikely that such a deep integration to a common union would take place. Most likely, the CEA would stop with the creation of a free trade zone. Such a free trade agreement within the boundaries of the four CIS countries would not contradict Ukraine's orientation towards the EU. In fact, such a free trade zone may benefit Ukraine without any harmful consequences for Ukraine-EU cooperation plans.