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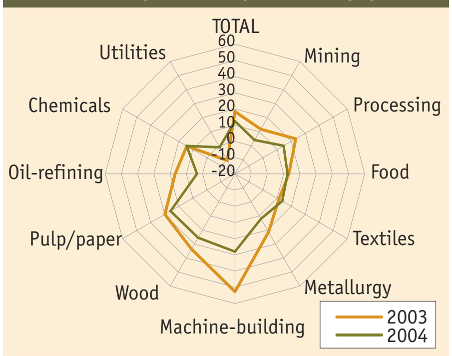
Summary

Sharp acceleration in industry, agriculture and trade supported robust gross domestic product (GDP) growth in 2004. During the year, real GDP increased 12% year-over-year (yoy), which was one of the best macroeconomic performances in the world. The biggest concern during the year was the substantial fiscal loosening during the pre-election period in the last quarter of 2004, which resulted in a fiscal deficit of 3.3% of GDP compared to the planned 1.7% deficit. The fiscal outlook for 2005 is uncertain because of the large amount of resources required to finance the commitments made by the previous government on social security payments. The new government expects to raise resources by eliminating tax privileges and special preferences in free economic zones, actions that may find political resistance. The fiscal expansion in the last few months of 2004 has also generated strong inflationary pressure. As a result, end-of-period (eop) inflation reached about 12.3%, exceeding the official target rate of 8.5%. On the other hand, the external position of Ukraine remains very strong as the current account surplus reached 11% of GDP in 2004.

Economic Growth

In 2004, Ukraine demonstrated one of the best macroeconomic performances in the world. According to preliminary data, real GDP growth reached 12% yoy in 2004 compared with 9.4% yoy growth in 2003. The economic growth was broad-based, with impressive export performance and booming domestic demand. The major contributors to economic growth were industry, wholesale and retail trade, and agriculture. Favorable external demand, especially for metal products, encouraged 12.5% yoy growth in industry. However, this figure is lower than the 18.4% yoy industrial expansion in 2003.

Industry Growth by Sector, % yoy



Source: State Statistics Committee

At the product level, machine-building production increased by 28% yoy, one of the highest growth rates in 2004. Despite some slowdown in export-oriented industries, metallurgy demonstrated impressive rates of growth, encouraged by high world prices for metals. During 2004, output in metallurgy increased 12% yoy. Since metal production represents the highest share of industry, its contribution to industrial GDP is the largest. Other growth areas included the domestic market-oriented food processing sector (12.4% yoy), wood processing (25.5% yoy) and the chemical industry (14.4% yoy).

Although these numbers are encouraging, economic growth in Ukraine is still based on utilization of existing capacity. Preliminary data suggests that Ukraine's GDP in 2004 reached only 66% of its pre-independence level. Ukraine needs substantial investment to renovate existing and build new production capacity. Ukraine's economic growth is expected to slow down in 2005 in response to weaker world prices for metals. According to IMF estimates, Ukraine can achieve some 5-6% of GDP growth in 2005. The government anticipates slightly higher 6.5% GDP growth for the year, and this rate of growth is assumed in the 2005 budget.

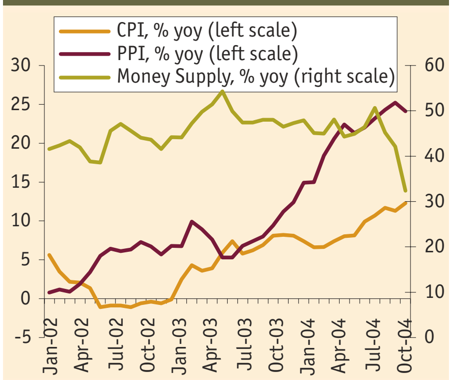
Fiscal Policy

The previous Ukrainian government followed prudent fiscal policy through the first eight months of 2004. Since September, however, substantial fiscal loosening took place in the run-up to the presidential election. At that time, the government decided to increase retirees' pensions to reach subsistence wage levels (set at UAH 284.6 or about $54 per month). As a result, fiscal expenditures increased by about UAH 4.5 billion ($850 million) in four months. According to preliminary estimates, this led to a fiscal deficit of 3.3% of GDP in 2004, compared to the originally planned 1.7% deficit.

The fiscal outlook for 2005 raises concerns. In late December, the Parliament of Ukraine adopted the 2005 State Budget calling for a fiscal deficit of UAH 8.9 billion ($1.7 billion), which is equivalent to 2.2% of GDP. This budget was based on GDP growth of 6.5%, with fiscal revenues estimated to increase by 24% yoy in 2005 (in nominal terms), which is unrealistic. Taking into account the likely shortfall in revenues, the fiscal deficit might increase by another 1.5% of GDP. In addition, the government is currently short of resources to fully finance all social security payments, including pension outlays following the increase to the living wage level in January. In order to fully finance the declared pension expenditures, the new government has to additionally transfer about UAH 1.5 billion ($280 million) to the Pension Fund each month. Therefore, the total cost of adjusting pensions to the current living wage of UAH335 is about UAH 18 billion ($3.4 billion). But only one third of this sum (UAH 6 billion) is envisaged by the approved 2005 budget.

If not adjusted, the state budget may end up with up to a 5% — 6% of GDP deficit, which is unsustainable. Thus, it is evident that the new government will have to amend the 2005 budget. The former head of the Budget Committee of the Parliament, who is a leading member of the current government's party, has said that amendments envisaging an increase of budget revenues to target a deficit of 2.7% of GDP might be adopted in February. The additional revenues (some $1.9 billion) may be generated from the elimination of tax privileges and free economic zones, and the adoption of a new tax code.

Prices and Money Supply Dynamics, 2001–04

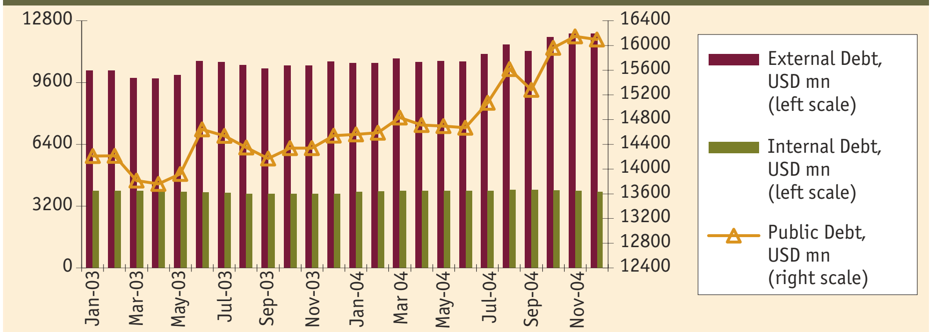


Source: State Statistics Committee, NBU

In 2005, the government plans to finance the expected fiscal deficit through privatization receipts and external borrowing. In particular, the government is targeting some UAH 5.02 billion ($950 million) of privatization receipts and UAH 8.4 billion ($1.6 billion) of external borrowing. At the same time, the government has to repay UAH 9.41 billion ($1.76 billion) of its external obligations in 2005.

In 2004, the stock of public debt grew by 10.7% yoy to $16.1 billion. External public debt picked up to

Public Debt Dynamics, 2003-04



Source: Ministry of Finance

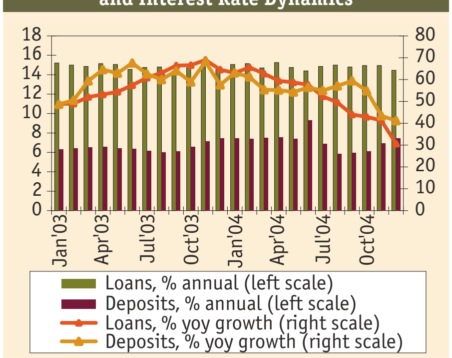
$12.2 billion, while domestic debt remained relatively stable at around $4 billion. The increase was the result of Eurobonds placements on the external market and the VAT refund debt restructuring to domestic creditors. Although debt increased in absolute terms, sound external debt management reduced public debt as a percentage of GDP from 24% in 2002 to 22% in 2004.

Monetary Policy

In 2004, consumer inflation reached 12.3%, considerably higher than 8.2% a year before. During the first half of the year, inflation was moderate but significantly higher producers' inflation spilled over into the retail market in the second half. Prices of foodstuffs grew by 15.3% yoy, which is attributed to the 48.6% and 21.6% yoy increase in meat and milk prices, respectively. The non-food price index picked up 5.4% yoy following the acceleration of gasoline prices to 61.6% yoy during the second half of the year. Service tariffs grew by 7.9% yoy mainly due to higher transport service and utilities prices. Extraordinarily high world prices for metals and oil contributed to an increase of producer inflation. The producer price index (PPI) increased to 24.1% yoy in December. The highest growth of input prices was in resource-intensive industries like coke and oil refining, mining, metallurgy and chemicals. Expansionary fiscal policy and economic growth slowdown threaten to cause inflationary pressures in 2005. The official inflation forecast (assumed in the 2005 budget) is equal to 8.7% eop, which seems overly optimistic. The IMF inflation forecast of 9.5% eop appears to be more realistic.

Monetary aggregates growth slowed down significantly during the last two months of 2004. Over the period, money supply (M3) growth dropped from 42% yoy in November to 32.4% yoy in December. The reason for the sharp deceleration of money supply growth at the end of 2004 was an upsurge of demand for cash foreign exchange in November-December. During that period, people started converting their hryvnia holdings into foreign currencies or foreign-currency denominated assets.

Loans and Deposits Growth and Interest Rate Dynamics

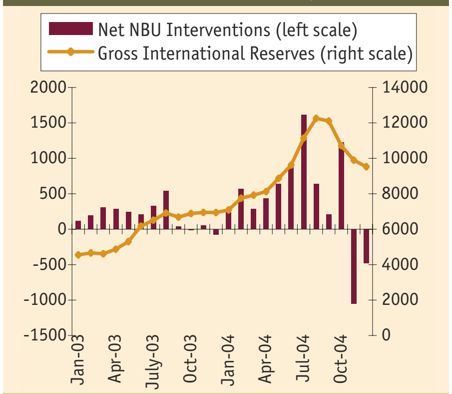


Source: National Bank of Ukraine

Similarly, the stock of household deposits at commercial banks shrunk by 8% over November-December. During the period, people withdrew their hryvnia-denominated deposits (down by 8% in two months) and converted them into foreign currency-denominated deposits (up 1% over the same period) or cash foreign exchange. The immediate result of the latter development was a sharp contraction of credit growth. In December, expansion of commercial bank credit to the real sector dropped to 31% yoy compared to 41% yoy a month before. However, the average cost of loans declined in December after an abrupt increase the previous month. In December, commercial banks provided loans at an average rate of 14.5%, some 50 basis points lower than in November. Such interest rate dynamics reflect stabilization in the money market and the political situation.

In an attempt to prevent mass withdrawals of money from banks and subsequent liquidity problems in the banking sector, the NBU kept selling its international reserves. Thanks to strong foreign trade surpluses, these sales did not significantly erode the NBU's reserves and had sterilization effect that helped to ease increasing inflationary pressures. In November-December, the NBU sold a record high $1.53 billion on the interbank market. At the end of 2004, the NBU's gross international reserves amounted to $9.5 billion, considerably lower than $12.1 billion back in September, but above the $6.9 billion attained at the beginning of the year. In addition, the NBU introduced a 2% fluctuation band for cash rates in order to curb large fluctuations in the cash foreign exchange rate. At the same time, the official hryvnia rate has continued to gradually appreciate over the last three months reflecting robust export growth. During the last year, the official hryvnia exchange rate appreciated by 0.5% to 5.305 UAH/USD at the end of December. Over the same period, the hryvnia/euro rate picked up by 8.4% to 7.2 UAH/EUR, reflecting the strengthening of the euro on the international forex markets.

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



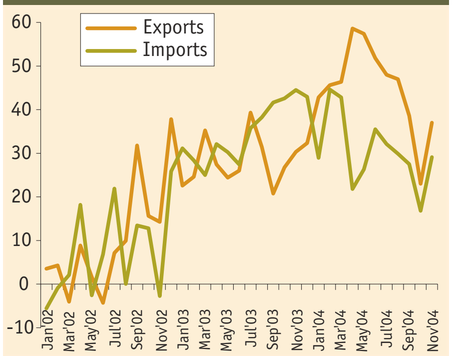
Source: National Bank of Ukraine

International Trade and Capital

According to preliminary balance of payment data, the current account surplus grew by 141% yoy to $7 billion in 2004. This amount represents 11% of GDP, thus lending support to the argument that Ukraine's economic growth is, to a great extent, externally driven. This large surplus of the current account is attributed to a substantially positive goods and services trade balance as well as high growth of remittances from Ukrainians working abroad.

The robust demand for Ukraine's traditional export commodities on the external markets along with the competitiveness of the exchange rate explain this remarkably strong export performance. In January-November, the merchandise trade surplus reached $3.4 billion, more than eight times higher than over the same period last year. Over the period, merchandise exports grew by 42.6% yoy (to $29.5 billion), outpacing import growth of 28.8% yoy (to $26.1 billion).

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

The main export commodities remained ferrous metals, machinery and equipment, and chemicals. The largest contribution to overall growth of goods exports, however, came from ferrous metals. Export volumes of these items expanded by more than 60% yoy in January-November, and their share in total exports made up about 33%. To a great extent, the increase in metals and metal products export revenue is explained by high international prices for these products. The cross-border sales of machinery and transport equipment increased by an impressive 56% yoy, which is a very positive development for the diversification of Ukraine's export base.

The structure of Ukrainian imports reflects high investment demand in the country. After energy resources, imports of machines and transport equipment are the biggest items contributing to total import growth. In January-November, Ukraine imported 38% yoy more machines and equipment than over the same period last year. At the same time, energy resources imports grew by 30% yoy, and their share accounted for 36% of total goods imports. The geographical orientation of Ukraine's foreign trade was dominated by Russia, which is the single biggest trade partner, accounting for 18% of all exports and 41% of all imports. Meanwhile, European countries' share of total merchandise exports and imports constituted 36.1% and 34%, respectively. Greater development of trade relations with the EU is expected after the new government of Ukraine negotiates a new agreement with the EU and Ukraine's accession to World Trade Organization (WTO).

International Programs

The new government intends to reconsider the terms of its cooperation with the International Monetary Fund (IMF). The current Precautionary Stand-By Program is valid through March 2005. This program was launched in March 2004 for 12 months, during which time Ukraine could use funds amounting to $607 million (or 30% of Ukraine's quota) in case an urgent need arises. However, it is unlikely that the Ukrainian government will request financing from the IMF within the pre-cautionary stand-by. The IMF has stated that it is ready to consider the new government's initiatives towards further cooperation with the Fund. Since 1999, Ukraine has been gradually reducing its obligations to the IMF. By the end of 2004, Ukraine's debt to the IMF shrunk to SDR1.034 billion from SDR2.045 billion in 1999. In its latest report on Article IV Consultation with Ukraine, the IMF praised impressive macroeconomic developments over recent years, but expressed concern on Ukraine's fiscal loosening, which may threaten the economic stability of the country.

The World Bank financing under the Second Programmatic Adjustment Loan (PAL-2) Program remains blocked. After disbursing $75 million of the PAL-2 late in December 2003, the transfer of the remaining $175 million of the loan was postponed until further progress in energy sector reform. In particular, the World Bank expects Ukraine to adopt a law regulating debt restructuring in the energy sector. It is likely that the new government will negotiate the continuation of financing under PAL-2 in 2005.

The European Bank for Reconstruction and Development (EBRD) plans to increase its investment portfolio in Ukraine. During the Davos World Economic Forum, President Viktor Yuschenko met with the President of EBRD, Jean Lemierre, who stated that EBRD would be able to attract about EUR1 billion of investments in Ukraine every year through its programs. The new government is expected to implement liberal reforms to improve the investment climate in Ukraine.

Other Developments and Reforms Affecting the Investment Climate

The major international rating agencies upgraded Ukraine's sovereign rating soon after the political crisis was settled. In January 2005, the international rating agencies Fitch and R&I upgraded Ukraine's long-term foreign and local currency ratings to BB-/Stable from B+. The major reason for the upgrade of the ratings was stabilization of the political situation in the country after the official publication of the presidential elections results. The uncertain political situation in Ukraine has long been the major limiting factor for the country's sovereign investment ratings. In December 2004, Moody's changed its outlook for Ukraine's rating from 'developing' to 'positive'. All these revisions reflect considerable improvement of the country's international image and investor confidence. The next step is for the new government to demonstrate its strong commitment to implementing market reforms in order to create a business environment attractive for foreign and domestic investors.

During the World Economic Forum in Davos, President Viktor Yushchenko presented his reform strategy envisaging a number of important first-priority steps that the government intends to take in the very short-run. Among them are reducing the size of the shadow economy, recovering the foundations of macroeconomic stability, fighting corruption, accessing the WTO, and developing mutually beneficial cooperation with all of Ukraine's neighbors. President Yushchenko has a strong backing of the electorate and a clear mandate to accelerate reforms and improve living standards. The appointment of Yulia Tymoshenko as Prime-Minister sends a clear signal of the pro-reform orientation of the government.