THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

Ukraine - Economic Situation

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Economic Growth.

During October and November, the economy grew at a pace lower than the peak achieved in June 2001. Nevertheless, GDP is still increasing at a relatively high tempo, with a growth rate of 8.0% in October and 8.4% in November, compared to the same months last year. During the first eleven months of the year, real GDP rose by 9.0% compared with the same period a year ago. In the ten-month period to October, the highest increase in the gross value-added was registered in the processing industry (19.3%), wholesale and retail trade (17.5%), construction (11.5%), and agriculture, the hunting, and forestry industries (11.2%). GDP for November is expected to be at around 8%, year-to-year. For the entire year 2001, the Government's most recent forecast is that GDP will grow by 8.2%, still one of the highest rates of growth in a world facing recessions elsewhere.

In November 2001, industrial output declined by 8.4% compared to the previous month. This led to a reduction in the cumulative rate of industrial growth from 16.1% for January-October to 15.4% for January-November, compared to the same periods last year. This decline reflects a number of negative influences on external demand, including the slow down in the world economy, the negative impact of lower oil prices in Russia (a key trading partner for Ukraine), antidumping and other trade restrictions imposed by Ukraine's main trading partners, and lower world prices for some of Ukraine's main export commodities.

For next year, the economy should continue to slow down reflecting the continuation of the above-mentioned negative factors. In addition, the rate of growth will be affected by limitations in capacity utilization. Many key sectors are reaching their limits in capacity utilization and further growth will require major increases in investments. So far in this year, foreign investments have been lower than in 2000, reaching only $529 million during the period January-October 2001, or 10% below the level achieved last year during the same period. Although total fixed capital investments increased by 45% in January-September compared to 2000, the level is still low: at a level of UAH 17.5 billion during this period, fixed capital investments represent only 11% of the period's GDP. Most of these investments went to the construction sector, including oil and gas pipelines, an oil terminal and investments in the power sector.

Nevertheless, next year in 2002, Ukraine should show positive rates of growth. Most economic analysts forecast rates of GDP growth for 2002 between 3% (projection by

CASE) to 4.5% (projected by ICPS). The Government's draft budget for 2002 anticipates at a rate of GDP growth of 6%, which would be hard to achieve.

Fiscal Policies.

Ukraine's fiscal situation continues to be sound, despite shortfall in privatization revenues and deficiencies at the central level in tax collections from enterprises. During the period January-October 2001, privatization revenues reached only UAH 2.05 billion, compared to a plan of UAH 5.0 billion for this period and UAH 5.9 billion for the entire year. At the central level, tax collections from enterprises are deficient, particularly in the energy and fuel sector, despite the tax amnesty under which the Government adjusted about UAH 19 billion of enterprise tax debts. As of November 1, private and state enterprises owed about UAH 6 billion to the consolidated budget. On the other hand, most of the fiscal revenue shortfalls were compensated by other taxes principally as a result of the robust growth of the economy.

During January-October 2001, consolidated budget revenues reached UAH 43.9 billion (including UAH 2.05 billion of privatization receipts), whereas consolidated budget expenditures amounted only UAH 42.3 billion. As a result, the consolidated budget had a surplus of UAH 1.6 billion during January-October 2001, including privatization receipts. Based on the IMF methodology that excludes privatization revenues, the fiscal deficit was only UAH 450 million or about 0.2% of estimated GDP for 2001, a figure well within the guidelines approved by the IMF. For the entire year, the Government anticipates that consolidated revenues will be about UAH 600 million lower than the original revenue plan, due to the shortfalls in privatization. This is a relatively small amount and the Government expects to reduce Government expenditures to balance the budget totally.

Key elements of the fiscal budget for 2002 were approved by Parliament during the Second Reading on December 13. Final approval is now expected during the Third Reading scheduled for December 20. However, the key parameters are already approved. There is agreement that the fiscal deficit should not exceed UAH 4.3 billion or 1.7% of GDP (based on the IMF methodology). There is also agreement on the level of fiscal revenues and expenditures. Many Members of Parliament want to increase fiscal revenues and expenditures by about 30% from the figures presented by the Government, principally to be used in the social sectors, in anticipation of the March Parliamentary elections. But they settled for a relatively small increase proposed by the Government. The State Fiscal Budget (which omits local budgets) now calls for expenditures of UAH 48.6 billion and revenues of UAH 44.3 billion. The Government believes that these figures are realistic. The final approval of the fiscal budget for 2002 will facilitate the release of IMF funds, currently planned for January 9, 2002.

The current draft budget for 2002 is based on the Government's expectation that GDP will growth by 6%, the annual inflation rate will be 9%, and the average exchange rate of the Hryvnia would be 5.6 UAH/$1.

Monetary Policies.

During its visit to Ukraine in Mid-November, the IMF stated that the monetary policies of the NBU in year 2001 had been broadly correct. Although money supply had increased significantly during the year, these increases were absorbed by greater money demand associated with the growth of the economy. As a result, inflation had been under control, while international reserves increased and the exchange rate appreciated slightly. The IMF however warned the Government that in the future, the growth of money supply should be restrained, as it may lead to an upsurge of inflation, given lower rates of economic growth in year 2002.

For the eleven-month period from January to November 2001, money supply (M3) grew by 29% and the Hryvna had appreciated to 5.27 UAH/$ by the end of November. NBU's gross international reached USD 3.2 billion as of the end of November. Inflation was contained to 0.2% in October and 0.5% in November, bringing the total inflation rate for the eleven-month period from January to November to only 4.5%.

The increase in international reserves was supported by significant purchases of foreign exchange by the NBU on the inter-bank foreign exchange market. Since the beginning of the year, the NBU has bought about $2.0 billion on the inter-bank market. Major sources of foreign exchange reserves were strong exports and disbursements by international financial institutions.

International Trade and Capital.

During January to September 2001, Ukraine’s surplus in its merchandise trade balance increased by 60% compared to the same period last year, reaching $635 million. Merchandise exports reached $12.0 billion (or about % of the period’s GDP) while merchandise imports amounted to $11.4 billion. However, during the last month of this period, in September 2001, the merchandise trade surplus narrowed to only $6 million, reflecting the negative factors mentioned earlier on external demand. Further deterioration is expected in the last few months of the year, though for the entire year the merchandise trade balance is still expected to be positive.

Including “services”, in January-September 2001 the total foreign trade in merchandise and services amounted to $26.8 billion, of which $14.6 billion were in exports and $12.2 billion were in imports. The surplus in total foreign trade amounted to $2.4 billion.

Ukraine main imports come from Russia (particularly energy). Russia now provides about 40% of Ukrainian imports ($4.3 billion during January-September 2001). Russia also remains as the main export market for Ukraine. However, Russia’s share in Ukrainian exports has been declining, reaching only $2.9 billion during January-September 2001. Currently, Russia accounts for only 24% of Ukrainian exports (compared to over 40% two years ago). Although Ukraine has been successful in finding other export markets (particularly in Turkey – which now takes 6% of exports, Italy -- 5%, Germany -- 4%, and US – 4%), Ukraine is keen to regain its exports to Russia. Over the last two months some progress has been made in this regard: there is now preliminary agreement on a higher quota for Ukrainian exports of pipes and there is agreement on a reduction of the re-export tariff for Russian natural gas. There is also a preliminary agreement that in the first quarter of 2002, Ukraine and Russian will finalize a new free trade agreement. The old 1994 free trade agreement is now inadequate since over 400 exemptions were introduced since then. The new agreement would reduce significantly the number of exemption and would deal with the negative effects of VAT and other indirect taxes introduced recently by Russia on Ukrainian goods.

The President of Ukraine has also given highest priority to the accession of Ukraine to the World Trade Organization. With the encouragement of the Chancellor of Germany during his recent visit to Kiev, Ukraine is also bidding to become an associate member of the European Union. On the other hand, Ukraine is still facing a number of trade sanctions, including antidumping tariffs in a number of countries. The US may also impose penalties affecting about $500 million of Ukrainian exports due to lack of Parliament approval of legislation to protect property rights, particularly in CDs production. If this legislation is not enacted shortly, during the second half of December, the US would decide to apply the penalties.

As noted earlier, despite the good performance of the economy during the last two years, foreign direct investments (FDIs) continue at a low level. In January-September, 2001 FDIs amounted to $529 million, or about 10% less than in the corresponding period last year. The cumulative amount of FDIs in Ukraine since independence amount to $4.2 billion or only $85 per capita, a very low number by any international standards. The U.S. has been the largest investor (16.8% of the overall amount), followed by the Netherlands (8.8%), Cyprus (9.5%), the U.K. (8.7%), Russia (7.0%), and Germany (6.3%).

Structural Reforms

Given the low levels of FDIs and insufficient domestic savings, the Government in now developing an accelerated program to improve the business climate in Ukraine. This Program will be based on a Presidential Decree issued in July 2001, which in turn is based on the report of the Task Force on International Private Capital, which was chaired by SigmaBleyzer, and which included private firms and international institutions working in Kiev. It is expected that this Program will lead to concrete measures to provide a more attractive environment for investments.

During the last two months, the Government has also been fairly successful in securing the enactment by Parliament of a number of important legislative measures. As reported earlier, in October, Parliament enacted the Land Code, which establishes the right for private ownership of agricultural land, land leasing, and its use in mortgage lending operations. The Land Code will become effective on January 2002, though there is a moratorium on agricultural land trading until year 2005. However, this moratorium should not be an undue restriction since land would be able to be leased and mortgaged freely.

Parliament also has enacted the Civil Code, which will become effective on January 2003. The new Civil Code contains important business related measures, including better protection of property rights and better definition of punishment for violation of contracts obligations.

In addition, at the end of November, Parliament enacted the Commercial Code. The Commercial Code provides for better umbrella legislation on business activities, including bankruptcy, fair competition, corporate governance, pricing decisions, and corporate security issues.

International Programs

As scheduled, in early December, the World Bank disbursed the second tranche of $100 million under the Programmatic Adjustment Loan (PAL) of $250 million, which was approved in September 2001. In disbursing this amount, the World Bank stated that Ukraine had met the loan conditions, including the resumption of the privatization of electricity companies, increasing cash payments in the electricity sector, and increasing electricity tariffs in some Oblasts. These funds are not tied and would be used to increase foreign exchange reserves, with the local currency counterpart used to increase fiscal budget resources. A second PAL loan of $250 million is expected to be approved by mid-2002. In early December, the World Bank also approved a loan of $50 million for a Social Investment Fund Project. These funds will be disbursed over the next six years to local communities to improve the delivery of social programs, such as building small water supply systems, improving schools, etc.

The Government has requested the European Bank to reconsider the terms and conditions of the $215 million loan for the completion of the Rivne and Khmelnysky nuclear power plants. In particular, the Government believes that the budget for completing the project (estimated by the EBRD at $1.4 billion) should be reduced drastically. Based on consultations with Russia, the Government believes that greater supply by Russia should be able to reduce the cost of the project by about 60%. A Government team is in London to review this matter with the ERRD.

The IMF visited Kiev in mid-November to review progress under its EFF Program. It was not able to recommend disbursement of the $370 million December Tranche due to the fact that the following loan conditions were still pending at that time: Parliament approval of a satisfactory Fiscal Budget for 2002, audit of the gas company Naftogaz Ukrainy, draft of a Program to repay delayed VAT reimbursements, increasing electricity tariffs in all Oblast as agreed with investors, and strengthening of commercial bank supervision. If these measures were to be taken by December 25, the Executive Board would be able to consider disbursements in its January 9 meeting.