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Economic Growth

As stated in previous reports, the Ukrainian economy is expected to continue to grow at a reasonable positive rate during 2002 — though at a lower pace than in 2001. In 2002, GDP is expected to increase by approximately 3% to 5% in real terms, compared to a GDP growth rate of 9.1% achieved in 2001. The lower economic growth in 2002 is due principally to the negative effects of the slowdown in the world economy, foreign trade restrictions and penalties imposed on Ukrainian exports by various countries, and capacity utilization rates nearing ceilings in many sectors of the Ukrainian economy. The government is now keenly aware that, over the medium term, the sustainability of growth in Ukraine will depend on its ability to increase investments, both domestic and foreign. The government is preparing a detailed Action Plan to carry out further economic reforms in the near future to improve Ukraine's business environment and attract investment. Economic growth in Ukraine will also depend on the evolution of external economic conditions, particularly in Russia, its main trade partner.

In January-February 2002, the Ukrainian economy grew in accordance to expectations. During these two months, GDP increased by 3.6% in relation to the same months last year. In February alone GDP grew by 4% compared to February 2001. In this two-month period, the fastest growing GDP sectors were wholesale and retail trade — 18.6% year-to-year, agriculture and forestry — 10.4% year-to-year, and processing industries — 4.1% year-to-year. Small declines were registered in mining, ferrous and non-ferrous metal production, chemicals and petrochemicals, transportation, and electricity generation.

Fiscal Policies

For the third year following the Russian financial crises of 1998, Ukraine maintained sound fiscal policies. Before 1998, unsustainable fiscal deficits were common, averaging 5.6% of GDP during 1994–1997. Since 1999, however,

Ukraine has shown a strong commitment to maintain the fiscal deficit below 1.7% of GDP (in accordance to the IMF methodology and with agreements under the IMF program.)

For 2002, the consolidated fiscal budget deficit is expected to be UAH 4.3 billion (about \$800 million) or 1.7% of the 2002 GDP. The government expects to finance this fiscal deficit by privatization receipts and external borrowing.

For 2002, privatization receipts have been budgeted at UAH 5.8 billion (\$1.1 billion), an ambitious figure unlikely to be met. During the first two months of 2002, the State Property Fund had transferred to the state budget only UAH 94 million, out of sales of UAH 160 million, including UAH 115 million from the sale of preferential shares of the national telecommunication operator, Ukrtelecom. During the rest of the year the government hopes to sell 281 state companies, including large metal, chemical and engineering enterprises (such as Azovstal, Rosava Tire and the Nikopolskyi Pipe), two groups of oblenergos (regional energy distributors), and a 37% stake in Ukrtelecom. All of these are unlikely to materialize.

In addition to the likely shortfall in privatization revenues in 2002, a second risk for the 2002 budget is the possibility that revenue projections would not materialize as planned. In the approved 2002 Fiscal Budget, fiscal revenues were calculated assuming a GDP growth of 6% for 2002, a growth figure that may not be achieved. In fact, during January and February 2002, state revenues are already 4.5% below the target for these months.

Nevertheless, as was the case last year, the government has designed its fiscal budget in such a manner that many budget expenditures planned for later in the year would be incurred only if fiscal revenues and privatization receipts were to materialize. This expenditure control policy gives credibility to the government's commitment to maintain the fiscal deficit within the planned parameters.

Monetary Policies

Inflation in Ukraine continued to be under control. In fact, during February 2002, the Consumer Price Index actually declined by 1.4% compared to the previous month. From the beginning of the year, the inflation rate has been negative, with deflation of 0.4%. Given these results, the National Bank of Ukraine is now forecasting that the inflation rate for 2002 may be around 7.0% to 7.5%, lower than the original estimate of 9.8% for the year.

The deflation in January and February 2002 is explained by two factors. First, foodstuff prices declined by 0.6% during the period, led by a 40% decline in grain prices associated with the plentiful 2001 grain crop and strong control of bread prices. Second, deflation was supported by a decline of 1.2% in money supply (M3) during this two-month period (a decline of 4.3% in January and an increase of 3.3% in February).

For 2002, the government forecasts that money supply (M3) will grow by about 18–20%. To achieve this goal, monetary policy will need to be under tight control during the year. In fact, the favorable monetary results of January-February 2002 were due to a large decline in money supply in January, and compensated by a large money supply increase of 3.3% in February. This monthly increase cannot be continued. The government will need to maintain monthly supply increases at less than 1.8% per month to achieve the yearly target.

Over the last three years, the hryvna has been reasonably stable, at around 5.3 UAH/\$1. As of March 15, the exchange rate was 5.32 UAH/\$1. Since the beginning of the year, the level of gross foreign exchange reserves has also been stable, standing at \$3.1 billion as of March 15, 2002. This represents about 8 weeks of imports. The government intends to increase gross international reserves during the year. The IMF recommends countries to maintain sufficient reserves to cover three months of imports, which would imply international reserves of about \$5.2 billion.

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Government Debt

Since the 1998 financial crises, the level of foreign government debt has been declining to approximately \$9.8 billion by February 2002. Of this amount, \$7.9 billion are owed by the Ministry of Finance and \$1.9 billion are owed by the NBU to the IMF. During the last few years, the government carried out significant foreign debt repayments even though international agencies provided little additional financing and no new private foreign debt was forthcoming. As a result, foreign government debt now represents only 22% of GDP, down from almost 40% of GDP in 1999.

In 2003, the government plans to re-enter the international private capital market, after a halt in "voluntary" lending of five years, following the 1998 financial crises. The government is considering borrowing about \$500 million. These funds may be raised by issuing Eurobonds with maturities of 7 to 10 years, or by securing a syndicated bank credit, depending on the conditions proposed by investors.

Regarding bilateral debt due to the Paris Club, the general debt restructuring agreement signed in July 2001 called on the signing of separate bilateral agreements between Ukraine and country members by March 31, 2002. In December 2001, Ukraine signed a bilateral agreement for \$295 million due to Germany, the largest creditor of Ukraine within the Paris Club. However, the Ministry of Finance has now reported that the signing of other individual agreements for a total of \$285 million with France, Germany, Italy, Japan, and the US have been delayed until June 1, 2002. It is not expected that this matter will become an issue.

International Trade and Capital

In 2001, the external trade surplus of goods and services remained at the same level achieved in 2000, or about \$2.9 billion. For 2002, the government forecasts that the country will be able to maintain a similar surplus in its goods and services account. This expectation is based on the active engagement of the government, including the President, to open new markets in non-traditional countries. The government expects that the share in total exports of machine-building, metal-working, grain and food products would increase substantially, compensating for the expected decline in the share of metallurgical and chemical products.

In fact, Ukraine has been fairly successful in opening new export markets in the face of trade restrictions imposed by some countries. The share of traditional buyers such as Russia has continued to decline. In January, the share of exports to Russia declined to 14% of the total exports, compared to 23% in 2001. The reduction of Ukrainian exports to Russia was compensated by export growth to other countries, particularly Turkey, China, Germany, and Italy.

However, given the global economic slowdown and the antidumping investigations and trade sanctions imposed against Ukrainian exports, the country's trade surplus of goods and services is unlikely to be as large as forecast by the government. In fact, some analysts predict that the country may be able to show only a slight surplus in its trade account.

So far, the trade balance is proceeding satisfactorily. In January-February 2002, the surplus in the merchandise trade account reached \$537 million compared to a surplus of \$60 million in January-February 2001. During these two months, exports of goods increased by 6.9% compared to the same months in 2001, reaching \$2.5 billion, while imports declined by 13.6% to \$2.0 billion. Ferrous metals continued to represent the largest share of exports at 28% of total exports (\$700 million), even though this amount implied a decline from a 34% share over the same months last year. However, exports of other products compensated, particularly exports of mineral fuel, oil, and oil products, whose share increased from 5.1% during the same period last year to 9.1%. Grain also increased its share of exports.

International Programs

The IMF has not yet agreed to disburse by May 30, the \$370 million tranche originally expected for December 31, 2001 under the EFF Program by May 30th. This is because of disagreements between Ukraine and the IMF on the issue of refunding about \$360 million of overdue Valued Added Tax arrears owed to exporters. The Ministry of Economy reported that the government could not comply with the IMF requirement to repay about \$130 million in March 2002, and \$120 million by the end of June 2002. As noted earlier, however, IMF disbursements have become less critical for Ukraine over the short term, because the level of loan repayments to the IMF has declined sub-

stantially from \$800 million due and paid in 2000 to only \$230 million due in 2002. This level of loan repayments can be handled by the government given its level of international reserves.

The satisfactory resolution of the VAT arrears may take some time and may not occur before the September 2002 expiration date of the EFF Program. However, the government is keen to continue some form of program with the IMF. After September 2002, the government may wish to request another EFF lending program with new conditionality, or only a "precautionary" arrangement (under which disbursements would take place only in case of need), or just a monitoring IMF program, which would not involve any disbursements but would imply a seal of approval by the IMF on the macroeconomic policies of the government. These arrangements may be important in connection to the planned borrowing by Ukraine on international capital markets in 2003.

In fact, if IMF financing were not to proceed, the government will need to seek other sources for medium to long term international financing (either from the private sector or multilateral agencies, such as the World Bank and the European Bank). This is because the government may not be able to maintain its international reserves in the future by purchasing foreign exchange on the inter-bank market. In 2001, the NBU was able to purchase about \$2.2 billion in foreign exchange while maintaining a stable exchange rate for the hryvna. With a less favorable export outlook, this high level of foreign exchange purchase may affect the stability of the hryvna exchange rate in the future.

The World Bank is continuing with the preparation of the second Programmatic Adjustment Loan for \$250 million. This balance-of-payments loan is conditional on Ukraine's removal of institutional bottlenecks that delay economic reforms. In particular, Ukraine will have to show progress on energy sector restructuring and privatization, improved fiscal discipline and budget execution, better property rights protection, and continued social reforms. A World Bank mission visited Kiev from February 3 to 13 and reported good progress discussing the conditions of the loan. Given the Rada (Parliament) elections at the end of March and the possible change in government thereafter, the PAL program is expected to be finalized only after September 2002.

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