Ukraine - Economic Situation

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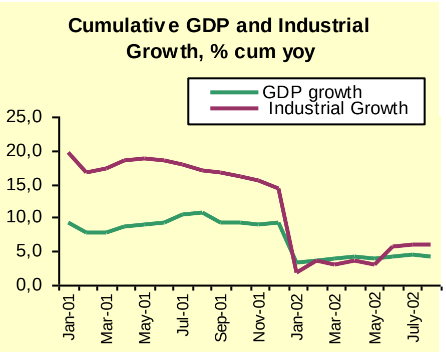
September 2002

Economic Growth

After high growth rates in June and July, in August 2002 GDP growth rate decelerated to 3.3% year-to-year, resulting in overall real GDP growth of 4.2% for January-August 2002, as compared to the corresponding period of 2001. The slow down of the economic growth in August was due to the decrease in the rate of growth of value-added in agriculture and wholesale and retail trade.



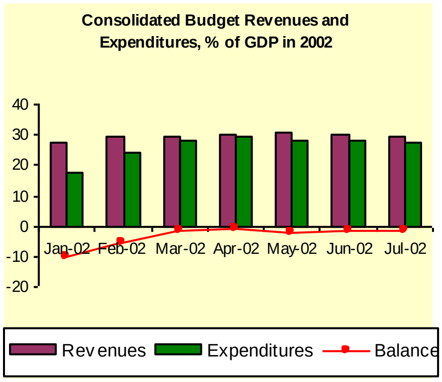
Source: State Statistics Committee

In August, industrial production grew by only 4.5%, following 7.5% yoy growth rates in June and July. Negative growth rates were observed in the mining of metals and food industry, while high positive growth rates were noticed in the wood industry, chemical industry and metallurgy and metal-processing. For the first eight months of the year industrial output grew by 5.9% (compare to 17.1% for the same period of 2001).

As of August 30, the harvest of grain had reached 36 million ton, on about 97% of the total area under crop. It is expected that grain production will reach 37-38 million tons, compared to about 40 million last year. This is still a remarkable achievement, considering that two years ago, grain output was only 24 million tons. Grain exports are expected to reach 7-10 million tons in the 2002-2003 marketing year, placing Ukraine among one of the world's largest grain exporters.

Fiscal Policies

For January-July 2002 the consolidated budget had a surplus of UAH1.8 billion, or 1.6% of GDP (compare to 0.3% deficit for the same period of 2001). The Government had to produce this fiscal budget surplus in order to make necessary principal debt payments on Government debt. To serve this debt, no other options were available, given the absence of external financing (which reached only 3% of the planned yearly amount), legal limits on internal borrowing, and the shortfalls in privatization receipts (with receipts reaching only 8% of the yearly amount). The fiscal budget surplus was generated principally by lowering budget expenditures below the original plan.



Source: State Treasury

From January to July 2002, consolidated budget revenues and expenditures represented 29.5% of GDP and 27.8% of GDP respectively. Although these budget revenues and expenditures were above the levels achieved in 2001 (25.4% and 25.7% of GDP for the 7 months of 2001, respectively), they were behind the planned levels. The yearly targets for revenues and expenditures are not likely to be met.

To cover a possible fiscal gap during the rest of the year, the Government will need to take further measures to curve Government expenditures, increase internal financing through the issuance of government bonds, and improve the collection of fiscal revenues. These measures would require amendments to the 2002 Budget Law.

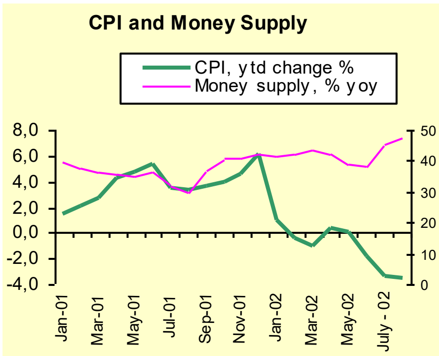
Further expenditure reduction during the rest of the year will be necessary, though it may be difficult to achieve. To balance the budget, increases in budget revenues are necessary. For this, the Government will need to reach agreement with Parliament to abolish a number of tax privileges and exemption enacted last year.

The Government will also need to address the issue of VAT refund. VAT refund arrears -- after some decline in the first quarter of the year -- increased to UAH6.1 billion as of August 2002, of which overdue VAT refunds amounted to UAH2.3 billion.

During the January-July period, privatization receipts to the budget reached only UAH 455 million (only 8% of the annual target of UAH5.8 billion). The Cabinet of Ministers decided to postpone the privatization of Ukrtelecom (42.86%) expecting the situation at world telecommunications market to improve in 2003 and securing enough time to prepare Ukrtelecom for privatization and develop new laws on telecommunications and tariff policy. The Government has now approved the sales terms of nine regional energy distribution companies. However, the timing of sales has not been decided upon yet. One of the problems to solve is the debt of energy-supplying companies. Taking into account the last trends in the privatization process and current economic situation, the State Property Fund has revised its 2002 privatization receipts forecast to UAH 1.0 billion. The privatization of Ukrtelecom, oblenergos and UMC were to bring about 85% of the yearly plan of the privatization revenues (UAH 5.8 billion).

Monetary Policies

Price deflation continued in August, though at a lower rate. In August consumer prices decreased by 0.2% as compared to July, resulting in overall 3.5% year-to-date inflation rate. Prices for food products went down by 0.7% as compared to July, while prices for non-food products and services increased by 0.1% and 0.9%, respectively. Among the services, the highest growth rates were registered in communications (9.6% as compared to July), reflecting the announced increase in the tariffs for telecommunications services, which became effective as of July 31. Increases in the tariffs for transport, electricity and communal services can influence the inflation level in the subsequent months. The Ministry of Economy has revised its inflation forecast for the year down to 3.5%.

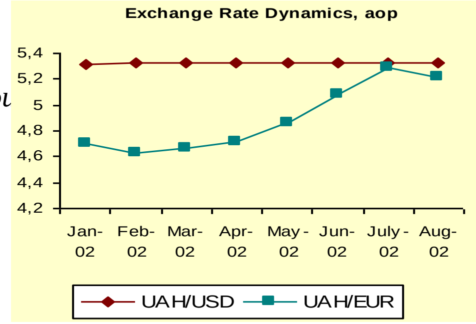


Source: State Statistics Committee, NBU

In July, the Producer Price Index (PPI) also decreased by –0.4%, bringing the rate of growth of the PPI to 5.0% since the start of the year. Since December 2001, the highest growth rates in Producer Prices were registered in the intermediate industries, including the production of coke and oil processing (25.5%), production and distribution of electricity, gas and water (12.8%) and in the mining of energy materials (14.2%). Industries oriented at the final consumer faced either declines or slight growth in prices. The lowest decline rate was registered in the prices for food industry and food processing (-2.5%). The rise in prices in the intermediate industries also led to lower profitability of final producers, reducing tax payments and lowering the amount of excess funds for investment.

The low level of price increases since the beginning of the year occurred despite large increases in money supply. Money supply (M3) rose by 47% yoy to UAH 56.3 billion at the end of August. The monetary base increased by 41% yoy to UAH 28.9 billion.

The average official exchange rate UAH/US$ has been stable during the last several months. In August it stood at 5.33 UAH/US$. The average UAH/EUR exchange rate has slightly appreciated to 5.21 UAH/EUR after several months of depreciation. Currently, there is a stable excess supply of foreign exchange over demand. The commercial banks trading on the inter-bank currency market predict further stability of Hryvnia.



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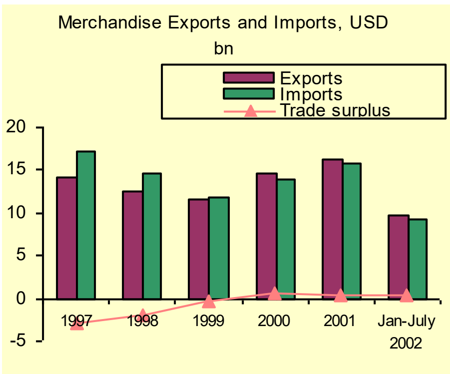
The NBU has continued its purchase of foreign exchange in the inter-bank market. The level of NBU international gross reserves has continued to grow reaching $4,080 million. in August (an increase of 32% since the start of the year).

The average deposit rate has slightly decreased to 7.6% as of August 31, while the average lending rate decreased by about 30% from 29.39% at the start of the year to 20.9% in August. The total volume of domestic bank credits has increased by 25% since the start of the year.

International Trade and Capital

During the first seven months of the year, the general volume of foreign trade in goods reached $18.8 billion, representing an increase of 4% as compared to the corresponding period of 2001. Exports grew by 2.3% to $9.6 billion while imports of goods increased by 5.8% to $9.2 billion. The goods trade balance had a surplus of $400 million, a deterioration of almost 40% as compared to the corresponding period of the previous year. However, considering Services, the current account balance for the first half of 2002 was higher that in 2001, amounting to $600 million (compared to $500 million in the first half of 2001).



Source: State Statistics Committee

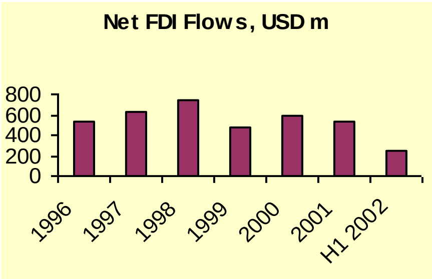
Ukraine's exports of steel products stabilized somewhat in the last 3-4 months. Improvements in the world steel market allowed the Ukrainian steel producers to slow down the decline in exports of ferrous metals and products from them (for January-July, the decline was only 0.9%). Their share in the total amount of goods exported is about 42%. World prices for steel have gone up and may remain relatively stable during the rest of the year. The stabilization of the external demand and further growth of internal consumption may contribute to the stable development of the metallurgical sector.

However, the increasing number of antidumping investigations remains the most important risk for Ukraine's steel producers. Recently, the EU refused to increase the quota for imports of steel products from Ukraine by 27%, failing to ratify the corresponding agreement. China's market, one of the most important Ukraine's steel markets, is now increasing protectionism, which manifested itself in the August introduction of new imports and customs duties for certain steel products. Russian steel market continues to be restricted notwithstanding some improvements. During the last meeting, the Prime Ministers of Russia and Ukraine agreed to cancel some trade restrictions following the earlier agreements of the Presidents. Russia will abolish quotas for Ukrainian pipes and Ukraine will remove trade barriers for the imports of 19 types of Russian goods. It was agreed that for some steel products exported to Russia, quotas instead of prohibitive import duties will be introduced, in particular, for galvanized steel, metal bars and some other ferrous metals. These decisions can contribute to the liberalization of trade between the two countries. Ukrainian exports to Russia had declined significantly this year as a result of the introduction of different trade barriers by Russia and movement to the destination principle of VAT administration.

The US Government has postponed the decision to grant Ukraine the status of a country with a market economy, which could be beneficial for Ukrainian steel and other exporters and improve Ukraine's investment image as a whole. Nevertheless, on the positive side, the US Government approved a decision to exclude another 178 of steel products from the list subjected to the import duty. Nevertheless, the world steel market continues to be highly distorted by state interventions.

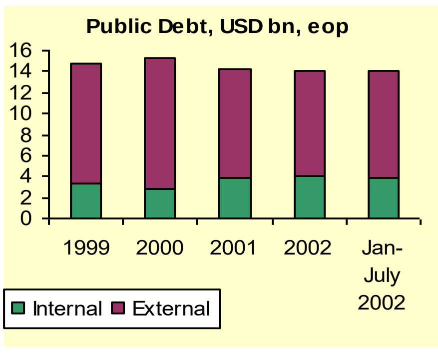
Agricultural production growth and favorable external conditions allowed the expansion of exports of cereal crops. The world markets for grains have been quite favorable for Ukrainian exporters. In particular, Ukraine's grain exports were positively influenced by EU easing of trade restrictions for some grain products, following the negative consequences of floods in Europe. Japan and Brazil have showed greater interest in Ukrainian grains. Currently, Ukraine is exporting its grain products to the Near East, North Africa and EU markets. Lower grain harvest in the traditional country-exporters, such as the USA, Australia, Canada and Argentina, has also benefited Ukraine. Grain exports may be, however, may be affected by the increases the arrears to exporters of VAT refunds. The high level of grain exports will increase Ukraine's chances of preserving the positive trade balance till the end of the year.

During January-June 2002, the net flow of Foreign Direct Investments (FDI) was $276 million, or 15% above the low levels achieved in the first half of 2001. This brought the total stock of FDI in the country to $4.7 billion as of July 2002. This flow of FDI is significantly below the potential flows for Ukraine. The largest foreign direct investment came from the USA, United Kingdom and Virgin Islands. The major net capital inflows came into the food and food-processing industry (11%), wholesale trade (28%), metallurgy and metal processing (31%), property operations (11%) and production of other non-mineral materials (6.5%).



Source: Cabinet of Ministers

During January-July 2002 the level of public debt, domestic and external, decreased by $101 million to $14.0 billion, mainly due to the decrease of the external part of the debt. External debt now amounts to $10.1 billion. The major categories of the external debt are WB (23%), Russia (18%),



Source: Ministry of Finance

external private debt obligations (22%) and IMF (19%). The Government approved the decision to issue additional series of long term 7-year Eurobonds in the amount of $250 million to complete the restructuring of its commercial debt before those creditors who had earlier refused to restructure their debts in 2000-2001.

International Programs

The World Bank

The proposed second Programmatic Adjustment Loan (PAL-2) for $250 million was agreed upon at the working level between Ukraine's Government and the WB. The loan is aimed to support the following areas: fiscal and financial discipline, regulatory reform, property rights, public sector accountability and mitigation of social and environmental risks. The IMF confirmation that there is a sustainable macroeconomic framework in Ukraine is required for the proposed package to be presented to the WB Board of Executive Directors for approval. It is expected that the loan would be approved before the end of the year. The Government is accounts on receiving the credit from the World Bank notwithstanding the problems with the IMF as it has been previously scheduled – in November before the new Program with the IMF is launched.

The World Bank has also granted a loan of $24.5 million to Ukraine to upgrade Lviv water supply and sewerage.

IMF

The IMF decided not to disburse the last loan tranche to Ukraine under the EFF Program that expired on September 3, 2002 due principally to disagreements on fiscal policies problems. In particular, the IMF was concerned with the failure to solve the VAT refund problem and to abolish tax exemptions. Giving the present exceptionally high level of the NBU international reserves, positive external situation and current ability of the Government to serve its debt fully and in time, the decision may not have any severe negative consequences at present. However, next year is expected to be difficult for Ukraine in terms of external debt repayments. The external debt payments for 2003 are scheduled at the level of $2 billion (including the IMF), compared to $700 million due this year.

The Government and the NBU are now discussing the development of a new program of cooperation with the IMF. It is envisaged that the most plausible forms of cooperation are either a new Stand By program or IMF Staff Monitoring program. The Government expects an IMF mission to discuss forms of cooperation in October.