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Ukraine
Macroeconomic Situation

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Highlights

During the past few months, political developments overshadowed relatively good economic performance, affecting the business environment and leading a number of international rating agencies to express doubts on the future creditworthiness of the country. These negative political developments included international issues, in particular the accusations that Ukraine illegally sold advanced radar systems to Iraq. But there were also political uncertainties, such as the dismissal of the Cabinet, the proposed dismissal of the National Bank President (which was rejected by Parliament), and the lack of a clear and solid working majority in Parliament.

Following the dismissal of the Cabinet, the President has appointed Mr. Viktor Yanukovitch as Prime Minister. Mr. Mykola Azarov (the former head of the State Tax Administration) was appointed as First Vice Prime Minister and Minister of Finance; Mr. Vitaliy Haiduk as Vice Prime Minister for Fuels and Energy; Mr. Dmytro Tabachnyk as Vice Prime Minister of the Social Sector; and Mr. Ivan Kyrylenko as Vice Prime Minister for Industry and Agriculture.

The ultimate performance of the new Cabinet will depend less on the qualifications of its individual members and much more on its ability to work effectively with a majority in Parliament and secure approval of key pending legislation. In fact, over the last two years, very important pieces of key economic legislation have been drafted with the assistance of international agencies. If this legislation were to be enacted now, it would yield a remarkable improvement in Ukraine's business environment.

This legislation includes the Law of Joint Stock Companies that would improve corporate governance and protect minority shareholders; the Civil Code and Commercial Code that would provide a more stable legal framework for businesses and protect property rights; the Tax Code that would reduce tax rates and expand the tax base; the Law on Tax Exemptions that would repeal special privileges and improve fiscal revenues; the Laws on Land Markets and Land Titling and Registration which are required to make effective the new Land Code; the Law on Privatization of Energy Companies that would permit the debt restructuring of state energy companies and facilitate their privatization; the Law on Secured Transactions that would protect creditors' rights and facilitate mortgage financing; the Law on Financial Leasing that would permit leasing of agricultural and other equipment; and the Laws on Judiciary Procedures that would complement the new Law on the Judiciary and facilitate the resolution of business disputes. Most of this legislation has been drafted and discussed widely, but is currently stalled in Parliament.

The next few months will reveal whether the new government will be able to constitute a working relationship with the majority in Parliament that would permit the enactment of key pending economic legislation. If this were to happen, the performance of the new government in improving Ukraine's business environment would be successful. Otherwise, the next two years, prior to Presidential elections, would be faced with political instability and only mediocre economic growth.

Economic Growth

In October 2002, GDP grew by 3.8% year-to-year, following a 3.1% growth rate in September. Both rates are below the 4.1% growth rate achieved during the ten month period from January to October 2002, as compared to the same period last year, indicating a further slowdown of economic activity. This led the government to revise downwards its forecast for economic growth in 2002 from 6% to the range 4.5%–4.8%. Most forecasting agencies (IMF, World Bank, EBRD, ICPS) predict GDP growth rates for 2002 within this range.

Most economic agencies anticipate that GDP growth in 2003 will range between 3.5% (ICPS) to 5.0% (IMF). The EBRD forecasts a GDP growth rate of 4.5% for 2003. The Government's own "conservative" GDP forecast for the 2003 fiscal budget is 4%. Higher rates of economic growth would depend on an acceleration of domestic and foreign investments. In turn, this acceleration of investments will depend on the ability of the new Cabinet to implement major economic reforms based on the early enactment of pending supporting economic legislation by Parliament.

Currently, the economic activity of the country continues to be driven by the growth of domestic demand, particularly wholesale and retail trade (which increased by 10.3% in the last ten months compared to last year). Other growth areas have been the mining industry and agriculture.

In October 2002, industrial production increased by 4.7% compared to the same month last year. This brought the growth rate of industrial production to 6% for the period January-October 2002 compared to the respective period of 2001. The highest growth rates were registered in the wood industry and in the production of coke and oil processing. Negative growth was observed in the production of energy.

Agriculture has performed at reasonable levels as expected, with value-added in agriculture increasing by 4.1% in January-September 2002, compared to the same period last year. At the same time, the grain harvest reached 37 million tons with the expectation that it will reach 38-40 million tons by the end of the year. This output is similar to last year's record output and significantly above the 24 million tons obtained in 2000. The government expects grain exports to reach about 10-12 million tons in the current marketing year. Exports were helped by a decision made on September 5th, by the European Commission, to abolish import duties on Ukrainian grain. The exports of grain to the EU may reach about 3 million tons. In 2001, the major markets for Ukrainian exported grain were the EU, South Korea, Northern Africa, and Israel. For 2002-2003, Ukraine intends to expand its grain exports to non-traditional markets, including Brazil.

Fiscal Policies

During the January-October 2002 period, the consolidated fiscal budget was kept under control with a surplus on a cash basis. However, this surplus was achieved principally by withholding expenditure payments on incurred costs, since the planned level of fiscal revenues did not materialize. In fact, from January to October 2002, state budget revenues have amounted to about 70-80% of the planned amounts.

The receipts from privatization are not considered fiscal revenues, but are also important because they are budget-financing items. As noted earlier, the shortfall in privatization receipts is significant. From January to October 2002, privatization receipts amounted to only $100 million compared to an original plan of $1.1 billion for the entire year.

In order to make up part of the shortfall in revenues and privatization receipts, the government decided to borrow domestically and abroad. To borrow domestically, the government obtained Parliamentary approval to increase the ceiling on domestic borrowings for 2002 by UAH 2.4 billion (increase from UAH 1.5 billion to UAH 3.9 billion). This increase is significant and its successful placement on a non-inflationary basis is still in doubt. The government failed to sell government bonds with a maturity of 3 and 4 years in September. The yield of those bonds was 9.25% and 9.75%, respectively. For the proposed issuance to be successfully placed, their yields would need to be raised. Otherwise, the NBU may be forced to absorb these resources with potential inflationary effects.

To secure external financing, the government issued $260 million of Eurobonds 2000 in mid-November with a yield of 10.8% and a final maturity in 2007. The amount placed was below the original plan of $350 million. For a larger placement, investors had required a higher yield to reflect the negative recent assessments made by bond rating agencies as a result of the current political uncertainties facing the country. The placement was managed by Credit Suisse First Boston and Dresdner Kleinwort Wasserstein.

The size of the proposed fiscal budget for 2003 is another important issue that may affect future international financing possibilities. The government submitted the draft 2003 fiscal budget to Parliament in September 2002. The original draft budget envisaged a consolidated fiscal deficit of UAH 800 million or 0.3% of GDP, with consolidated fiscal revenues of UAH 62.6 billion and consolidated budget expenditures of UAH 63.4 billion. Consolidated budget revenues were forecast to increase by 8% compared to the original 2002 budget revenue plan. The proposed 2003 budget was drafted on reasonable macroeconomic forecasts: real GDP growth of 4%, inflation of 7.7%, an average exchange rate of 5.57 UAH/$, internal borrowings of UAH 1.3 billion, external borrowings of $850 million, and foreign direct investments of $750 million. It is also based on the existing tax legislation. The draft Budget Law also envisages the repayment of overdue VAT refund debt in the amount of about UAH 900 million. The share of social expenditures would be raised from 50.7% in 2002 to 53.8% in 2003. The share of the local budgets was increased from 41% to 46%. Most analysts had regarded this draft budget as realistic.

Unfortunately, during the review of the draft 2003 fiscal budget by Parliament, proposals were introduced to increase budget revenues and expenditures substantially, by about UAH 4.0 billion or 1.6% of GDP. Parliament also increased the original plan for privatization receipts from UAH 2.1 billion to UAH 4.3 billion (1.7% of GDP) and included this amount in the budget as a revenue item (not as a financing, below the line item as proposed by the government and recommended by the IMF). The overall increase in revenues would amount to 3.3% of GDP. However, these increases in revenues are unlikely to materialize, since they were not supported by specific budget measures, such as increases in the tax base. Therefore, at the new planned level of expenditures, with likely shortfalls in revenues, a high fiscal deficit of about 2% of GDP (IMF methodology) could emerge. The new government has stated that the proposed revenue increases are unrealistic and has requested Parliament to delay further consideration of the fiscal budget until December 12 in order to permit the new government to develop alternative proposals.

Monetary Policies

Following several months of price deflation, prices increased by 0.2% in September, 0.7% in October and 0.7% in November 2002. This resulted in an overall deflation of 1.9% over the eleven month period. The government now forecasts that inflation in 2002 will be slightly above zero. Part of the price increase in October was due to the decision on October 1, 2002 by Russia to increase export duties on oil products.

The growth rates of the monetary aggregates slowed in September compared to the summer months. In September, money supply (M3) grew by 2.5%, bringing the rate of growth to 27% since the beginning of the year. According to the NBU's Council, money supply will grow by 30-36% in 2002. Although the rate of growth in money supply has been high, it has not been reflected in high inflation so far, due to higher rates of growth in money demand.

During the last few months, the average Hryvnia exchange rate has remained stable at about 5.33-5.38 UAH/$. For 2003, the NBU forecasts that the average exchange rate will be 5.48 UAH/$. The Government has used an average exchange rate of 5.57 for the preparation of its draft 2003 fiscal budget.

The amount of gross international reserves is at a reasonable level of about 12 weeks of imports. As of November 15, 2002 the NBU's gross international reserves amounted to $4.1 billion, an increase of about 30% since the beginning of the year. In the next few months, the NBU predicts lower trading volumes of dollars over the interbank currency exchange market, which may contribute to a slower pace of reserves growth. Exports are the major source of foreign exchange into the country at present. The NBU's Council forecasts a current account surplus of $2.1 billion in 2002 and $1.45 billion in 2003.

International Trade and Capital

Despite numerous trade sanctions imposed on Ukraine, the country's foreign trade has continued to perform better than expected. During January-September, the total volume of foreign trade in merchandise amounted to $24.8 billion, representing an increase of 6.1% year-to-year. During this period, exports of goods increased by 6.3% to $12.8 billion whereas imports of goods increased by 6% to $12.1 billion. The positive trade balance of $710 million is above the $630 million surplus achieved in the same period of last year. Including services, the balance was even more favorable. For January-September, the trade balance in goods and services reached $2.6 billion (12% over the balance achieved in the same period last year). Exports of goods and services reached $15.6 billion (6.9% increase over last year), whereas imports of goods and services reached $13.0 billion (an increase of 5.9%).

Geographically, Ukrainian exports have been increasing in Europe, Asia and Africa, compensating declines in exports to CIS countries and the US. Russia remains Ukraine's main trading partner, but with only 17.9% of exports and 36.4% of imports. Turkey is the second export market (7.5%), followed by Italy (4.9%), Germany (4.4%), China (3.9%), and the United Kingdom (3.2%).

Weather problems in many countries favored increased exports of grain products to these countries, which increased the share in total exports to 4.8% for January-September, compared to 1.6% for the same period one year ago. Improved world market conditions also allowed increases in exports of oil and fuel products (whose export share grew from 7% to 9.1%), tools (from 2% to 4.1%), and locomotives (from 0.8% to 1.7%). These increases compensated for declining exports in ferrous products, chemical products and equipment.

Foreign direct investments are still running at levels significantly below their potential. From January to September, FDI amounted to only $454 million on a net basis. Further increases in FDI would require large-scale implementation of reforms to improve the country's business environment. With the assistance of international firms operating in Ukraine (the IPCTF Steering Committee), the previous government had prepared a detailed Action Plan to achieve this objective. Political uncertainties, however, have hampered its implementation so far.

In terms of foreign debt financing, in absolute terms, Ukraine's foreign debt is still reasonable at about 28% of GDP. But given its short maturity, Ukraine will face significant annual debt service obligations over the next three years. In 2003, public foreign debt payments (interest and principal) are forecast at $1.85 billion (including $240 million due to the IMF) compared to $1.42 billion due in 2002. In 2004 and 2005, foreign debt service obligations would amount to $1.9 billion and $2.1 billion, respectively. In order to meet these obligations, the government plans to borrow about $850 million abroad in 2003. In addition, the government plans to receive non-project financing amounting to $250 million from the World Bank under PAL-3 in 2003. About $600-800 million could be made available under a 3-5 year Precautionary Stand-By with the IMF. The ability of the government to attract these levels of financing will depend on the approval by Parliament of a reasonable fiscal budget for 2003 and the implementation of key economic reforms as mentioned earlier in this report.

International Programs

During the last few weeks, the government and the IMF have held discussions of their future form of cooperation. The IMF has indicated its readiness to support Ukraine in pursuing effective economic policy. A Precautionary Stand-By Program of $600-800 million for 3-5 years has been discussed as a possible form of cooperation. Under this Precautionary Program, the government will not receive regular tranches but will receive the funds in case of necessity. However, the finalization of any agreement with the IMF will require several economic measures, including the enactment of a satisfactory fiscal budget for 2003 and measures to eliminate tax privileges and exemptions.

The Ukrainian government has also discussed with the World Bank the possibility of receiving non-project financing amounting to $250 million under the PAL-2. It is now unlikely that these resources would be available in 2002, since the World Bank is also requiring the enactment of a satisfactory 2003 fiscal budget, the repeal of tax privileges and exemptions, and the restructuring of energy company debts. Further delays in disbursing these resources beyond early next year would probably lead to a renegotiation of loan conditionality, since many other loan conditions would have become obsolete. The World Bank is currently developing a new strategy for Ukraine for 2003-2008, which may include a $250 million PAL-3 to be approved in 2003.