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Key Achievements and Shortfalls in 2002

In 2002, Ukraine had both negative as well as positive results. In particular, negative political developments overshadowed relatively good economic performance. From the economic point of view, the economy performed better than anticipated by most analysts. Although the pace of GDP growth slowed from the high level of 9.1% achieved in 2001 to about 4.2% for 2002, GDP growth will still be better than the rates achieved by most countries of the world, which are still facing economic slowdown. On the other hand, negative political news during the year affected business confidence and led a number of international rating agencies to express doubts on the future economic situation of the country. These negative political developments included international issues, in particular the accusations that Ukraine sold illegal advanced radar systems to Iraq. This issue led the US to suspend a portion of its financial assistance to Ukraine. In addition, there were domestic political uncertainties, such as the dismissal of the Cabinet, the dismissal of the NBU President, and the lack of a clear and solid working majority in Parliament.

Following the dismissal of the Cabinet and the NBU President, President Kuchma appointed a new Cabinet (led by Prime Minister Viktor Yanukovitch) and a new NBU President (Mr. Sergey Tygypko). As noted previously, the ultimate performance of the new government 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 privi-

leges and improve fiscal revenues; the Laws on Land Markets, Land Titling and Registration which are required to make effective the new Land Code; the Law on the 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 creditor 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 would facilitate the resolution of business disputes. Most of this legislation has been drafted and discussed but is currently stalled in Parliament.

The next few months could 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 the Presidential elections, would be faced with political instability and only mediocre economic growth. The new government has indicated that it is currently preparing its own Economic Program for Ukraine and that this Program would be ready by February 2003.

Economic Growth

GDP growth in 2002 is likely to reach about 4.2%. In November 2002, the pace of GDP growth accelerated to 4.6% compared to November last year, bringing GDP growth for the eleven month period to 4.1%. The economic activity of the country continues to be driven by the growth of domestic demand, particularly wholesale and retail trade (which increased by 9.6% in the last eleven months compared to last year), the processing industry (which increased by 8.1% during the same period), and agriculture (which increased by 3.9%). Domestic demand was stimulated by increases in the population's income (which increased by 28% in October 2002, compared to the same month in 2001) as well as by increases

in credits provided by the banking sector (which increased by 33% during January-October 2002). The increases in bank credit provided during the first 10 months of 2002 represented 5.2% of GDP.

As noted earlier, most economic agencies anticipate that GDP growth in 2003 will range between 3.5% (ICPS) and 5.0% (IMF). 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 will 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 economic legislation.

Fiscal Policies

During 2002, the consolidated fiscal budget was kept under control with a surplus on a cash basis. According to the NBU, from January to October 2002, consolidated fiscal revenues amounted to UAH 48.7 billion, consolidated expenditures were UAH 45.4 billion, and the fiscal surplus was UAH 3.3 billion (or 1.9% of GDP). However, as noted earlier, this surplus was achieved principally by withholding expenditure payments on incurred costs, since the planned level of fiscal revenues did not materialize. A recent estimate indicates that for 2002, consolidated budget revenues will amount to about 95% of the originally planned amounts.

Privatization receipts were significantly below the original plan. Although the receipts from Privatization are not considered fiscal revenues, they are important because they are budget-financing items. From January to November 2002, privatization receipts amounted to only \$104 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 on November 25 (from UAH 1.5 billion to UAH 3.9 billion). Accordingly, on December 17 and 19, the Ministry of Finance was able to place 5.5-year Government bonds for UAH 244 million and UAH 205 million respectively, with annual yields of 9%. Since the beginning of the year, the government has placed UAH 2,820 million in bonds (compared to the new debt ceiling of UAH 3,900 million). It is uncertain whether the additional UAH 1 billion will be placed before the end of the year. The fiscal budget was also expected to benefit from the placement of UAH 3.5 billion in 10-year bonds by Gaz Ukraine. However, the new NBU President has already stated his objection to a proposal that the NBU would refinance these bonds (without which its placement is uncertain). These funds were expected to be used for fiscal budget financing, since Gaz Ukraine planned to use these resources to repay its debt obligations to the government.

The government has also been successful in raising international resources. In mid-November, the government issued \$260 million of Eurobonds 2000 with a yield of 10.8% and a final maturity in 2007. As reported earlier, the placement was managed by Credit Suisse First Boston and Dresdner Kleinwort Wasserstein.

The proposed fiscal budget for 2003 is still under discussions. The draft 2003 fiscal budget was submitted 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% as compared to the original 2002 budget revenue plan. The draft 2003 budget was based 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 local budgets was increased

to 46% from the 41% planned in the current year budget. Most analysts had regarded this draft budget as realistic.

During the review of the draft 2003 fiscal budget by Parliament, proposals were introduced to increase budget revenues and expenditures, by about UAH 4.0 billion or 1.6% of GDP. The new government felt that these increases in revenues were unlikely to materialize, since they were not supported by specific budget measures, such as increases in the tax base. Therefore, in late-December, the government submitted a new draft budget to Parliament under which revenues were increased by UAH 2.0 billion compared to the original proposal, and expenditures were increased by UAH 3.2 billion to yield a fiscal deficit of UAH 2.0 billion, or about 0.8% of GDP. The increase in revenues would be supported by changes in tax and revenue legislation (including adjustments in customs revenues, corporate profit tax, VAT, and excise taxes). Parliament is expected to act on the new government proposal by the end of the year. If Parliament were to approve this government proposal, it would facilitate discussions with the IMF and World Bank on financial support for 2003.

Monetary Policies

With inflation rates of 0.7% in both October and November 2002, the high deflation experienced in early 2002 was reduced to an overall deflation of 1.9% over the eleven-month period. The government now forecasts that inflation in 2002 will be close to zero. For 2003, the government had originally anticipated an inflation rate of 7.7%, which was used in the proposed 2003 budget. The new Cabinet, however, has recently indicated that it now expects inflation in 2003 to be 4%.

In October 2002, the monthly growth rate of money supply (M3) was only 1.7%, continuing its slowdown compared to the higher monthly rates of about 4.8% experienced in the summer months. For January-October 2002, money supply (M3) grew by 31%. By the end of 2002, money supply should have increased by about 35% since the beginning of the year. Although the rate of growth in money supply has been high, they have not been reflected in high inflation so far. This might not be the case next

year. In fact, for next year, in order to validate an inflation rate of 4%, the NBU plans to reduce the growth rate of money supply to around 17%-20%.

Since the beginning of the year, the average hryvna 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 level of Gross international reserves is at a reasonable level of about 12 weeks of imports. As of December 15, 2002, the NBU's gross international reserves amounted to \$4.35 billion, an increase of about 30% since the beginning of the year.

International Trade and Capital

The most recent information for the balance of payments is for the period January-September 2002. It shows that Ukraine's foreign trade for the year 2002 is likely to perform better than anticipated. Despite numerous trade sanctions imposed on Ukraine, the country was able to maintain a healthy trade balance thanks to an aggressive search for new markets. During the January-September period, the total volume of foreign trade in merchandises amounted to \$24.8 billion, representing an increase of 6.1% year-to-year. 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. This improved export performance was due in part to better market conditions abroad for metal products, machinery and equipment, and to a major increase in agricultural grain exports, principally to Europe.

The trade balance for goods and services was even more favorable. During 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%).

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Ukraine has continued to diversify its exports, increasing trade with Europe, Asia and Africa in order to compensate declines of 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%).

As reported earlier, 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 the large-scale implementation of reforms to improve the country's business environment.

International Programs

During its recent visit to Kyiv, the IMF indicated its readiness to support Ukraine with a financing program, which may be either a regular stand-by or a precautionary stand-by program. A precautionary stand-by program of \$600-800 million for 3-5 years is a possible form of cooperation. Under this precautionary program, the government would notify the IMF in advance that it would not request tranche releases unless there were to be a clear necessity. The new government, however, may opt

for a regular stand-by, a decision that would be welcomed by the IMF. As noted earlier, however, the finalization of any agreement with the IMF will require several economic measures, including the enactment of a satisfactory fiscal budget for 2003, new legislation to eliminate tax privileges and exemptions, actions to improve the health of the banking sector, and measures to reduce debts and improve transparency in the energy sector. The latter measure is necessary to facilitate the privatization of energy companies and meet the privatization revenue goal of UAH 2.1 billion included in the draft fiscal budget for 2003. In January 2003, the new Minister of Finance will visit Washington DC and have further discussions with the IMF on future collaboration. It is expected that during the visit an agreement in principle will be reached on future IMF financing. A follow up IMF mission to Kyiv is planned for February 2003 after the government completes its new economic program.

A World Bank mission visited Ukraine in December to discuss its new country strategy for the next four years. It is expected that World Bank financing will give priority to social-oriented projects, including education. Balance-of-payments support would also continue through the Programmatic Adjustment Loans (PAL). In early 2003, about \$250 million would be made available under the PAL-2,

provided that the government meets several loan conditions, including 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. In addition, a new PAL-3 loan for \$250 million may be made available during 2003. During the five-year period from 2003 to 2008, World Bank financing to Ukraine may reach \$1.5 billion.

The European Bank continues to be quite active in Ukraine. As of September 2002, since it started operations in Ukraine, the European Bank has provided financing for a total amount of Euro 1.4 billion, under 57 projects. In 2001, total financing reached Euro 175 million. During the first 9 months of 2002, EBRD financing to Ukraine amounted to Euro 122 million. About 66% of EBRD financing has been provided to the private sector. The Country Strategy for Ukraine, approved by EBRD's Board in September 2002, gives priority to projects aimed at facilitating the privatization of utilities, energy efficiency, small and medium-size companies, agriculture, and nuclear safety.