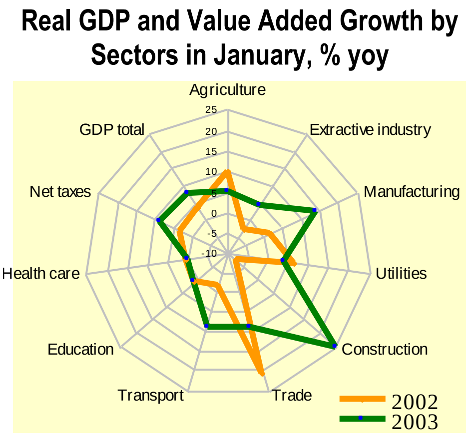
Ukraine - Economic Situation

February 2003

Economic Growth



Source: State Statistics Committee

Ukraine started the year 2003 with a remarkable rate of economic growth. In fact, in January 2003, real GDP grew by 7.7% compared to January 2002. This high GDP growth rate was caused by good performance in several sectors, including construction (which grew by 24.4% yoy in January), manufacturing (13.8% yoy), wholesale and retail trade (8.8% yoy), and transport (8.3% yoy).

At the product level, metal production showed one of the highest growth rates in January, at 22.3% yoy. This growth was supported by high world prices for metals). As metal production represents the highest share of industry, in January industrial GDP also increased by a relatively high rate of 11.6% yoy. Other growth areas included the domestic market-oriented wood processing industry (19.9% yoy) and the chemical industry (15.9% yoy). Although these numbers are encouraging, the importance of metals and grains confirm the view that Ukrainian economy is still not making significant progress towards diversification of its output, thus remaining highly vulnerable to changes on the world markets for its traditional commodities. Nevertheless, given an impressive GDP growth in January, the official forecast of 4% GDP growth in 2003 looks realistic.

Fiscal Policy

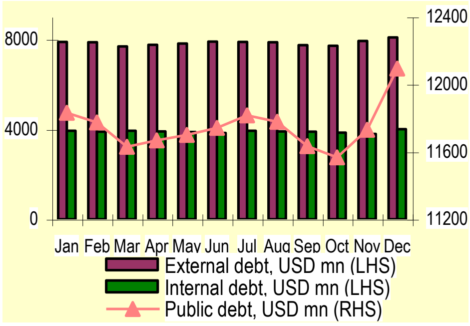
Throughout 2002, the performance of the consolidated fiscal budget was inadequate as the amount of revenue collected over the period constituted only 93% of annual target. This was due to a large number of tax exemptions and privileges granted by Parliament early in the year, the overly optimistic macroeconomic parameters assumed in the original budget, and poor privatization revenues. On the other hand, fiscal budget expenditures were curtailed drastically, and amounted to only 85% of expenditures planned for the year. As a result, over the year 2002, the consolidated budget had a surplus of UAH 1.7 billion. **(**with revenues at UAH 60.8 billion and expenditures at UAH 59.1 billion.

Fiscal revenues in 2002 also suffered by inadequate tax collection. In fact, over the year the volume of tax arrears enterprises owed to the budget grew by 133%, reaching UAH 14.7 billion. The largest debtors continued to be the state-run companies such as Naftogas Ukrainy (which owes UAH 4.1 billion) and Energoatom (which owes UAH 628 million). On the other hand, the Government continued accumulating debts on VAT refund to exporters in 2002, which soured relations with the IMF.

Low privatization revenues in 2002 were also responsible for poor fiscal performance. In 2002, the State Property Fund collected only 10% of its ambitious UAH 5.8 billion annual target, or only UAH 576 million. The main reason for the shortfall was the failure to sell the telecommunications company Ukrtelekom and the energy distributing companies. In 2003, the government expects to receive UAH 2.15 billion of privatization revenue (excluding the uncertain proceeds from Ukrtelecom and oblenergo sales).

Fiscal problems (lower budget revenues and privatization revenue shortfalls) and the ambiguous situation with IMF/World Bank borrowings led the Government to seek additional borrowings from private external and internal markets. These funds were used principally to repay external debt obligations. With heavy repayments, the stock of public debt increased only marginally. In fact, during 2002 public debt increased only by 1.5% or by UAH 1.1 billion (US$215 million) to a total of UAH 75.7 billion as of the end of 2002. Domestic debt grew by UAH 380 million to UAH 21.4 billion, while the stock of external debt increased by about $100 million to USD 8.08 billion. The composition of external debt changed somewhat as Ukraine managed to reduce its debt to IMF by 3.7% to US$2.07 billion in 2002. Despite borrowings, Ukraine's public debt burden remains modest (at an estimated at 37% of GDP) compared to other B-rated countries (e.g. Russia with public debt at 47% of GDP).

Direct Public Debt Dynamics in 2002



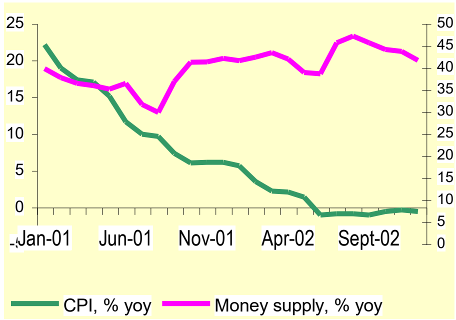
Source: Ministry of Finance

Although the overall size of public debt remains reasonable, annual debt service obligations over the next three years will be increasing. External debt repayments growth will reach its maximum peak of US$ 1.8 billion in 2005. In 2003, interest and principal public debt payments are forecast at UAH 11.6 billion, out of which UAH 2.5 billion should be paid on internal obligations and some US$ 1.6 billion should go for external debt repayment and service. In addition, the Government will also need to seek financing for its fiscal budget deficit of UAH 2 billion in 2003. The approved 2003 budget foresees revenues at UAH 50.02 billion and expenditures at UAH 52.06 billion, thus generating a deficit that would amount to 0.8% of GDP. So far, the ability of the Government to meet its debt obligations has depended primarily on its fiscal performance, to generate sufficient local currency savings. Foreign exchange has not been a constraint, given the remarkable growth of international reserves held by NBU.

Monetary Policy

Following a relatively high inflation rate of 1.5% in December, in January 2002, consumer prices accelerated to 1.5% (or % on an annual basis) as earlier declines in food prices reversed. Over the month, food prices grew by 2%, while services and non-foods prices posted growth rates of 0.8% and 0.1% respectively. These rates are above the Ministry of Economy forecast of 1.6% CPI growth in the first quarter of 2003. The 2003 year inflation is expected at 6%. In 2002, consumer prices had dropped by 0.6% yoy, following an inflation rate of 6.1% yoy in 2001.

CPI and Money Supply Dynamics, 2001-02



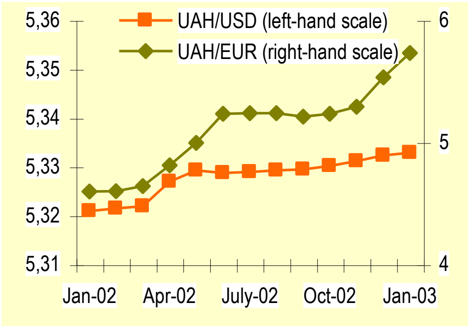
Source: NBU, State Statistics Committee

Overall, the consumer price index is quite sensitive to food prices, as the share of this group remains the largest in the total consumer basket (about 64%). In 2002, a rich harvest and recovering livestock farming were responsible for declining prices for bread, cereals and meat. At the same time, in 2002 prices of services and non-foodstuff items grew by 3.4% yoy and 1.6% yoy respectively. The increases in Service prices were attributed to a 9.5% yoy increase in communication tariffs.

Over the year 2002, monetary policies were expansionary. Money supply grew by 41.6%, while base money increased by 33.6% and cash in circulation expanded by 37.1%. According to NBU calculations, in 2002 the monetization of the GDP grew from 19.2 % of GDP to 24.9% of GDP. Given fears of inflationary pressures, since January 2003, the NBU has been following a tighter monetary policy. During January, money supply M3 dropped by 2.6%. Cash in circulation was down by 6.5% while base money declined by 3.2% mom. For 2003, the NBU expects M3 growth to growth by 22-27%, while the monetary base is expected to expand by 17-20%.

During January, the gross international reserves of the NBU increased by $158 million to reached US$ 4.6 billion at the end of the month. Throughout 2002, NBU managed to increase its international reserves by 42%. The NBU expects gross international reserves to further expand by US$ 850 million (19%) in 2003.

Exchange Rate Dynamics, eop



Source: NBU

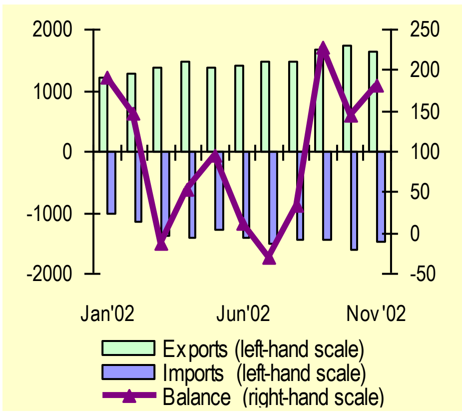
High deposit growth and excessive liquidity of the banking system boosted up commercial banks lending to the real sector. The lending volumes picked up by 48.9% yoy in January, while deposits grew by 48.7% yoy. The structure of deposits has been gradually changing. Growth of household deposits in Hryvnias tends to decelerate, whereas foreign currency deposits are increasing. In January, an average lending rate of commercial banks dropped by 90 bps to 18.6% annually. The average deposit rate increased to an annual rate of 6.7%.

Over January, the official Hryvnia exchange rate remained quite stable at 5.3329 UAH/US$ as of January 31. On the other hand, given the strength of the Euro, the official UAH/EUR exchange rate grew abruptly during the month by 3.6% 5.73 UAH/EUR.

International Trade and Capital

Improved external conditions for Ukrainian export in the second half of 2002 resulted in a merchandise trade balance surplus for the year, despite an increase in energy resources imports. In 2002, the surplus in the trade of goods reached $980 million, compared to a surplus of $490 million in 2001. Over 2002, exports increased by 10.4% to US$18.0 billion while import grew by 7.6% to $17.0 billion.

Merchandise Trade Dynamics in 2002, USD mn



Source: State Statistics Committee

The expansion of export is attributed to an increased demand for agricultural grains and metals on the world markets. The share of grain exports in the total export volume increased form 3% in 2001 to 5.6% in 2002.

The geographical orientation of merchandise trade has continued to change, with Russia taking 17.8% of Ukrainian products. Among the other major export destinations are Turkey with 6.9%, Italy with 4.6%, Germany with 4.3%, China with 3.9% and the UK with 3% of total exports. Exports to the US were only 2.9% of total exports. On the import side, Russia remains the largest supplier of imports, accounting for 37.2% of all Ukrainian imports, principally in oil and gas products. Other major import suppliers to Ukraine include Turkmenistan (11.1% of imports), Germany (9.8%), and Poland (3.2%).

Trade on goods and services in 2002 also performed well. The surplus in goods and services in 2002 reached $3.5 billion, compared to a surplus of $2.9 billion in 2001. Exports of goods and services increased by 11.1% to $22.0 billion whereas imports grew by 9.4% to $18.5 billion

International Programs

Ukraine’s relations with international financial organizations are still ambiguous. An IMF mission is currently visiting Ukraine to continue negotiations on possible cooperation with Ukraine on a precautionary stand-by program. The extended facility program IMF was suspended in September 2002 due to slow reform progress, especially in the area of tax privileges and repayment of VAT arrears. Another issue for discussion is the adequacy of the 2003 fiscal budget and may seek Parliamentary approval of amendments to the 2003 budget.

Resumption of cooperation with IMF is one of the pre-conditions set by the World Bank for disbursing the Second Programmatic Adjustment Loan (PAL-2). The total PAL loan amounts to US$ 750 million and it is a basis of the World Bank assistance strategy for 2001-2003. During 2003 to 2008, the World Bank plans to disburse about US$ 1.5 billion to Ukraine. Except for the IMF condition, the World Bank has indicated that it is satisfied with Ukraine's fulfillment of other Bank's conditions.