Turning Transitions Into Prosperity

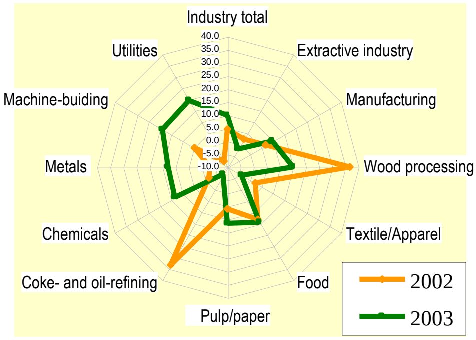
# Ukraine - Economic Situation

**March 2003**

## Economic Growth

Supported by an impressive expansion of industrial production, the Ukrainian economy has continued to show robust growth. In February 2003, real GDP grew by 6.7% compared to February 2002, bringing the year-to-date growth to 7.2% compared to the first two months of 2002. In February 2003, industrial production posted a 9.7% year-to-year growth. Since the beginning of the year, industrial output grew by 10.8% yoy, far exceeding the 3.5% growth reported in January-February 2002.

**Industrial Production by Sector in February, % yoy**




*Source: State Statistics Committee*

The major contributors to February's industrial growth were major increases in metal output, machine building, wood processing, food industry and utility generation. Metal production grew by 12.7% yoy, following a remarkably high growth in January. This growth was supported by high world prices for metals. A sharp rebound in machine building to 18.7% yoy growth in February represents a positive development in the structure of industrial output. Other growth leaders included the domestic market-oriented wood processing industry (15.1% yoy) and the food industry (14.5% yoy). Utility generation showed a spike-wise growth in February (19.4% yoy) which could be explained both by the expansion in the utility requirements of industry and by a colder weather in February 2003. Nevertheless, despite the good growth performance in January and February 2003, it is expected that economic growth rates will gradually slow down over the year. The Government still maintains its official forecast of 4% GDP growth in 2003. High world oil prices, poor harvest expectations (due to loss of winter crops) are among the reasons for economic growth slowdown over the rest of 2003.

For 2002, the State Statistics Committee has revised upwards its published GDP growth figure for the year. In 2002, real GDP posted a 4.6% rate of growth, against the 4.1% rate reported earlier. Based on a supply side breakdown, the major growth driving sectors were manufacturing (9.0% yoy growth), wholesale and retail trade (8.1% yoy), and transport (4.3% yoy). Agriculture posted only 3.6% growth in 2002 after a remarkable 9.8% pickup a year before.

## Fiscal Policy

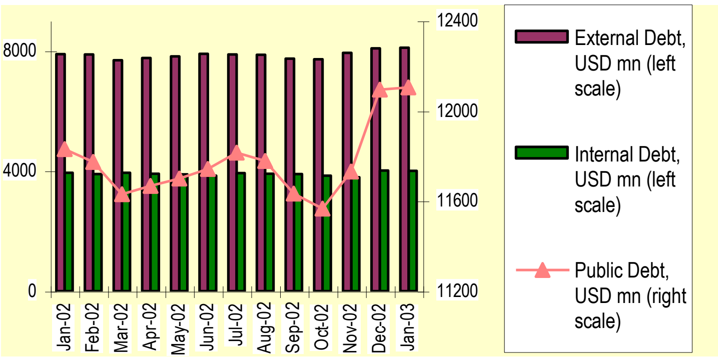
The robust economic growth since the beginning of the year has contributed to a satisfactory fiscal budget performance. Improved tax collection and under-financing of expenditures generated a budget surplus that enabled the government to meet its public debt obligations of UAH 2.0 billion ($350 million) due in March 2003. In January, the consolidated budget surplus amounted to UAH 1.4 billion ($270 million), with revenues of UAH 4.6 billion ($870 million) and expenditures at UAH 3.2 billion ($600 million). Tax proceeds grew by 24.4% yoy largely due to large VAT and excise tax receipts. For January and February 2003, consolidated budget revenues amounted to UAH 9.8 billion ($1.8 billion), or about 15% of the annual target.

The 2003 Fiscal Budget has yet to be amended to reflect a minimum wage increase approved by the Parliament after the Budget adoption. So far, the Ukrainian legislature has failed to reach consensus on the sources needed to finance the increase in the minimum wage. Another budget issue is that VAT refunds to exporters remains large. Currently, VAT arrears amounts to about UAH 2.9 billion ($540 million), only UAH 100 million below the level at the beginning of the year. The solution of this issue is a key condition to improve relations with the IMF.

Internal and external public debt has been relatively stable at about $14.2 billion equivalent. External public debt amounts to $10.2 billion (or 28.3% of expected GDP for 2003), including Direct Public Debt plus IMF debt owed by the NBU. Ukraine is due to pay a total of $1.5 billion on its external public debt in 2003, with another peak payment of $325 million to be made in September 2003. The continued rapid accumulation of international reserves by the National Bank of Ukraine will contribute to the country's strong external position. Thus the primary risks of nonpayment of foreign debt still lie on the fiscal side.

The timely payments of Eurobond and public internal debt obligations in March (some $350 million) are likely to improve Ukraine's credit rating, and thus reduce the cost of further borrowings for the country. Earlier JP Morgan had improved the outlook on Eurobonds issued by Ukraine, from underweight to market-weight as macroeconomic situation improved. S&P's still rates Ukraine at B negative.

**Direct Public Debt Dynamics, 2002-03**

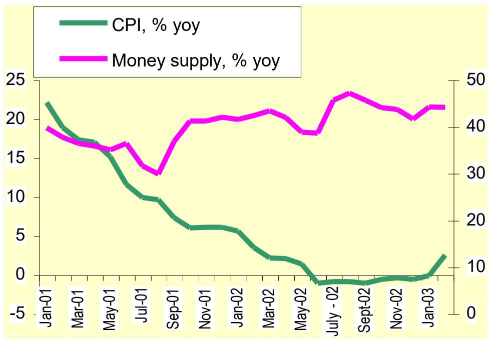



*Source: Ministry of Finance*

## Monetary Policy

Following a monthly inflation rate of 1.5% in January, in February the growth in consumer prices slowed down to 1.1% month-over-month (or 14% on an annual basis) bringing cumulative inflation to 2.6% over the first two months of the year. Food prices were up 1.5% in February, against 2% in January, while services prices posted a 0.4% growth over the month. Non-foods prices remained the same as in January. However, these rates have already exceeded the Ministry of Economy forecast of 1.6% CPI growth in the first quarter of 2003. The inflation figures in the first two months of the year puts in jeopardy the government's forecast of 6% inflation for 2003. The inflation rate may further speed up given the anticipated poor wheat harvest this year due to bad weather conditions, and also an increase of oil prices in response to war in Iraq.

**CPI and Money Supply Dynamics, 2001-03**

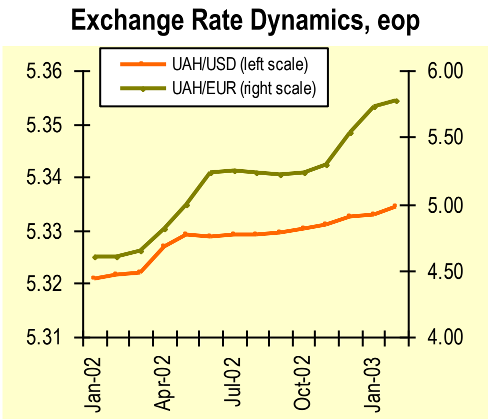



*Source: State Statistics Committee, NBU*

The somewhat higher than expected inflation, has not led NBU to tighten its monetary policies. Following a decline of 2.6% in money supply (M3) in January, during February, money supply grew by 3.2% with cash in circulation expanding by 4.1% over the month. For 2003, the NBU expects M3 growth to growth by 22-27%, while the monetary base is expected to expand by 17-20%.

During February, the gross international reserves of the NBU increased by $220 million (2.4% mom), reaching $ 4.7 billion by the end of the month. The NBU expects gross international reserves to accumulate up to $5.2 billion by the end of 2003 despite heavy external debt payments.

During the last 12 months, commercial banks' lending to the real sector has been growing at a high pace thanks to high private deposit growth and excessive liquidity of the banking system. Lending volumes picked up by 49% yoy in February, while deposits grew by 50.5% yoy. The share of foreign currency deposits in the total deposits has been increasing gradually. In February, the average lending rate of commercial banks dropped by 90 bps to 17.7% annually. The average return on deposits increased to an annual rate of 6.8% as inflationary expectations rise.



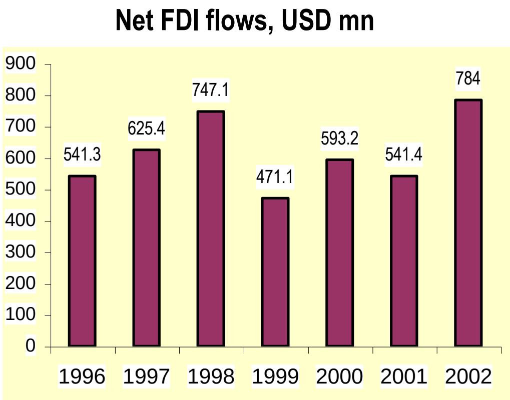

*Source:NBU*

The official UAH/USD exchange rate has remained quite stable at 5.33 UAH/USD as of February 28. Euro appreciation in the international markets led to the growth of the UAH/EUR exchange rate. Since the beginning of the year, Hryvnia depreciated against Euro by 4.34% year-to-date, to 5.773 UAH/EUR. With the intention of liberalizing the foreign currency market, the NBU cancelled the 5% fluctuation band from the official exchange rate for operations in the cash market. It also allowed commercial banks to purchase foreign currency at inter-bank currency market for their own hedging needs, even if they don't have any foreign currency denominated liabilities. The NBU also permitted the provision of foreign currency loans to individuals. In addition, the NBU allowed residents to trade Eurobonds, although a number of limitations for these operations were introduced, including a ban for the sale of Eurobonds in foreign currency. However, the major regulation of mandatory sale of 50% of export proceeds in the internal foreign exchange market has not been lifted.

## International Trade and Capital

The Merchandise Trade Balance posted a surplus in January, even though import growth accelerated significantly due to the large importation of energy resources. In January 2003, the surplus in the trade of goods amounted to $145 million; that is $43 million less than the surplus achieved over the same period last year. Over the month, exports increased by 22.6% to $1.49 billion, while imports picked up by 31.1% to $1.34 billion.

Ukraine economic growth is having an impact, though still minor, on the flow of foreign direct investment (FDI). During 2002, net FDI grew by 15% yoy from $541 million in 2001 to $784 million in 2002 (after adjustment for exchange rate changes). Nevertheless, the stock of FDI has reached only $5.3 billion since 1991, which is one of the lowest levels on the CEE region. Based on cumulative figures, the largest amount of investment came from the USA – $898 million (16.8% of the total), followed by Cyprus with $602 million (11.3%). On a sector breakdown, wholesale and retail trade attracted the largest share of FDI ($855 million), followed by food and machine building with $852 million and $470 million, respectively. According to government expectations, FDI is expected to increase by $750 million in 2003. On the other hand, Portfolio Investments (up to 10% of statutory fund) of non-residents remained extremely low due principally to lack of protection of minority shareholders' rights. Despite an increase by 23% in 2002, portfolio investment inflows reached only $251million as of January 1, 2003.




*Source: State Statistics Committee*

## International Programs

International financial organizations are still undecided on the terms of their relations with Ukraine. Having finished its Article IV consultations in Ukraine, the IMF issued a concluding statement giving little hope to the resumption of cooperation under a precautionary stand-by arrangement in the near future. The outstanding issues include a slow pace of structural reforms, in particular, the backlog of VAT arrears to exporters, energy sector reform, and problems in the fiscal budget, particularly regarding tax privileges and exemptions. The government expects the IMF to return to the question of a precautionary stand-by program in June-July this year. This automatically postpones the World Bank's approval of the Second Programmatic Adjustment Loan (PAL-2) of $250 million. In addition to IMF requirements, the World Bank urges Ukraine's Parliament to adopt laws on tax reforms and reforms in energy sector before the summer, when the active preparation for presidential elections in 2004 would begin.

The European Bank for Reconstruction and Development (EBRD) has approved a Country Strategy that considers the possibility of financing projects in Ukraine worth EUR 200-350 million of loans in 2003. This would represent a large increase over the EUR 176 million apportioned to Ukraine last year. Among priority areas of EBRD financing are municipal development, the transport sector, and credit lines for small and medium enterprises.

## Other Developments

The Financial Action Task Force on Money Laundering (FATF) recommended its members to lift countermeasures against Ukraine after concluding that the measures adopted by Ukraine to prevent money laundering were satisfactory. Nevertheless, Ukraine was put in the black list of countries not cooperating in fighting money laundering. According to the FATF official report, Ukraine will remain in the black list until its anti-money laundering legislation is effectively enforced.

Ukraine has taken several steps to facilitate its accession to the World Trade Organization. A key next step is the signing of bilateral agreements with key WTO member-states. Ukraine signed a bilateral protocol on access of internal markets with Hungary, while 12 more agreements are still pending to be agreed and signed with the country-members of WTO. The government expects to sign bilateral agreement with the EU in March. Overall, Ukrainian government expects Ukraine to enter WTO in 2004, which is still an ambitious target.

On February 23, top officials of Ukraine, Belarus, Kazakhstan, and Russia announced their intention to create a Common Economic Area, aiming at establishing a free trade zone across these four countries by September 2003. In addition, Ukraine and Russia drafted a bilateral free-trade agreement in February.

The Ukrainian Parliament passed new versions of Civil and Commercial Codes in January 2003 and early in March, the President signed both Codes, which will become effective on January 1,

2004. Adoption of the Codes came as a result of intense political dialogue and represented a consensus of different groups. Their final approval will significantly improve the business environment in Ukraine. The Civil and Commercial Codes provide for less regulation of economic activities by government authorities. They also give greater protection to property rights and to the rights of minority shareholders. Thus, the Codes give greater assurances to investors that international contracts would be honored in Ukraine. However, there are still a number of issues that were not adequately addressed in the Codes. In particular, on a number of topics the Civil Code and Commercial Code are inconsistent among themselves as they provide for regulations in different ways. This situation may lead to legal inconsistencies and create possibilities for legal manipulations. These inconsistencies should be resolved before the Codes become effective in 2004.