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Ukraine

Macroeconomic Situation

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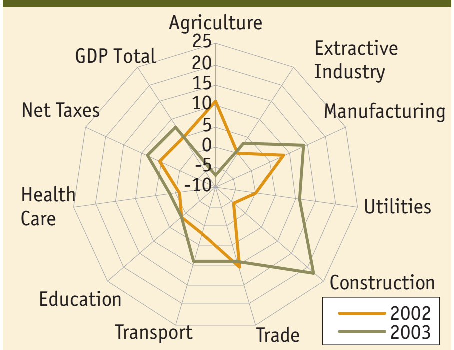
Economic Growth

The Ukrainian economy posted a marked acceleration in May-June 2003 driven by strong external and domestic demand. In June, real GDP growth picked up by 8.2% year-over-year (yoy) bringing the cumulative January-June figure to 7.5% yoy. The major contributors to GDP growth were the processing industry (14% yoy), construction (21.8% yoy) and utilities (10.5% yoy). At the same time, value added in agriculture fell by 7.2% yoy during the first half of 2003.

Real GDP and Value Added Growth by Sector in January-June, % yoy



Source: State Statistics Committee

Industrial production expanded rapidly, responding to favorable external conditions and growing domestic demand. Growth of the export-oriented metallurgy industry slowed to 12.1% yoy in the first half of 2003, primarily due to the lower pace of pipe production expansion. The output of chemicals accelerated to 13.8% yoy, indicating stronger external demand. The domestic market-oriented industries also demonstrated high rates of growth driven by strengthened domestic demand. Over the first six months of 2003, growth in the food and wood processing industries picked up to 20% yoy and 22% yoy respectively. Rapidly growing energy-intensive industries stimulated the growth in utilities, which remained at a high of 10.5% yoy during the period. Growing demand for transport services encouraged further expansion in machine building, which reached a record high of 28% yoy in January-May.

Good developments in industry contrast with the situation in agriculture. Unfavorable weather conditions threaten the agricultural harvest this year. Total agricultural grain output is likely to be 25-27 million tons this year, compared to 39 million tons produced last year. This poor agricultural result is contributing to fears of deteriorating macroeconomic indicators through the end of the year. According to official forecasts, GDP growth should reach an expected 5-6% in 2003 (based on an optimistic scenario), which seems realistic assuming strong external demand for key export commodities remains in place until the end of 2003. In a base case scenario, the Ministry of Economy assumes 4.7% GDP growth in 2003. In 2004, the government expects the Ukrainian economy to grow at 4.8% based on a conservative scenario of economic development, and a high 8% rate of GDP growth is envisaged in an optimistic scenario, which assumes the successful implementation of structural reforms and strong external demand for Ukrainian exports.

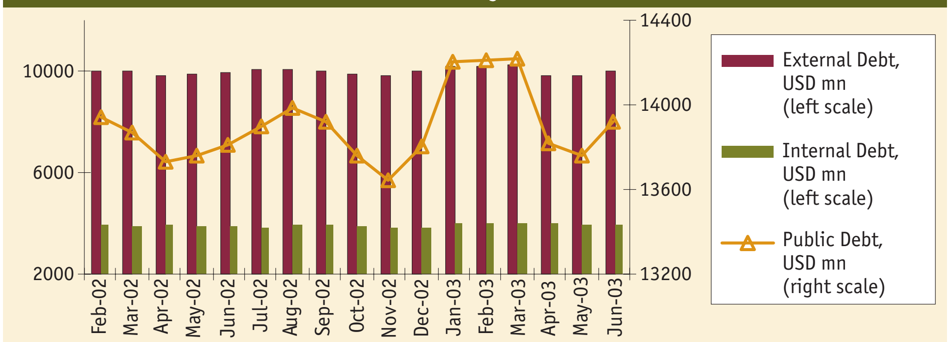
Fiscal Policy

Rapid economic growth has led to healthy fiscal surpluses since the beginning of the year. In January-May, the state budget surplus constituted UAH 1.2 billion ($225 million), or 1.4% of the period's GDP. Given the targeted deficit of 0.8% of GDP, the current fiscal performance looks quite positive. Over this five month period, the state budget revenues amounted to UAH 20.1 billion ($3.8 billion), and expenditures reached UAH 18.9 billion ($3.6 billion). According to the Ministry of Finance, tax revenues were 2.1% above levels targeted for January-May, primarily on account of plentiful corporate profit and personal income tax collections. Growth rates of fiscal revenues substantially exceeded the rates of overall economic growth, indicating improved administration of taxes. However, the problem of VAT refund arrears that has yet to be resolved still undermines tax discipline.

Together with improved tax enforcement, there have been positive changes in privatization performance. In January-June, proceeds from privatization of state property, an important source of budget-deficit financing, constituted almost $200 million or about 50% of the annual target. A significant increase in privatization proceeds during May took place following transfer of payments for the state share in Ukrainian Mobile Communication (some $80 million) and the Nikopol Ferroalloy Plant (about $40 million) to the budget. Despite brighter prospects in execution the 2003 privatization plan, the government has to rely on external sources of fiscal gap financing. Recent approval of amendments to the 2003 budget envisaging an increase in state budget revenues and expenditures (by about $550 million each) creates additional challenges for current year budget execution.

For next year, Parliament has approved a 2004 budget resolution that envisages the fiscal gap at 0.5% of GDP. Consideration of the main directions of the fiscal policy for 2004 took place following an adoption of important tax laws that will come into force in January 2004. As an indication of substantial progress in tax reform, three major tax laws have recently been adopted by the Parliament: law on taxation of personal income (PIT), corporate profit tax law, and law on VAT. In particular, the new PIT law foresees a 13% flat tax rate beginning in 2004 instead of the current progressive scale of 10% to 40% (in 2007, PIT will be increased to flat 15%.) The law on corporate profit tax, adopted earlier, reduces the corporate profit tax from 20% to 15%. Beginning in January 2004, VAT will also be lowered from 20% to 17%, and a new, more effective mechanism of VAT refunds to exporters will be introduced. Significant decrease of the major tax rates will

Direct Public Debt Dynamics, 2002-03



Source: Ministry of Finance

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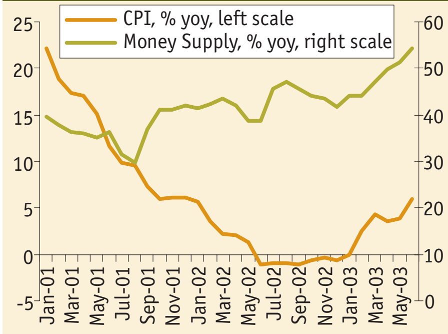
considerably reduce budget revenues next year. However, Ukrainian authorities expect that abolishment of tax privileges and de-shadowing of wage payments will compensate for the prospective loss. The other important component of the tax reform is the adoption of the law on single social tax, envisaging a reduction in deduction rates to various social security funds, including the pension fund, from 37% to 25%. The government is hoping for Parliament's approval of the law on tax amnesty in 2004, which would also help to compensate for the revenues lost as a result of tax rate decrease. However, the adoption of the tax code, which was expected before members of the Parliament left for summer break, did not take place.

The total public debt (external and domestic) fell by $280 million during January-May, and reached $13.9 billion equivalent at the end of May. Further appreciation of the Euro on international markets contributed to a slight (1%) increase in the value of Ukraine's external debt during May. External public debt amounted to $10 billion equivalent (or 22.3% of GDP expected in 2003.) At the same time, domestic debt constituted only 9.2% of expected GDP and amounted to $3.9 billion equivalent.

Taking advantage of the favorable macroeconomic situation in the country, the government placed $800 million worth of Eurobonds at a record low interest rate of 7.65% in early June. The maturity of the new Eurobonds is 10 years. The lower-than-expected yield came as a result of strong investor demand, which reached some $4.5 billion. This outcome can be partly attributed to greater investor interest in transition economies due to the slowdown of economic growth in the EU and the US, and to a new 144-A procedure of Eurobonds issue that allowed expanding the potential investor base to the US market. Facing uncertainty over the World Bank's financing and questionable execution of its privatization plan, the Ukrainian government increased the size of the issue from the originally planned $600 million to $800 million. Meanwhile, Parliament approved the government's decision to borrow some $113 million externally in order to purchase grain to compensate for this year's expected shortfall in grain production. Thus, an additional issue of sovereign bonds can be expected in forthcoming months.

Monetary Policy

CPI and Money Supply Dynamics, 2001-03



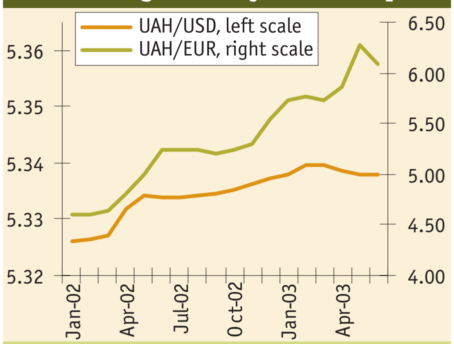
Source: State Statistics Committee, NBU

In June, the annual growth in consumer prices soared up to 5.9% yoy compared to 3.9% yoy growth in May. The sharp increase is explained by large demand for flour and cereals on the domestic market caused by worsened expectations of citizens about the new harvest. Since the beginning of the year, the Consumer Price Index (CPI) grew by 4.5% year-to-date (ytd.) Food prices, the major determinant of consumer inflation dynamics, increased by 6.4% ytd in January-June. Over the same period, non-foods and service prices picked up by a relatively small 0.2% and 1.8% respectively. Although summer is usually a period of falling prices for foodstuffs, growing fears over the extremely low agricultural harvest this year may further drive inflationary expectations. Therefore, consumer prices are expected to grow further unless authorities implement more active measures to contain inflation. The NBU council forecasts CPI inflation at 7-8% according to the optimistic scenario, while the pessimistic scenario foresees a 10-12% increase of consumer prices in 2003. So far, the NBU announced that it is going to keep its discount rate at a low 7% until September, thus signaling its intentions to put off inflation targeting until later.

Monetary aggregates continued rapid expansion in June. Annual growth of the money supply accelerated to a high 54% yoy due to a weighty increase of cash in circulation. Over the month, money supply (M3) growth amounted to 7% month-over-month as cash in circulation and the monetary base grew by 6.3% and 5.4% respectively. A steady increase of lending activity, high growth of deposits, and continued accumulation of international reserves by the NBU contributed to money supply expansion. In June, the NBU foreign exchange reserves increased by $207 million to a new record of $6.2 billion at the end of the month. However, an increase in reserves is attributed not only to exports proceeds inflow, but also to the depreciation of the US dollar against other currencies included in foreign reserves (including the Euro). By the end of the year, the NBU expects its gross reserves to reach $6.0-$6.2 billion.

Commercial bank lending sped up in June, as the average lending rate dropped. Over the month, the growth of commercial bank loans reached 57% yoy, while the average lending rate fell to 14.6% annually. High growth of household deposits, fueled by rapid wage increases, also contributed to the expansion of lending activity. In June, total deposits grew by 68% yoy, primarily on account of the household deposits increase. The average deposit rate went down to 6.4% annually in June compared to 6.5% in May.

Exchange Rate Dynamics, eop



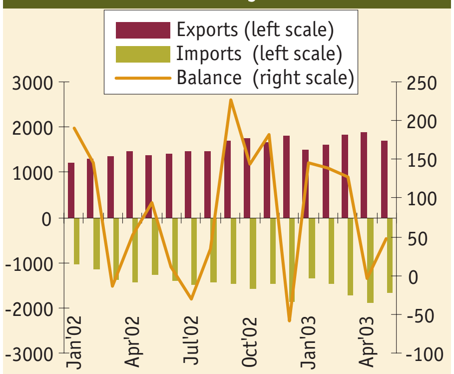
Source: National Bank of Ukraine

The official Hryvnia exchange rate stayed virtually unchanged at 5.33 UAH/USD as of end-June (depreciated by a negligible amount during the month.) A weakening of the Euro on international markets contributed to slight appreciation of the UAH/EUR exchange rate by 2.8% to 6.1 UAH/EUR. Since the beginning of the year, the hryvnia has depreciated by 13.5% ytd against the Euro. The NBU council made a second revision of its forecast for the average hryvnia rate in 2003. The hryvnia exchange rate is expected to reach UAH/USD 5.36 instead of the previously set UAH/USD 5.39.

International Trade and Capital

According to the NBU balance of payment report, during January-May 2003 exports of goods increased by 27% yoy, reaching $8.5 billion. Goods imports increased by 29% yoy reaching $8.1 billion. Thus, for this period the merchandise account showed a surplus of $450 million (or 3.5% of period GDP), which was about the same size as last year.

Merchandise Trade Dynamics, USD mn



Source: State Statistics Committee

Ferrous metals exports remained among the largest contributors to the overall growth of merchandise exports; these items' trading volume expanded by more than 33% yoy in January-May, while their share in the total exports made up 32%. Refined oil and gas exports were also on the rise as their share in the total exports went up from 9.7% in January-May 2002 to 14.2% during the same period this year. On the import side, imports of raw energy resources posted a 28% yoy increase to about $3.2 billion (or 39% of all imports.) In a regional breakdown, Europe accounted for about 40% of total merchandise exports during January-May, while Asia and CIS countries accounted for 26% and 23% respectively. At the same time, 53% of all goods imported to Ukraine came from CIS countries, whereas European countries' share constituted 33%. Still, demand for Russian goods grew much faster than for European products, largely due to heavy reliance on Russian energy resources and the relatively low income level in Ukraine.

For the rest of the year, the NBU forecasts a deterioration of the trade and current account balances due to expected higher growth of imports. According to NBU expectations, the current account surplus may fall by 50% yoy to $1.6 billion in 2003.

Over the first quarter of 2003, net FDI increased by almost 150% yoy to $300 million, primarily on account of investments from non-CIS countries. At the same time, about $820 million of portfolio investment flowed out of the country.

International Programs

Positive macroeconomic developments in Ukraine along with visible progress in tax reform should have improved the chances of resumption of international financing programs. So far, however, the situation with IMF and World Bank lending programs has remained uncertain. Although Ukraine is currently in no immediate need of IMF financing, renewal of active cooperation with this institution will significantly improve the country's international image, and also facilitate the resumption of World Bank adjustment lending. An IMF mission visited Kyiv at the end of June to assess the possibility of launching a precautionary stand-by program. The negotiations on the issue will continue in July and the IMF Board's decision is expected in August. Within a precautionary stand-by program, Ukraine may receive up to $800 million in 3-5 years upon request of the Ukrainian government in emergency cases. The IMF mission has to decide whether government efforts in implementing structural reforms were sufficient to justify resumption of suspended cooperation. There are four issues outstanding: repayment of VAT refund arrears, completion of the Naftogaz audit, further elimination of tax privileges, and restructuring of state-owned Oschadbank. Although IMF representatives may be satisfied with the adoption of the new tax laws by the Parliament, their primary concerns lie in the area of VAT refund arrears and in the abolishment of tax privileges, which is needed to avoid a drop in fiscal revenues. On VAT, the government has proposed to voluntarily exchange its VAT refund debt for special government securities as an alternative way of resolving the issue. However, the Parliament failed to adopt the corresponding bill before its summer break, thus diminishing Ukraine's chances for IMF cooperation renewal in August.

Resuming IMF funding would also unlock World Bank financing under the Programmatic Adjustment Loan (PAL-2) program, envisaging disbursement of $250 million this year. The World Bank decision on PAL-2 was postponed until September when the World Bank Board of Directors will consider the 2004–2007 country assistance strategy (CAS) for Ukraine.

Other Developments

Following a positive evaluation of Ukraine's actions in preventing money laundering by the Financial Action Task Force on Money Laundering (FATF), the government expects that Ukraine will be excluded from the list of non-cooperative countries in February 2004. The FATF will suggest that Ukraine work out a detailed action plan for effective introduction of the financial monitoring system. According to the FATF, Ukraine will have a strong chance of leaving the black list if it properly implements its legislation on preventing money laundering. Recently, the Ukrainian Finance Ministry and the US Treasury signed an agreement for the provision of US technical assistance to implement a Financial Monitoring System in Ukraine. According to the US representative, an advisor who has worked on a similar project in Russia will assist in effective functioning of the Ukrainian financial monitoring agency.

Recently, the Parliament approved amendments to the Land Code, giving its permission to sell land to non-residents if they set up a joint venture in Ukraine. These amendments will ease operations of companies with foreign participation and will positively affect the inflow of foreign investments to the country. However, it has not been specified whether foreign residents may acquire agricultural lands, because the effective Land Code prohibits foreign ownership of agricultural land.