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Ukraine Macroeconomic Situation

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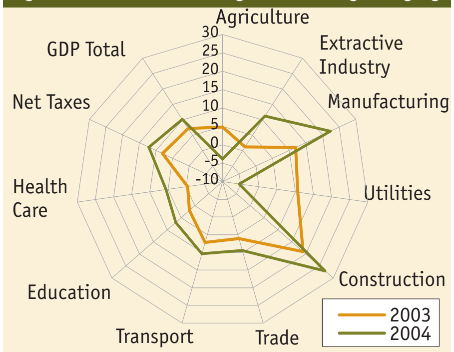
Economic Growth

In February 2004, economic growth in Ukraine accelerated following a remarkably good start in January. During the month, real GDP increased by 11.5% year-over-year (yoy) bringing the cumulative GDP growth figure to 10.2% yoy. These high rates of economic growth in the first two months of 2004 were caused by an impressive expansion of construction and industrial production.

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



Source: State Statistics Committee

Value added growth in construction reached a record high 27% yoy in February 2004, which compares very favorably with 19% yoy over the same period last year. Industrial output expanded by 19.4% yoy in February, a growth rate twice as large as the 9.7% rate recorded in February 2003. At the product level, metallurgy and machine-building demonstrated the highest rates of growth during the month. Growth in metallurgy output (25% yoy) was supported by high world prices for metals. Output in the machine-building industry increased by 35% yoy, primarily due to a substantial upsurge in production of transport machinery. Strong domestic demand for machinery indicates positive domestic investment dynamics, which contribute to an increase of production capacities in other sectors. A favorable external environment supported 22% yoy growth in chemicals. Rapidly growing domestic consumption supported almost 20% yoy output growth in the food industry in February.

Based on Ukraine's successful economic performance in the last two months, the government revised its GDP growth forecast for 2004 from 6.0%-6.5% to a record high 9.5%. Meanwhile, the approved 2004 Fiscal Budget assumes a much more conservative 4.8% annual GDP growth rate.

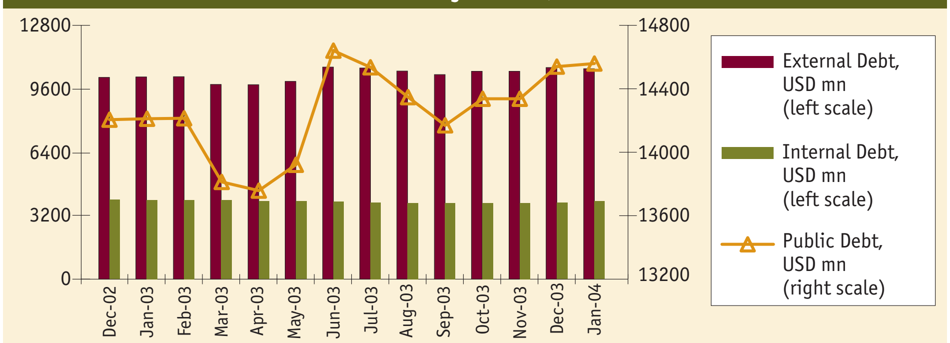
Fiscal Policy

In January, the unconsolidated state fiscal budget posted a surplus of UAH 816 million ($153 million), which is equivalent to 4.2% of period GDP. Over the month, state budget revenues reached UAH 3.4 billion ($640 million), while expenditures amounted to UAH 2.6 billion ($487 million). This fiscal surplus was achieved thanks to tight control of expenditures, in light of reductions in tax revenues. In fact, despite impressive rates of economic growth at the beginning of the year, state budget revenues amounted to only 17.8% of the period GDP, which is quite low compared to previous periods (an average 27%). The reason for such a development was lower income tax receipts as a result of new tax rates that came into effect in January 2004. The corporate income tax collections fell 27% short of the amount planned for January as the rate was cut from 25% to 20%. The personal income tax proceeds were lower than expected in January when a new 13% flat rate replaced a progressive scale with a 40% marginal rate. Part of the decline in these taxes was compensated by plentiful VAT, excises and import duties receipts. On the expenditure side, state budget expenditures were executed at 65% of the target as the government followed its usual policy of reducing expenditures to alleviate deficit financing risks. Last year, this policy resulted in an uneven distribution of fiscal expenditures with the highest amount of government funds spent in the last two months.

Despite the reductions in tax rates, higher than expected economic growth this year gives hope for successful fiscal performance in 2004. The projected budget gap of UAH 3.4 billion ($640 million) should be covered with privatization revenue and new borrowing. In the first two months of 2004, privatization proceeds amounted to UAH 865 million ($162 million), which is about 40% of the annual target. However, no big sales of state property have taken place this year, and such good performance is attributed to transfer of proceeds from last year's sales (in particular, the sale of Dniprovskyi Steel Works.) The largest privatization tender planned for 2004 is the sale of 42.86% in the state telecom Ukrtelecom, which may be unloaded for about $1 billion. On March 22, the State Property Fund organized an Ukrtelecom roadshow for potential investors in London. It was reported that several foreign telecoms including Russian Sviazinvest and Sistema Telecom, the Norwegian Telenor, Deutsche Telecom, and the Turkish Cukurova Holding expressed interest in Ukrtelecom's privatization. Nevertheless, political uncertainty due to October's presidential elections may result in lower demand for the stake since the tender sale is scheduled for the second half of the year.

During January 2004, the amount of public debt (internal and external) increased only marginally by 0.13% to $14.6 billion equivalent. As a share of GDP, this is a relatively low level compared to other transition economies in the region. Over January, the stock of external debt declined by less than 1% to $10.7 billion equivalent. However, foreign debt increased in February by about $600 million due to a Eurobonds placement at the end of the month. The recently attracted resources will help

Public Debt Dynamics, 2003-04



Source: Ministry of Finance

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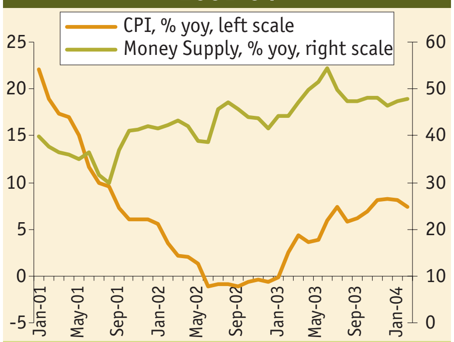
Ukraine to meet peak payment on its external obligations due in March (some $500 million). Overall, the 2004 budget envisages $1.2 billion in external borrowing and $1.53 billion in external debt repayment and service.

Monetary Policy

On a month-over-month basis, the Consumer Price Index (CPI) increased by only 0.4% during February 2004, a figure lower than previously expected. As a result, consumer inflation slowed down to 7.4% yoy in February due to a decline in the growth of food prices. Food prices increased by 9.1% yoy, having decelerated from 10.2% yoy in January. In February, services tariffs growth also decreased slightly to 6.9% yoy, while non-foods prices grew at a relatively low 1.7% yoy rate.

CPI and Money Supply Dynamics, 2001-04

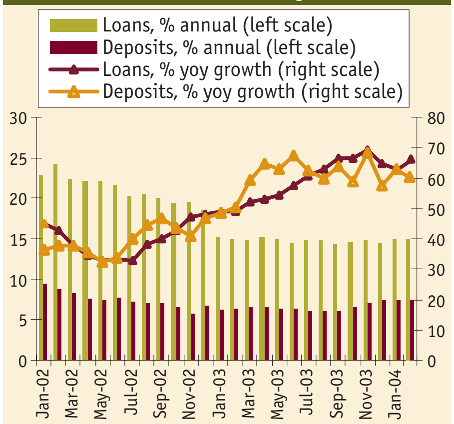


Source: State Statistics Committee, NBU

On the other hand, the Producer Price Index (PPI) increased significantly in February to 14.9% yoy from 12.4% yoy in January. Rapid growth of wholesale producer prices raises concern because it will eventually spill over to retail prices. The government has already announced that it intends to introduce price regulations, especially in construction materials and metals sector, in order to prevent producers' inflation acceleration in the pre-election period. Such a measure, however, will just delay inflation growth until after the elections. In 2004, the government expects the consumer inflation rate to reach 5.8-6.3% eop.

The expansion of monetary aggregates remained high in February as money supply (M3) growth amounted to 47.9% yoy. The NBU introduced no significant measures to suppress monetary expansion except for raising its overnight rate from 8.5% to 8.7-9% per annum. At the same time, the central bank discount rate remains at a low 7% annually. Following the Eurobonds placement on the international bond market, the gross international reserves of the NBU surged to about $8 billion at the beginning of March, having increased by 66% yoy. By the end of 2004, the NBU plans to increase its gross reserves to $8.5 billion, which is quite realistic, provided strong export performance continues through the current year.

Loans and Deposits Growth and Interest Rates Dynamics



Source: National Bank of Ukraine

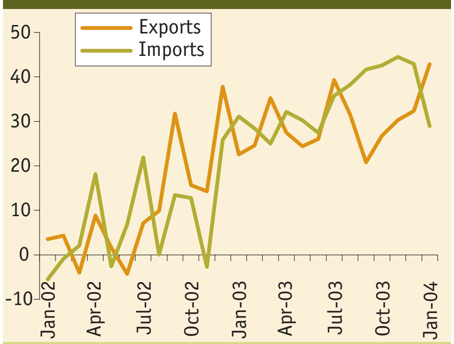
The NBU is trying to improve the stability of the Ukrainian hryvnia exchange rate in relation to the US dollar. Due to excessive US dollar supply, the NBU has continued to buy out the excess foreign exchange on the interbank market, thus preventing the hryvnia from significant appreciation against the US dollar. In February, the official hryvnia exchange rate appreciated by only 0.03% yoy to 5.33 UAH/USD. On the other hand, the hryvnia/euro rate decreased 0.11% to 6.64 UAH/EUR in February.

Due to increasing confidence in the banking sector and the growth in disposable income, domestic deposits with commercial banks have been increasing at a fast pace. In February 2004, bank deposits grew by 61% yoy. This led to an acceleration of domestic credits by the banking sector. In fact, the volume of commercial banks lending to the real sector picked up to a sizeable 66% yoy in February. This high lending growth took place despite increases in the cost of loans, indicating strong demand for financial resources in the country. The average lending rate picked up by 10 basis points in February to 15.2% annually. The average deposit rate fell 10 basis points to 7.5% annually, underpinned by decelerating consumer price dynamics.

International Trade and Capital

The beginning of 2004 was marked by very strong export performance, which was underpinned by robust world demand for Ukraine's traditional commodities. In January 2004, merchandise exports grew by 43% yoy to $2.13 billion, significantly outpacing imports growth of 28.7%. Imports of goods amounted to $1.73 billion in January. Thus, the surplus in the trade of goods account reached $394 million in January, a surplus that represented an almost threefold increase over the same indicator last year.

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

In January, exports of metals and chemicals, Ukraine's traditional export items, grew by 123% yoy and 70% yoy, respectively. Export of machinery was also on the rise (90% yoy growth) supported by robust economic growth in Ukraine's main trading partners. On the merchandise import side, imports of machines and equipment and of energy resources were the two biggest items contributing to total imports growth. In January, growth of energy resources imports, which account for 42% of the total imports, decelerated to 15% yoy (from 18% in December). On the other hand, the growth of machinery imports accelerated to 145% yoy, indicating remarkably strong investment demand in the country.

The geographical breakdown of Ukraine's foreign trade is still biased towards Russia, principally on the import side. Russia remains Ukraine's biggest partner, accounting for 42% of all imports and 14% of all exports. The rest of Europe has become much more important on the export side. In January, the rest of Europe accounted for 46% of Ukraine's exports and 29% of its imports. The largest European suppliers of goods to Ukraine were Germany (7.8% of total imports) and Poland (3.1% of total imports).

International Programs

On March 29, IMF management approved the resumption of its cooperation with Ukraine under a Precautionary Stand-By Program. The Ukrainian government had sent a formal request to the IMF after they settled all outstanding issues with the last IMF mission to Ukraine. The IMF program will be for 12 months, during which time Ukraine could use funds amounting to $607 million or 30% of Ukraine's quota, but only if an urgent need arises. However, Ukraine's external position has improved substantially in recent years, and it is quite unlikely that the government will resort to IMF financing under the program.

In approving the Precautionary Stand-By, the IMF stated that "Ukraine has achieved a broad-based and sustained economic recovery, and has subdued inflation following the 1998-99 financial crisis. Renewed confidence in macroeconomic stability has contributed to the remonetization of the economy, a strong balance of payments, the rebuilding of international reserves, and a significant improvement in the economic outlook. The latest indicators suggest that economic activity remains strong this year. Ukraine is well placed to consolidate these gains. Full implementation of the government's prudent financial policies and further progress on growth-oriented structural reforms will support growth and contain inflationary pressures, while bolstering debt sustainability and market confidence."

Resumption of cooperation with the IMF may speed up disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2) from the World Bank. After disbursing $75 million of the PAL-2 late in December 2003, the World Bank planned to unload the remaining $175 million of the loan in 2004 based on Ukraine's policy performance. In particular, the World Bank expects the Ukrainian government not to accumulate tax arrears, to improve fiscal discipline at the local level, eliminate all electricity tariff privileges assigned to individual companies or sectors, adopt a law on energy sector debt restructuring, continue suspended privatization of remaining state-owned oblenergos, and further reduce tax exemptions.

Other Developments

In March, President Kuchma vetoed the bill calling for the reduction of the VAT rate from 20% to 17% on January 1, 2005, and to 15% on January 1, 2006. The official reason for the veto was that the law would be "destabilizing" for the economy. In addition to cutting the VAT rate, the law also envisaged changes to other taxation laws complementing the 2004 State Budget. In particular, it partially restored VAT privileges to printed mass-media and VAT refunds for agricultural exporters, which were suspended in the 2004 Budget. In addition, the law introduced a simplified system of VAT refunds that requires no prior approval of the tax administration for the exporters applying for the refund.

In February, Ukraine signed a bilateral protocol on mutual market access with Switzerland, indicating further progress in Ukraine's integration into the World Trade Organization (WTO). The success in negotiations with Switzerland may speed up the negotiations with the remaining WTO members, in particular the USA and Japan. In addition, Ukraine has yet to settle all outstanding issues with Turkey, Lithuania and China. The government expects that Ukraine will join the WTO by the end of 2004, but it may well occur only in 2005 after presidential elections.

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