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## Economic Growth

In March 2004, economic growth in Ukraine further accelerated following a remarkably good start during the first two months of the year. During the month, real GDP growth reached 11.8% year-over-year (yoy) bringing the cumulative GDP growth figure to 10.8% yoy. The acceleration of economic growth in the first quarter of 2004 (Q1) was caused by a sharp rebound in construction and industry.



Value added growth in construction reached a record high 29.9% yoy in Q1, which compares very favorably with 18% yoy for the same period last year. Industrial output expanded by 19.6% yoy in March, a growth rate almost twice as large as the 10% rate recorded a year ago. At the product level, metallurgy and machine-building demonstrated the highest rates of growth during the month. Growth in metallurgy output (23.6% yoy) was supported by high world prices for metals. Output in the machine-building industry increased by 41.3% yoy, primarily due to a substantial upsurge in production of transport machinery, demand for which strengthened on both the internal and external markets. 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 led to 20% yoy growth in chemicals, and rapidly growing domestic consumption led to almost 16.5% yoy output growth in the food industry in Q1.

For 2003, the State Statistics Committee (SSC) has revised upwards its published GDP growth figure. It turned out that real GDP grew by 9.4% instead of the 9.3% rate reported earlier. Remarkable real sector performance in 2003 was supported by 28% yoy growth in fixed capital investment. Based on Ukraine's successful economic performance in the first quarter of 2004, the government revised its full-year GDP growth forecast from 6.0%-6.5%

to a quite ambitious 9.5%. At the same time, the approved 2004 fiscal budget assumes a much more conservative 4.8% annual GDP growth rate.

## Fiscal Policy

In January-March, the consolidated fiscal budget posted a surplus of UAH 1.25 billion (\$234 million), which is equivalent to 2% of period GDP. Over the period, consolidated budget revenues reached UAH 17.5 billion (\$3.27 billion), while expenditures amounted to UAH 16.2 billion (\$3.04 billion). Higher than expected rates of economic growth in the first quarter of the year yielded a 12% yoy growth in budget revenues. Budget expenditures also increased at a fast pace of 17.6% yoy. After an initial decline at the beginning of the year (when the new reduced income tax rates became effective), tax collections have started to catch up. At the same time, the tax base was broadened through suspension of several sectoral VAT exemptions and zero ratings, including for housing construction. Thanks to a broader tax base, the lower proceeds in income taxes were compensated for by plentiful VAT, excise taxes and import duties.

The government expects that fiscal budget implementation and expenditure control may be strengthened after the Rada approves a bill introducing special VAT accounts. This would improve VAT administration, since all VAT payments and reimbursements would be carried out through taxpayers' individual VAT accounts, thus eliminating the possibility of getting illegal VAT refunds. The introduction of these VAT accounts, however, has been challenged by the business community as they would reduce flexibility in the use of funds. In addition to introduction of VAT accounts, the draft law submitted by the government for Parliament's approval envisages a reduction of the VAT rate from 20% to 15% starting January 2005.

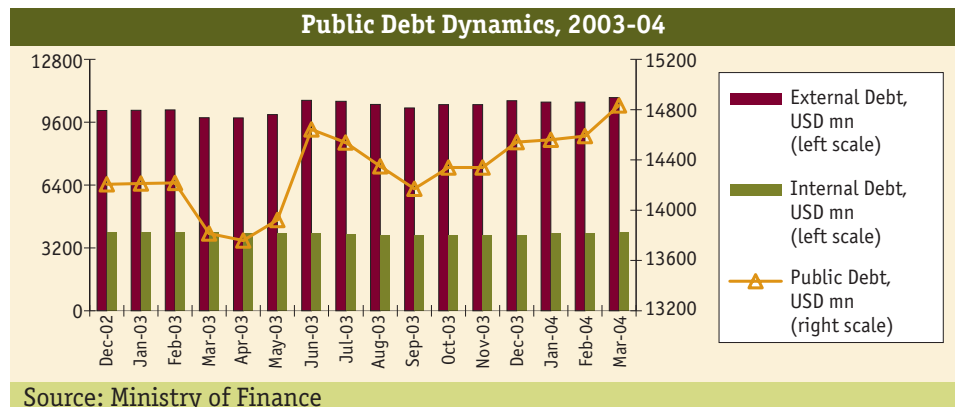
Despite uncertainty about the fiscal revenue outlook for 2004, the government is likely to maintain

prudent fiscal discipline this year. The projected budget gap of UAH 3.4 billion (\$640 million) should be covered by privatization revenue and new borrowing. In the first quarter of 2004, privatization proceeds amounted to UAH 900 million (\$168 million), which is about 40% of the annual target. So far, no big sales of state property have taken place, but the State Property Fund hopes to unload 42.86% in the state telecom, Ukrtelecom, which is the largest privatization tender planned for the second half of 2004.

During January-March, the amount of public debt (internal and external) increased by 1.7% to \$14.8 billion equivalent. As a share of GDP, this is a relatively low level compared to other transition economies in the region. In March, the stock of external debt increased 1.5% to \$10.85 billion equivalent. The increase is attributed to the \$600 million Eurobonds placement on the last day of February. However, the bulk of the recently acquired resources was used to meet peak payment on 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

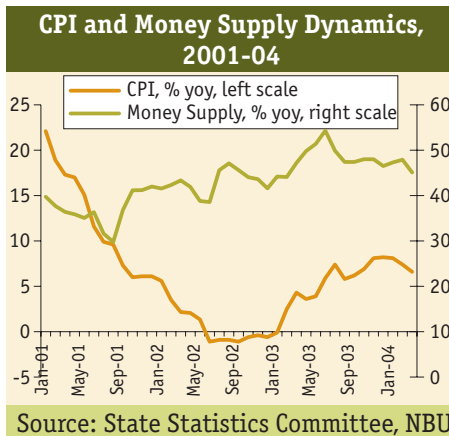
Since February, inflationary pressures on the consumer market have begun to fade away. The consumer price index (CPI) increased by only 0.4% on a month-over-month basis during March, after the same increase a month before. In April, CPI growth increased to 0.7% month-over-month, that is relatively low for this month. As a result, annual growth of consumer prices made up 6.64% yoy in April as the growth of food prices picked up slightly. Food prices grew by 8.3% yoy having accelerated from 8.0% yoy in March. Non-foods prices growth sped up to 2.2% yoy in April. In contrast to accelerating food and non-food prices dynamics, services tariff growth decelerated. In April, services tariff growth slowed down to 6.2% yoy, after 7.1% yoy growth a



## Macroeconomic Situation

month before. The end of heating season was the main reason for deceleration.

At the same time, producer inflation continued to accelerate. The Producer Price Index (PPI) increased significantly in April to 18.4% yoy from 15% yoy a month before. The highest growth in prices was observed in metal processing, coke and oil refining, and mining. Acceleration of wholesale producer price dynamics indicates that retail prices will eventually speed up too. The government intends to introduce price regulation, especially in construction materials and the metals sector, in order to prevent accelerated inflation 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.

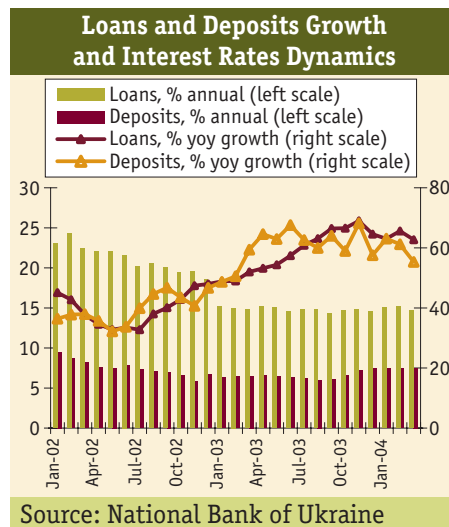


Monetary aggregates growth decelerated slightly in March as money supply (M3) growth fell from 47.9% yoy to 45.1% yoy. Inflation deceleration contributed to the slowdown in money growth. In an attempt to contain monetary expansion, the NBU again raised its overnight rate in April from 8.7% per annum to 8.8% for loans with government bonds as collateral, and from 9% to 9.2% per annum for unsecured loans. Still, the central bank discount rate remains at a low 7% annually.

Stellar export performance allowed the NBU to replenish its gross international reserves to about \$8.3 billion at the end of March. The NBU's year-end target for gross reserves is \$8.5 billion, which may well be surpassed provided that robust export growth continues through the current year.

Continuous buyout of excess foreign exchange supply by the NBU, which has been implicitly targeting the UAH/USD exchange rate, prevented the hryvnia from significant nominal apprecia-

tion. By doing this, the NBU kept the hryvnia exchange rate at a competitive level vis-a-vis the Euro, thus facilitating robust export growth. In March, the official hryvnia exchange rate remained at about 5.3 UAH/USD. On the other hand, the hryvnia/Euro rate decreased 2.5% month-over-month to 6.5 UAH/EUR.

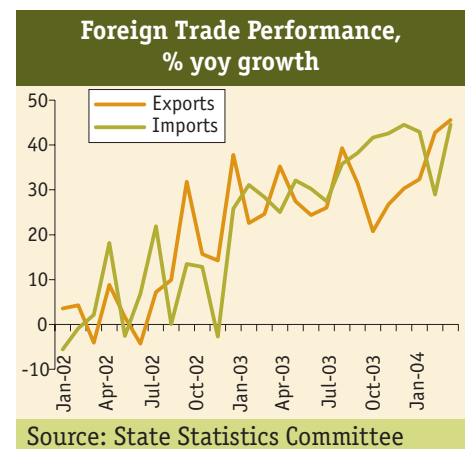


Increased growth of disposable income and improving confidence in the banking sector resulted in sustainable and rapid growth of domestic deposits with commercial banks. In March 2004, bank deposits grew by 55.3% yoy. Excessive liquidity of the banking system fueled by high deposit growth, on the one hand, and strong money demand in the country, on the other, were the driving forces of the lending expansion. In March, commercial bank lending to the real sector increased to a high 63% yoy. Although the cost of loans still remains high, it is on a declining trend. The average lending rate fell by 50 basis points in March to 14.7% annually, underpinned by decelerating consumer price dynamics. The average deposit rate remained unchanged at 7.5% annually. At the same time, the maturity of loans provided by commercial banks is relatively short. The share of mortgages in the aggregate loan portfolio of Ukrainian banks was equal to about 7% in March, which is a relatively low figure by international standards.

### International Trade and Capital

Robust world demand for Ukraine's traditional commodities in the beginning of 2004 led to remarkably strong export performance. In the

first quarter, growth of merchandise exports accelerated 45.2% yoy to \$7.2 billion, outpacing imports growth of 39.2%. Imports of goods amounted to \$6.3 billion in January-March. Thus, the surplus in the trade of goods account reached \$857 million in the first quarter of 2004, representing more than a twofold increase over the same period from last year.



In January-March, exports of metals and chemicals, Ukraine's traditional export items, grew by 40% yoy and 50% yoy, respectively. Export of machinery was also on the rise (70% yoy growth) due to robust economic growth in CIS countries, which are the main consumers of Ukrainian-produced machinery. The increase in the share of machine-building products in total exports indicates a positive trend towards export diversification, thus contributing to the reduction of Ukraine's external vulnerability.

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-March, growth of energy resources imports, which account for 38% of total imports, made up 23% yoy (up from 15% in February). On the other hand, machinery imports increased by 50% yoy, indicating notable growth of investment demand in the country.

The geographical breakdown of Ukraine's foreign trade still remained biased towards Russia, principally on the import side. Due to Ukraine's dependency on energy imports from Russia, this country is Ukraine's biggest partner, accounting for 39.6% of all imports and 15% of all exports. The rest of Europe has become much more important on the export side. In January-March, the rest of Europe accounted for 42% of Ukraine's exports and 31% of its imports. The largest European partners for

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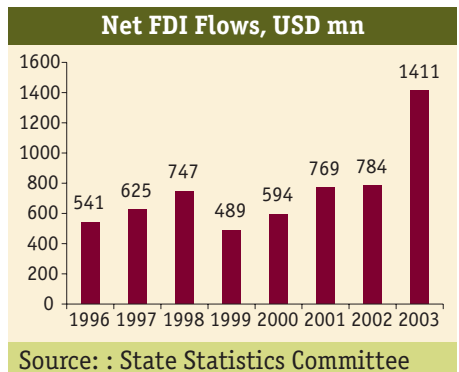
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**Macroeconomic Situation**

goods were Germany (9.8% of exports and 8.9% of imports) and Italy (4.6% of exports and 2.5% of imports).

According to the NBU's revised balance of payments report, net FDI inflow to Ukraine grew to \$1.41 billion in 2003. This is the largest annual inflow since Ukraine's independence, thus reflecting growing investor confidence in the Ukrainian economy. Since 1991, cumulative FDI has reached \$6.9 billion, or about \$145 per capita terms, which is still low compared to other transition economies. The largest amount of FDI originated from the USA (16% of the total), Cyprus (12%), and the UK (10%). The relatively large share of investments originating from Cyprus suggests that Ukrainian capital that earlier flowed out of the country is gradually returning back. The outlook for FDI in 2004 is less optimistic because of the forthcoming presidential elections, which usually make foreign investors more cautious in making investment decisions. However, impressive rates of economic growth since the beginning of 2004 are sending positive signals to international investors about economic development in the country.



**International Programs**

As reported earlier, IMF management approved the resumption of its cooperation with Ukraine under a Precautionary Stand-by Program at the end of March 2004. The IMF program is 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 May 2004, a regular IMF mission is scheduled to visit Ukraine to monitor the progress on structural reforms. The government of Ukraine is committed to improving VAT administration to cope with the backlog of VAT refund arrears and to enhance prudent regulation of the banking sector.

Ukraine still has much to do in order to qualify for disbursement of the remaining part of the World Bank's Second Programmatic Adjustment Loan (PAL-2). After disbursing \$75 million of the PAL-2 late in December 2003, the World Bank plans 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 to strengthen the social and financial viability of the pension system, enhance the accountability of the state tax administration, implement an energy debt restructuring plan and resume suspended privatization of remaining state-owned oblennergos, and establish unified registration for land and real estate ownership. Recently, the State Land Committee called on Parliament to approve the agreement with the World Bank concerning the land reform loan worth \$195 million, which would help to accelerate land reform in the country.

**Other Developments**

Ukraine's Parliament approved the creation of the Common Economic Area (CEA) within the borders of Ukraine, Russia, Belarus and Kazakhstan, thus indicating that Ukraine intends to expand its ties with CIS countries, which are important markets for Ukrainian exports. The agreement stipulates that the participating states will gradually integrate their trade and economic policies, leading to the eventual creation of a customs union. However, the approved document contains clauses introduced by the Ukrainian President stating that the agreement should not contradict the Ukrainian Constitution and Ukraine's Euro-integration policy. The CEA agreement provides for ample flexibility for the countries as to the pace of implementation. EU officials believe that if Ukraine limits its participation in the CEA to the creation of a free trade zone, it should not be an obstacle to Ukraine's future integration with the EU.