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Ukraine Macroeconomic Situation

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Summary

The second round of presidential elections held on November 21st was the dominant event of the month. Election results announced by the Central Election Committee (CEC) stated that Prime Minister (PM) Yanukovich was the winner with 49.46% of the votes, while opposition leader Yuschenko had received 46.61%. A huge number of protesters on the streets and opposition claims of election fraud led to a political crisis in the country and the Supreme Court of Ukraine postponed the official publication of election results. The Yanukovich and Yuschenko camps attempted to negotiate with the help of international mediators, but the talks did not bring a compromise.

The opposition appealed to the Supreme Court, accusing the executive authorities of widespread fraud in the second round of the presidential election. On December 3rd, the Supreme Court declared the second round results invalid and called for a new run-off vote to be held on December 26th. (According to preliminary election results (based on 99.6% of processed ballots), Victor Yuschenko has won the presidency with 52.1% of votes). However, the Supreme Court decision did not resolve the political crisis in the country. On the 8th of December, Ukraine's parliament approved a compromise package of laws calling for changes to the Constitution and special provisions to the election law, which were immediately signed by President Kuchma. The constitutional reform turned Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament. By having a fair democratic re-run of the presidential elections, Ukraine has a chance to improve its international reputation, taking into account the positive macroeconomic development.

Meanwhile, Ukraine's real sector continued to demonstrate impressive performance in November despite the political uncertainties. Real GDP grew by 12.4% year-over-year (yoy). This is one of the best GDP growth rates among all transition economies. Broad-based economic growth was supported by impressive export performance (43.3% yoy growth in ten months) and booming domestic demand (income growth reached 24% yoy). Unexpectedly, industrial performance improved significantly during the politically turbulent November following a deceleration in pre-election months. Industrial production accelerated to 11.3% yoy growth in November from 6.4% yoy in October. The outlook for Ukraine's economic development remains positive in 2004, although fiscal performance and inflationary pressures raise concerns.

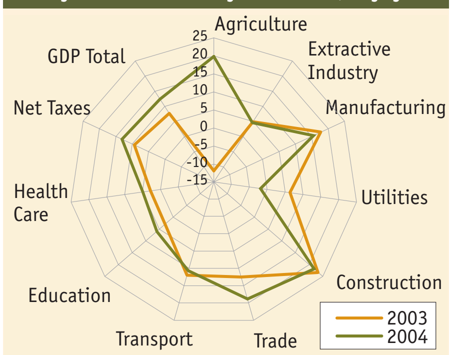
The pre-election fiscal ease, which the IMF considers inappropriate, may result in a fiscal deficit of 4% of GDP in 2004 compared to the previously planned 1.75%. This level is unsustainable, and could have a negative impact on the economy's stability unless proper policy adjustments are implemented. The 2005 budget assumes a fiscal deficit of 2.1% of GDP. However, this is based on optimistic assumptions about revenue growth. Inflationary pressures have also increased as consumer price growth reached 11.3% yoy in November. Inflationary expectations and political uncertainty led to a surge in demand for cash foreign exchange, when people started converting their hryvnia holdings into foreign currencies. As a result, monetary aggregates growth decelerated in November. In an attempt to restrain large fluctuations in the cash foreign exchange rate and restore public confidence in the hryvnia, the National Bank of Ukraine (NBU) introduced a 2% fluctuation band for cash foreign exchange rates. Despite this, net purchase of cash foreign exchange by the population reached $1.9 billion over October-November. As a result, the NBU's gross international reserves dropped to $9.9 billion at the end of November from a record high of $12.1 billion in September.

At the same time, a favorable external environment and a competitive exchange rate continued to drive foreign trade. In January-October, the trade of goods surplus reached $3.21 billion, more than eight times higher than over the same period last year. Despite some political uncertainties associated with the presidential election, the impressive macroeconomic performance in the country is sending positive signals to the international investment community. Net FDI inflow into Ukraine constituted $1.0 billion in January-September. However, the sustainability of Ukraine's superb macroeconomic fundamentals is dependent on the further improvement of the investment climate.

Economic Growth

Contrary to expectations, Ukraine's economy performed even better during November than in pre-election months. GDP growth accelerated to 9.9% yoy compared with 7.6% yoy growth in October. In January-November, the growth of GDP slid to 12.4% yoy from 12.6% in January-October. The major contributor to economic growth was industry, which demonstrated 11.3% yoy growth in November. This figure represents an almost twofold increase compared to October (6.4% yoy). The acceleration of economic growth can be mainly attributed to faster expansion of production in manufacturing.

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



Source: State Statistics Committee

Growth in manufacturing was encouraged by favorable external demand, reaching 13.5% yoy in November and bringing the cumulative figure to 15.5% yoy. Despite some slowdown in export-oriented industries, metallurgy and chemicals continue to demonstrate healthy rates of growth. During November, output in chemicals and metallurgy increased 14.3% yoy and 7.2% yoy, respectively. In January-November, output in these sectors picked up by 14% yoy and 13% yoy, respectively. It is evident that GDP growth for 2004 will be no less than 12%; therefore, the government's expectations of 12.4% real GDP growth are realistic.

Fiscal Policy

Pre-election fiscal expansion, including additional pension payouts, resulted in a substantially higher fiscal deficit in January-October than was previously targeted. Over the period, the consolidated budget posted a deficit of UAH 3.86 billion ($730 million), which is about 1.4% of period GDP. The fiscal budget had been in surplus at the end of August, but fiscal expenditures surged in the following two months, driving the budget out of balance. As a result, the budget deficit for 2004 may reach UAH 13.1 billion ($2.5 billion), which would be equivalent to about 4% of GDP compared to the previously planned 1.75%. This fiscal deficit level is unsustainable, and may be costly to the economy in terms of its stability unless proper fiscal policy adjustments are made. Facing large social security and wage bills and substantial external debt payments, the government will have to resort to a tighter fiscal policy next year in order to preserve macroeconomic stability. The Parliament approved the 2005 budget with a fiscal deficit of UAH 8.8 billion ($1.65 billion), which is equivalent to 2.1% f GDP. However, it is based on assumptions about fiscal revenue growth that are overly optimistic.

So far, the government has enough resources to finance the expected fiscal deficit in 2004. In January-November, the government managed to privatize some UAH 9.4 billion ($1.8 billion) worth of state property. However, these one-shot budget revenues could not be relied on in the longer-term. Also, external borrowings are an important source of fiscal deficit financing. Over the ten months period, the stock of public debt grew by 9.8% year-to-date to $15.96 billion. The largest recent increase is attributed to growth of guaranteed external debt when the Ukrainian government provided a guarantee to a Deutsche Bank loan ($480 million) for construction of the Kyiv-Odessa highway and to a Maglin Capital Ltd. loan ($700 million) for construction of the bridge over Dnieper river in Kiev.

Monetary Policy

In November, annual consumer inflation was 11.3% yoy, compared to 11.7% in October. Prices of foodstuffs grew by 11.4% yoy over the month, which can be mainly attributed to the 44.8% and 18.5% yoy increase in meat and milk prices, respectively. The non-food price index rose 4.8% yoy during the same period following the acceleration of gasoline prices-from 56.4% yoy in September to 61.3% yoy in November. Service tariffs grew by 7.6% yoy, on ac-

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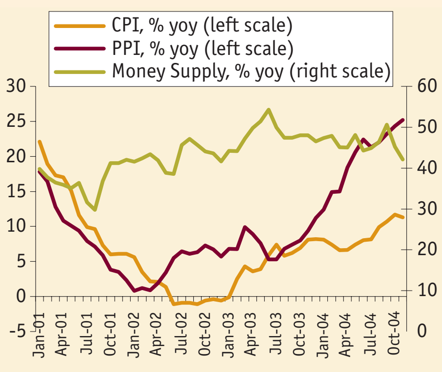
count of higher transport service and utilities prices. Year-end inflation should reach 11–12% in 2004. Meanwhile, growing world prices for metals and oil contributed to an increase of producer inflation. The producer price index (PPI) increased to 25.2% yoy in November from 24.3% yoy a month before.

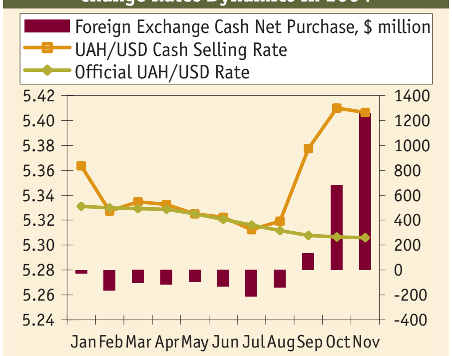
Prices and Money Supply Dynamics, 2001–04



Source: State Statistics Committee, NBU

Inflationary expectations and political uncertainty led to an upsurge of demand for cash foreign exchange. People started converting their hryvnia, and monetary aggregates growth decelerated in November as a result. The growth rate of cash in circulation dropped from 37% yoy in September to 31% yoy in November. Consequently, broad money (M3) growth also slowed, down to 42% yoy in November from 51% yoy in September. Household deposits at commercial banks shrunk by 5% over October-November, when people withdrew their hryvnia-denominated deposits (down by 15% in two months) and converted them into foreign currency-denominated deposits (up 11% over the same period) or cash foreign exchange. This trend led to a slowdown of private sector credit growth. In November, the amount of credit provided to the real sector grew by 41% yoy compared to 43% yoy a month before. At the same time, the average cost of loans picked up by 20 basis points to an annual rate of 15%, primarily on account of the higher cost of hryvnia-denominated loans.

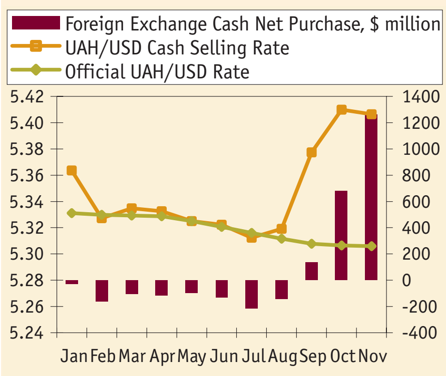
Demand for Cash Foreign Exchange and Exchange Rates Dynamics in 2004



Source: National Bank of Ukraine

In an attempt to curb large fluctuations in the cash foreign exchange rate and restore public confidence in hryvnia stability, the NBU introduced a 2% fluctuation band for cash rates. Despite this move, net purchase of cash foreign exchange by the population reached $1.9 billion over October-November. To support the hryvnia's stability, the NBU sold about $1 billion of foreign reserves to commercial banks in November. At the end of November, the NBU's gross international reserves dropped to $9.9 billion from a record high of $12.1 billion in September. At the same time, the official hryvnia rate has continued to gradually appreciate over the last three months; the retail UAH/USD rate picked up from 5.31 in August to 5.306 in November.

NBU's Forex Market Interventions and International Reserves, USD mn



Source: National Bank of Ukraine

International Trade and Capital

The competitiveness of the exchange rate and the favorable external environment kept Ukraine's foreign trade balance at a record high surplus. In January-October, the trade of goods surplus was $3.21 billion, more than eight times higher than over the same period last year. However, export growth has been decelerating since June, indicating some weakening of demand for Ukraine's main export commodities. Over the period, merchandise exports grew by 43.2% yoy (to $26.6 billion,) exceeding import growth of 28% yoy (to $23.3 billion.) By product breakdown, the largest contribution to overall goods exports came from metals and metal products. These items expanded by more than 50% yoy in January-October, and their share in total exports made up about 40%. However, the bulk of the increase in metals and metal products export revenue was caused by higher international prices for these products. As further increases in metal prices are uncertain, it is unlikely that metals export revenue will continue to expand in the future.

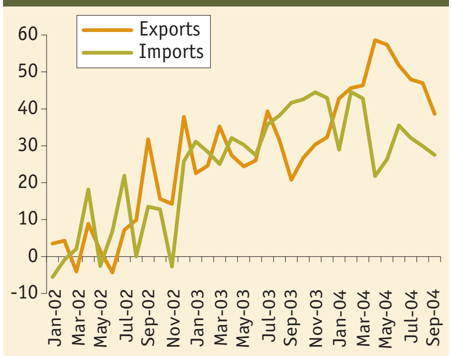
On the goods import side, imports of machines and transport equipment and of energy resources were the two biggest items contributing to total import growth. The geographical breakdown of Ukraine's foreign trade saw only slight changes, with Russia (the biggest single trade partner) accounting for 18% of all exports and 41% of all imports.

Ukraine's impressive macroeconomic performance in 2004 encouraged inflows of FDI to the country's economy. Net FDI inflow to Ukraine made up $1.0 billion in January-September. This amount is roughly equal to the level registered over the same period last year. Thus, the cumulative FDI stock remained at a relatively low level of $7.8 billion, which is equivalent to $165 per capita.

International Programs

Back in March, the IMF resumed its cooperation with Ukraine under a Precautionary Stand-By Program. The IMF program is for 12 months, during which time Ukraine can use funds amounting to $607 million (or 30% of Ukraine's quota) in case an urgent need arises. However, the recent review of the current program has not been completed because the IMF considers the recent fiscal expansion to be inappropriate. Also, the IMF recommended that the country save additional privatisation revenues until future periods in order to be able to perform counter-cyclical fiscal policies.

Foreign Trade Performance, % yoy growth



Source: State Statistics Committee

At the same time, the continuation of World Bank financing under the Second Programmatic Adjustment Loan (PAL-2) Program is unlikely until the end of the year. After disbursing $75 million of the PAL-2 late in December 2003, the transfer of the remaining $175 million of the loan was postponed until further progress in energy sector reform (in particular the law regulating debt restructuring in the energy sector) is adopted by the Parliament.

Other Developments and Reforms Affecting the Investment Climate

After the second round of the presidential election, the public protested the official results, which announced the alleged victory of the current PM, V. Yanukovich. Hundreds of thousands of Yuschenko supporters began demonstrations in the center of the

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Kyiv and the blockade of some public buildings. The wave of public protests swept across the regional centers. According to the official election results announced by the CEC, Mr. Yanukovich had won the presidency with the support of 49.46% of the voters. Meanwhile, Mr. Yuschenko was supported by 46.61% of voters. In particular, Mr. Yanukovich won the majority of votes in the east and southeastern regions of Ukraine, while Mr. Yuschenko was the winner in western and central regions. However, the results appeared inconsistent with exit polls held the day of election, which showed Mr. Yuschenko's receiving 54% of the votes. The striking difference between the two polls and the statements of international observers provided the grounds for claims of election result falsification, and this triggered the wave of public protests. A huge amount of protesters on the streets and opposition claims of election fraud led to a political, and the Supreme Court of Ukraine postponed the official publication of election results. Negotiations were held between the two camps with the help of international mediators (conciliators). During the first round of talks, representatives of the international community and President Kuchma failed to reconcile the two conflicting camps, but agreed to abstain from violence and to meet again after the Supreme Court made its decision.

The opposition filed an appeal with the Supreme Court, accusing the executive authorities of widespread fraud in the second-round of the presidential election, especially in the eastern region. Meanwhile, the Parliament of Ukraine declared no confidence in the CEC and the government of PM Yanukovich. On December 3rd, the Supreme Court declared that the second round of the election was invalid and called for a new run-off vote to be held on December 26th. However, the Supreme Court decision itself did not resolve the political crisis in the country. The opposition camp's legislative initiatives to improve the election law and change the personal composition of the CEC had to be approved by the outgoing President Leonid Kuchma. The next round of talks on December 6th between the two candidates, President Kuchma and international mediators helped to clarify calls of conflicting parties, but an agreement was not reached. The key issue was the dismissal of the incumbent PM Yanukovich and his cabinet, which was demanded by the opposition in return for parliamentary support of the political reform initiative. An agreement was reached when the PM was sent "on vacation."

On December 8th, 402 of the 450 members of Ukraine's parliament approved a compromise package of laws calling for changes to the Constitution and special provisions to the election law. The amendments to the Constitution of Ukraine and the election law were immediately signed by President Kuchma. The constitutional reform was meant to turn Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament. In particular, the power of the President of Ukraine is limited to the appointment of the Prime Minister upon the motion of the majority coalition of the Parliament, and the appointment of the Minister of Defense, Minister of Foreign Affairs, Head of the National Bank, and the Prosecutor General with the subsequent approval of the Parliament. The President has the right to dissolve the Parliament if it fails to form a majority coalition within one month of parliamentary elections or if it fails to form the Cabinet of Ministries within 60 days of the Cabinet's resignation. The powers of the Parliament of Ukraine were also widened to include the right to approve other Ministers (except those mentioned above) and heads of key state committees by motion of the Prime Minister, without the need for Presidential approval. The Parliament of Ukraine will be elected for five years on a proportional vote system, which replaces the previous four year term and the mixed (proportional-majority) vote system. The Cabinet of Ministries is automatically dismissed as the Parliament dissolves. In case of early termination of the President's powers, the Head of the Parliament will act as President until the new presidential election. Under the compromise, the constitutional changes will come into force between September 2005 and January 2006.

The election law was also amended to reduce electoral fraud, including tight limits on absentee ballots, voting at home, etc. Also, a new CEC was appointed without the discredited former head, Sergei Kivalov, and three other members. These legislative changes paved the way for the fair re-run of the second round of the presidential election, thus prompting the end of political unrest in the country. When the new Constitution is in place, the country's political outlook will improve significantly as opportunities for presidential power abuse become limited. A government backed by the parliamentary majority is likely to be more effective in dealing with economic and social problems in the country.

Despite some political uncertainties associated with the presidential elections of 2004, impressive macroeconomic performance is sending positive signals to the international investment community. However, the sustainability of Ukraine's superb macroeconomic fundamentals depends on further improvement of the investment climate. Thus, the main priority of Ukraine's economic program for the new government in the coming years is to maintain the recent macroeconomic gains and the current momentum of implementing growth-oriented structural reforms. The basis for sustainable economic growth lies in the improvements in Ukraine's investment climate. A recent Bleyzer Foundation publication, titled *"Ukraine Odyssey: Economy 2004 and Investment Climate" (found at www.sigmableyzer.com)*, recommends key policy measures to further improve the investment climate in Ukraine. Below are the most urgent and important measures for the new government to implement:

1. In order to **sustain macroeconomic stability**, (i) gradually introduce more flexibility to foreign exchange rate policy by reducing the foreign exchange surrender requirements for exporters; and (ii) ensure that the fiscal deficit is sustainable by eliminating tax privileges and exemptions, and ensuring that state obligations, such as repayment of VAT arrears, are met.

2. To further **liberalize and deregulate the business environment**, (i) eliminate the incentives of state agencies to carry out excessive government intervention in businesses and (ii) develop transparent procedures for the liquidation of companies, including disclosure of information.

3. To **create a stable and predictable legal environment**, implement well-defined "rules of the game" for all businesses, further improve the financing of courts and increase judges' salaries to ensure their independence.

4. The development of **sound corporate and public governance** will benefit greatly from (i) the adoption of the Joint Stock Company Law, according to international standards and (ii) the establishment of adequate procedures to ensure that the privatization process is transparent and competitive.

5. The key to further **liberalization of foreign trade** is to sign free trade agreements with the EU, US and CIS, which are the country's main trading partners. As preconditions for this, Ukraine has to complete the process of World Trade Organization (WTO) accession.

6. In order to develop a **healthy financial sector** capable of meeting the financial needs of growing businesses, it is necessary (i) to further improve banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.) and (ii) to facilitate the development of private pension funds.

7. Important measures to **prevent corruption** include (i) the continuation of public administration reform to improve transparency of the decision-making process, (ii) the reduction of ambiguity of government regulations, (iii) raising the accountability of public servants and (iv) strengthening the internal audit office.

8. In order to **minimize political risks** for business activities, it is important (i) to strive for governmental stability, and (ii) to take measures to eliminate power abuses at different levels of the authorities.

9. Among the priority actions to **promote and inform investors about business opportunities in the country** is ensuring the effective functioning of the investment promotion agency.