



Where Opportunities Emerge.



Ukraine - Economic Situation and Reforms

Dr. E. Segura

July 2004

Economic Performance

The year 2004 will be the fifth year in which Ukraine shows one of the best macro-economic performances in Eastern and Central Europe:

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>J/M2004*</u>
Real GDP Growth	6.0%	9.2%	4.8%	9.4%	11.3%
Fiscal Balance (%GDP)	0.6%	-0.3%	0.7%	-0.2%	0.8%
Inflation	25.8%	6.1%	-0.6%	8.2%	7.4%
Exchange Rate (Hr/\$)	5.4	5.4	5.3	5.3	5.3
Current Account (\$bn)	1.2	1.4	3.2	2.9	1.6**
International Reserves (\$bn)	1.6	1.7	4.4	6.9	8.8
Foreign Debt/GDP	32%	27%	24%	22%	22%

* January-May 2004; **Q1

GDP Growth

- Ukraine has now completed 4 years with significant rates of economic growth.
- In 2003, Industry and Construction overcompensated the poor performance of agriculture (which declined by 9.9% in 2003 due mainly to unfavorable weather conditions.)
- In 2003, industrial output grew by 15.8% yoy (principally in machine building, food processing, metallurgy and chemicals)
- Domestic demand was the main driving force.
- During January-May 2004, real GDP continued to grow (increasing by 11.3% compared to same period last year).
- In 2004, continued robust growth is taking place in machine building, metallurgy, food processing and construction.

- For the entire year, the Government anticipates a rate of growth of 9.5%. This forecast is seconded by the IMF. This would be an excellent overall performance.
- Growth is expected to continue in 2005, at a rate of 6-9% pa.
- Future growth would depend on further increase in investment. The good news is that gross fixed investment and foreign direct investment have increased during 2003.
- Gross fixed investment during 2003 was about 31% over the level achieved in 2002.
- The increase in gross fixed investment was supported by large increases in corporate net profits.
- Gross fixed investments now represents about 23% of GDP.

International Trade

- Since 1999, Ukraine has shown positive current account balances, reaching \$3.2 billion in 2002 (7.6% of GDP) and \$2.9 billion in 2003 (5.9% of GDP).
- This improvement took place despite the fact that economic growth has increased demand for imports of goods.
- In 2003, good imports increased by 34% yoy, while good exports increased by 28% yoy.
- The importance of Europe as a Ukraine trading partner has continued to increase, with 40% of Ukraine's exports to the European countries.
- Only 26% of Ukraine's exports now goes to the CIS countries.

International Capital

- Positive macroeconomic developments are having a positive impact on foreign direct investments (FDIs).
- In 2003, FDIs increased by almost 80% yoy, to \$1.4 billion, reflecting growing investor's confidence.
- As of end of 2003, cumulative foreign direct investment has reached \$6.9 billion or \$145 per capita.
- Although important, this is still a small number, compared to other economies in the region.
- SigmaBleyzer's studies indicate that Ukraine could receive about \$3.5 billion per year if it were to take stronger policy actions to improve its business environment, particularly on business liberalization, legal framework and governance.

Public Debt

- The size of Ukraine's public debt has remained constant during the last few years, but has declined significantly as a percentage of GDP.
- External debt amounts to \$10.7 billion, or about 22% of 2003 GDP. This is one of the lowest debt ratios in emerging markets.
- Debt service at about \$1.7 billion per year, is also manageable, given the country's large current account surpluses and its large level of international reserves.
- Given a good public debt situation, Ukraine has recently regained access to the private Eurobond market on reasonable terms.

International Lending Programs

- On March 29, 2004, the IMF approved a Precautionary Stand-by Program for \$607 million, which would be available if necessary during the next 12 months.
- In approving the Stand-By, the IMF stated that Ukraine had:
 - Achieved a broad-based economic recovery;
 - Subdue inflation following the 1998 crisis;
 - Remonetized its economy due to increased confidence;
 - Achieved a strong balance of payment position;
 - Rebuilt its international reserves;
 - improved significantly its economic outlook.

Ukraine's Business Environment

- The economic performance of Ukraine over the last four years is due in part to improvements in Ukraine's business environment following the debt crises of 1998.
- The following slides discuss the progress made by Ukraine in the key "investment drivers" of:
 1. Macroeconomic Stability
 2. Business De-Regulation
 3. Legal Environment
 4. Governance
 5. Foreign Trade Liberalization
 6. Financial Sector Reform.

1. Macroeconomic Stability

- The major achievement of Ukraine in the last four years has been its ability to maintain internal and external stability.
- In fact, domestic prices and foreign exchange rates have been quite stable, thanks to sound fiscal and monetary policies.

Fiscal Policies

- Since the 1998 financial crises, fiscal policies have been sound, with fiscal deficits of less than 2% of GDP.
- In 2002, the fiscal accounts showed a surplus of 0.7% of GDP.
- This was followed by a small fiscal deficit of 0.5% of GDP in 2003.

- Good fiscal performance was due to robust economic growth, tax collections from corporate profit and personal income taxes were larger than expected. A major fiscal achievement in 2003 has been the approval of several tax laws:
 - Starting in 2004, personal income is taxed at a flat 13% (15% starting in 2007), replacing the current 10%-40%.
 - Corporate profit tax was reduced from 30% to 25% in 2004.
 - VAT would be reduced from 20% to 17% (this VAT law was rejected by the President since Parliament had not approved the elimination of certain exemptions).
- Another important improvement in tax policies would be the adoption of the law on a single social tax, which would reduce the deductions on various social security funds from 37% to 25%.

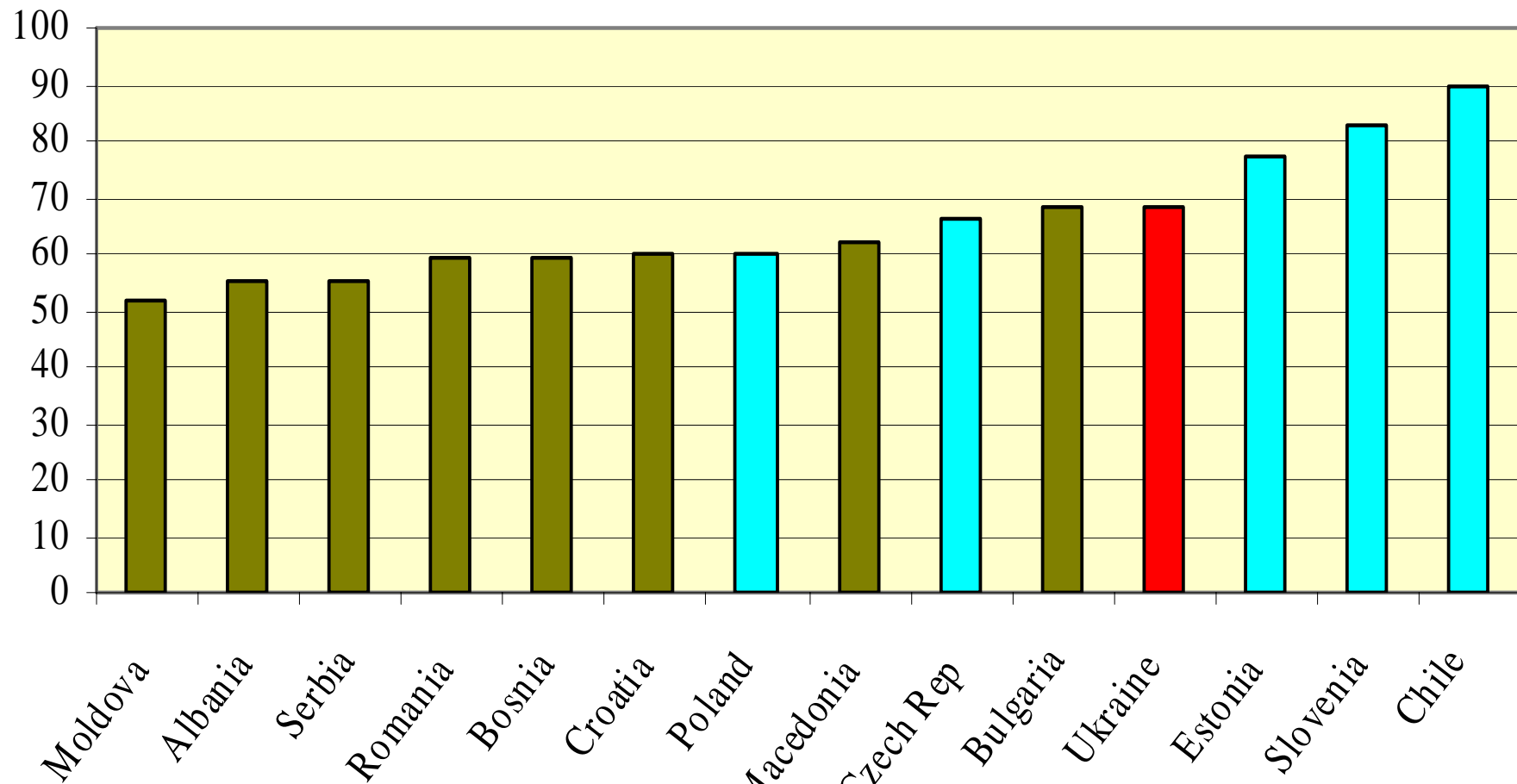
- The major fiscal issue is still the lack of progress in the repayment of significant VAT arrears due to exporters. This is a major issue in discussions with the IMF.

Monetary Policies

- In 2003, the country experienced an inflation rate of 8.2% (due principally due to increases in prices of agricultural products), following a deflation rate of -0.6% in 2002.
- In May 2004, the consumer price index increased by 7.4% over May 2003.
- Inflation for the entire year is not expected to exceed 6%.
- Money supply (M3 - currency in circulation and bank deposits) has continued to increase at a high rate of 50% per year.
- So far it has been accommodated by increased money demand.
- This increase was due principally by the purchase of Foreign Exchange by the NBU.

- These M3 increases were reflected as high growth rates in bank deposits.
- High growth in bank deposits has led to a major expansion of bank credit. On a year to year basis, growth of commercial bank loans have increased by about 60%.
- Though previously, most bank resources were placed in government securities, now, new lending instruments have emerged, including car loans, housing loans, consumer credit, etc. This should spur further economic growth.
- The level of international reserves of the NBU has been expanding rapidly, reaching \$6.9 billion at the end of 2003. This is equivalent to about 13 weeks of imports, consistent with IMF guidelines for international reserves.
- The US dollar/Hryvnia exchange rate has remained stable at around 5.3 Hr/\$.

SigmaBleyzer: Driver #1 Macroeconomic Stability

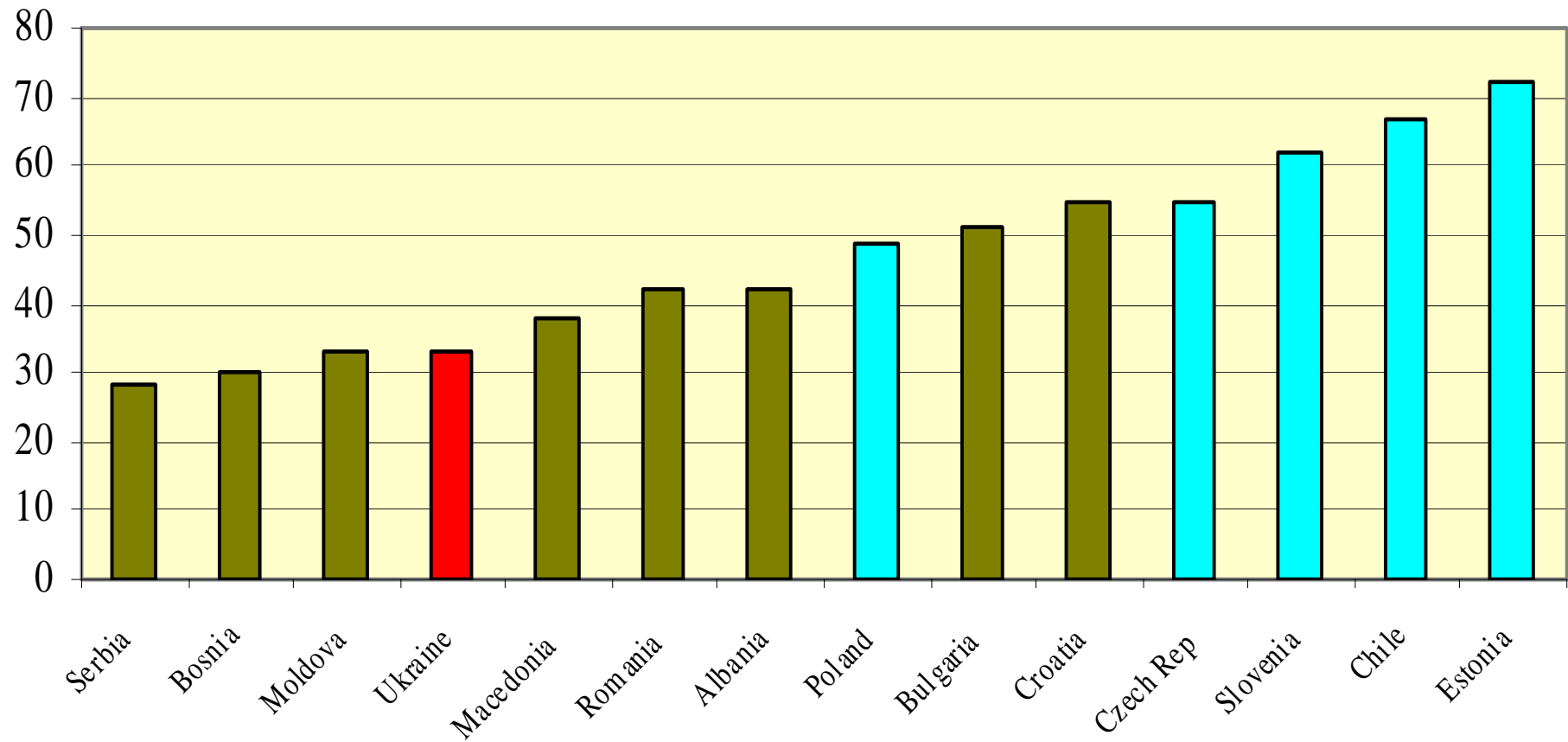


2. Business De-Regulation

- Ukraine has made good progress in eliminating barriers to entry and exit: it has simplified business registration and licensing and approved a good bankruptcy law. The one-stop shops are working throughout Ukraine.
- On land property rights, the approval of the Land Code was a major cornerstone to privatize land.
- Recently, Parliament approved amendments to the Land Code to allow sale of land to non-residents under joint-ventures with Ukrainians.
- Good progress was also made in reducing the cost of doing business, particularly on tax policies, with major reduction on tax rates on corporate profits and personal income.

- The major remaining barriers to businesses are the innumerable "permits" and "licenses" that businesses have to obtain for their normal operations (health, sanitary, fire, construction, etc.)
- Furthermore, a number of government agencies regularly interfere in the operations of businesses
- The approval of these permits and the intervention of government agencies are not only cumbersome and time consuming, but they also provide opportunities for corruption.
- Because of these barriers to operations, Ukraine's business de-regulation compares unfavorably with other countries in the region.

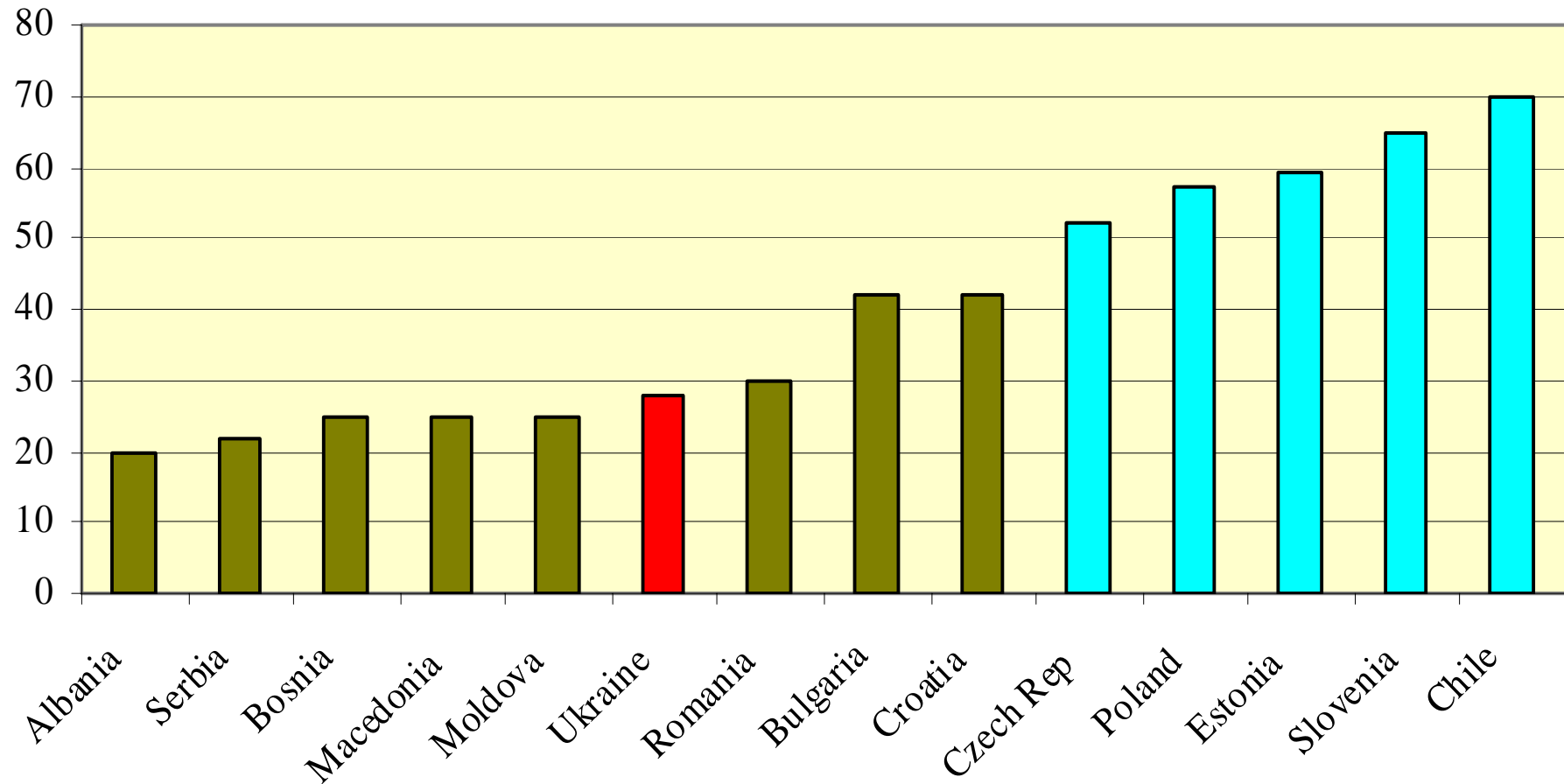
SigmaBleyzer. Driver #2: Business Liberalization and Deregulation



2. Legal Environment

- Ukraine has passed a number of Codes and Laws that should have improved its business environment, including the Civil Code, the Commercial Code, the Criminal Code, the Fiscal Budget Code, the Law on the Judiciary, the Law on Banks and Banking Services, the Law on Mortgages, etc.
- However, expected benefits from these laws are not fully materializing due to conflicts among laws, poor implementation and problems with the Judiciary.
- Further improvements in these areas are necessary to allow Ukraine to have a quantum jump in domestic and foreign investments.

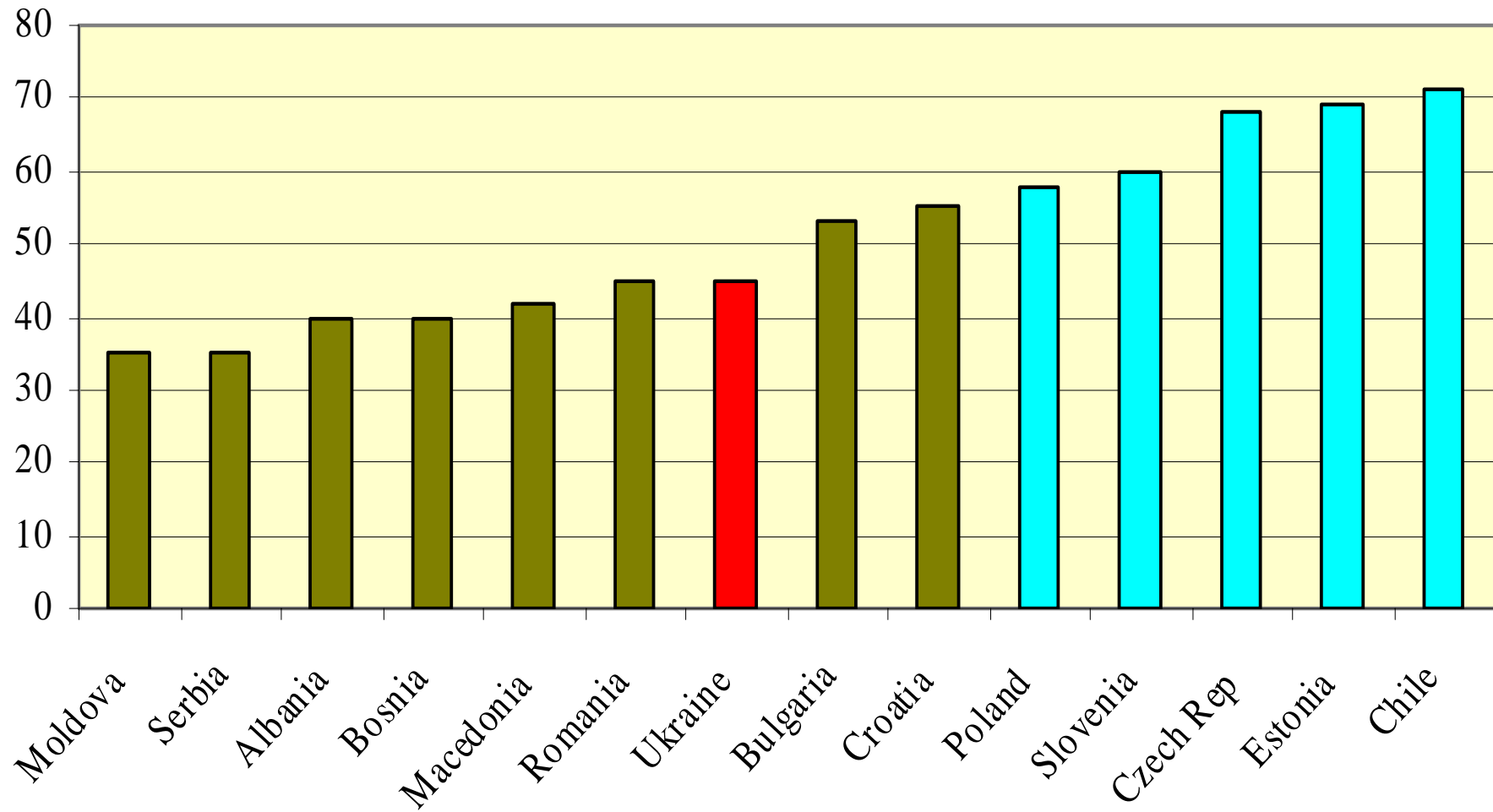
SigmaBleyzer. Driver #3: Stability and Predictability of Legal Environment



3. Governance

- The approval of the draft Law on Joint-Stock Companies would go a long way in improving corporate governance, including protection of property rights, protection of small shareholders, defining responsibilities of Board of Directors, and avoiding abuses of power by corporate managers.
- The approval of this law, however, has been delayed in Rada.
- Nevertheless, international agencies, including the World Bank, IFC, EBRD and USAID are implementing training and other programs to improve corporate governance.
- Improvements in business transparency were supported by reductions in barter trade and non-cash payments for energy.
- The privatization of remaining state enterprises should further improve corporate governance in general.

SigmaBleyzer. Driver #4: Corporate and Public Governance

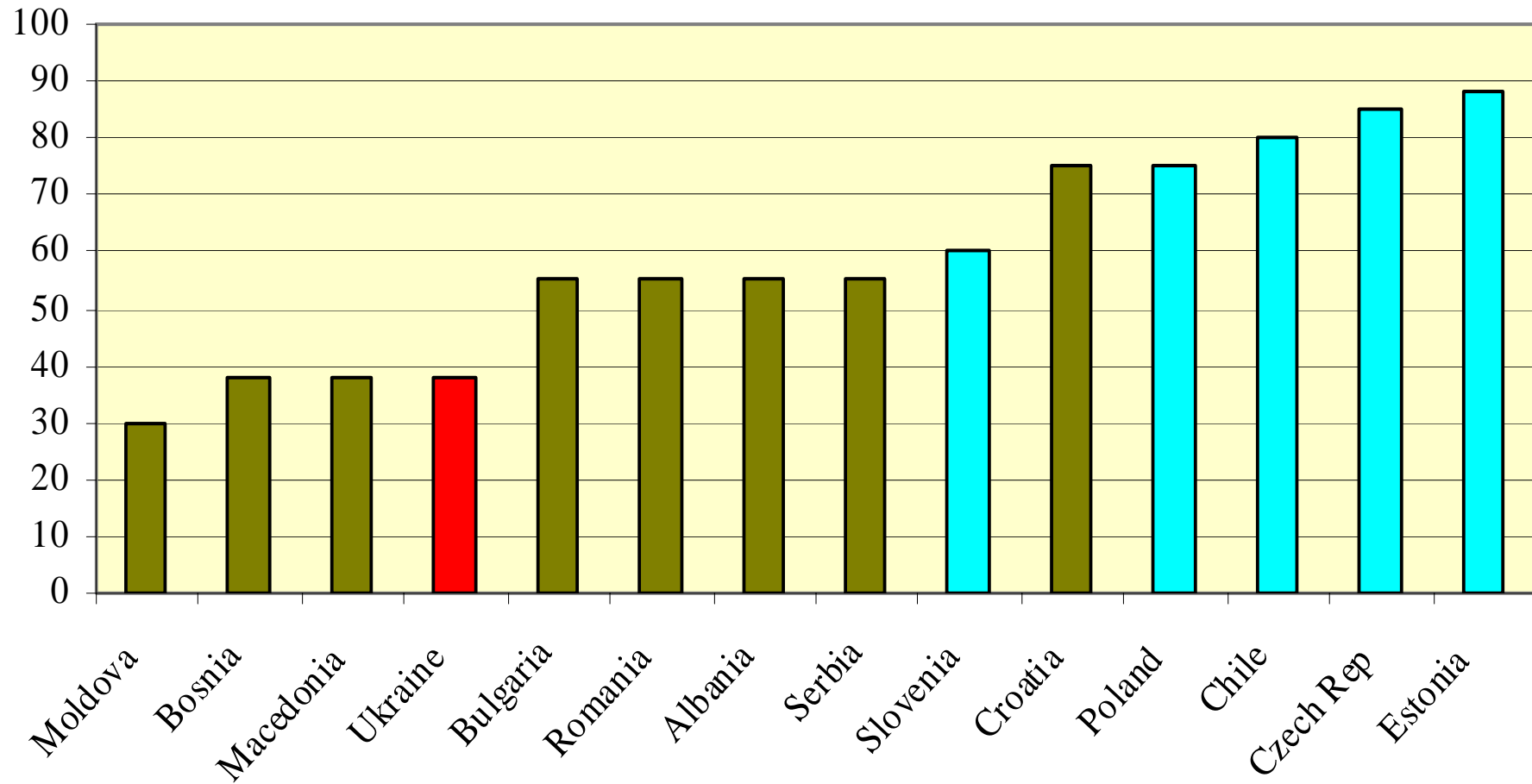


4. Trade Liberalization

- Further trade liberalization in Ukraine would be boosted by Ukraine's joining the WTO.
- Under its current plan, the Government expects to join the WTO in 2005. It has already signed 24 agreements with member countries on market access.
- The main obstacle is reaching agreement with the US, as there are still differences on protection of property rights.
- Agreements are still pending with Japan, Turkey, Lithuania and China.
- Meanwhile, top officials of Ukraine, Russia, Belarus and Kazakhstan have approved an agreement on the creation of a Common Economic Area (with unified custom mechanisms, free movement of goods, services and capital, and work force.)

- The CEA agreement however is an agreement to agree, since every country can proceed at its own pace, based on future bilateral or multilateral agreements.
- Ukraine believes that this Common Economic Area agreement will boost its exports, whereas the EU and WTO are concerned with the possibility of conflicting rules.
- There is agreement, however, that the CEA would be beneficial to Ukraine if it is limited to a free trade area.
- In the meantime, poor customs procedures and practices constitutes a major impediment to international trade, dissuading potential exporters and importers.
- For this reason, Ukraine's rating on trade liberalization is not very high.

SigmaBleyzer. Driver #5: Liberalization of Foreign Trade and Capital Movements

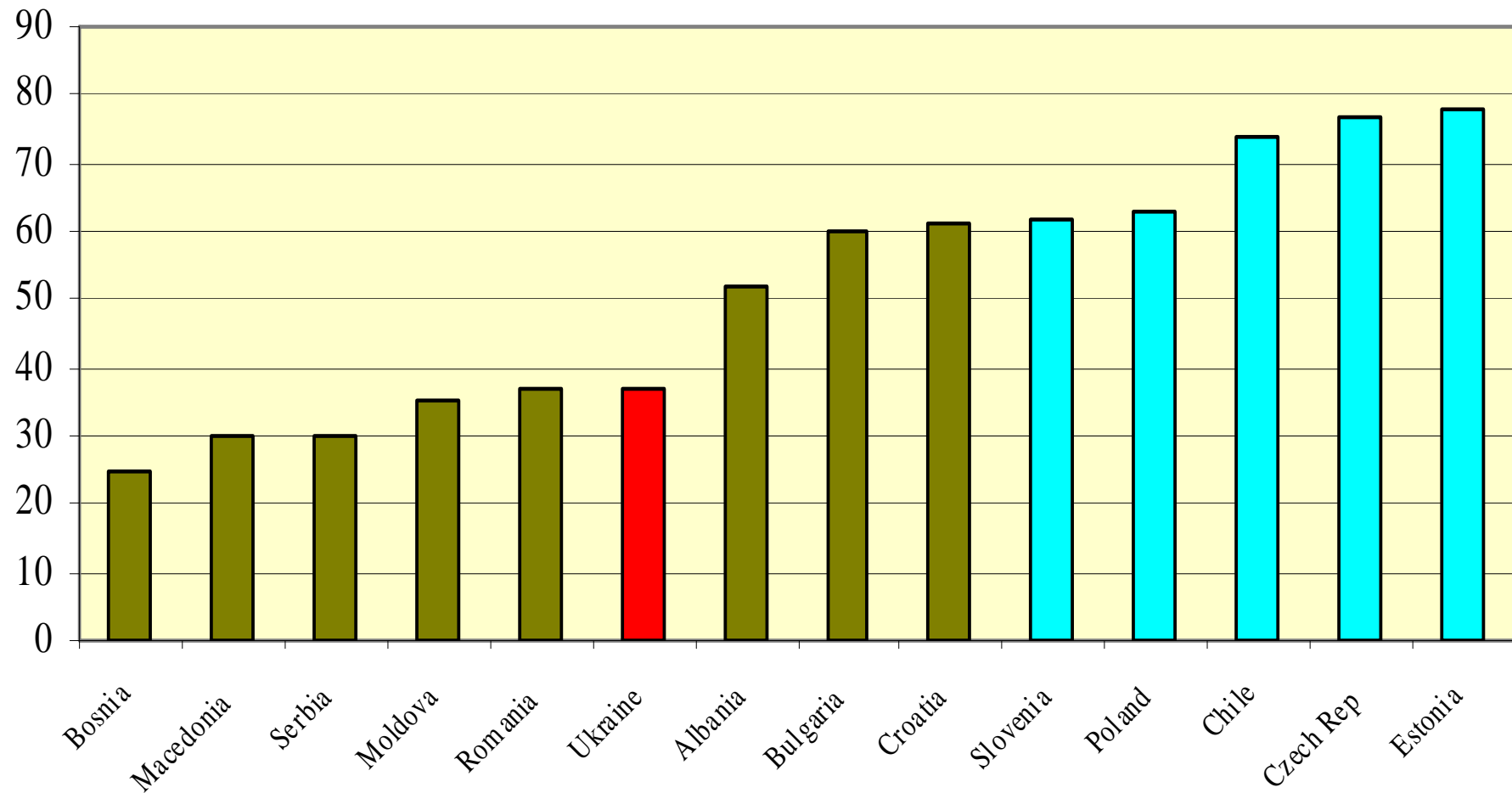


5. Financial Sector

- As noted earlier, in the last three years, the banking sector has been improving its operations:
 - Professional managers are introducing more sophisticated lending and credit practices.
 - Lending to micro and small enterprises is increasing.
 - Banks are starting to lend to individual consumers for car loans and housing loans.
 - Banks are starting syndication and securitization operations.
 - Banks are starting to participate in corporate bond issues.
- The NBU has also developed modern prudent regulations and has developed stronger capacity to supervise banks.
- A remaining issue is to improve the capitalization of a number of smaller banks, or merge them.

- The new Law on Pension Reform would create a three-pillar pension system, of which the development of private pension operators would be key. This should facilitate, over time, the development of capital markets.
- Ukraine has taken a number of actions to prevent money laundering, including modern legislation and a sound financial monitoring system (with US help). As a result sanctions on the banking system have been removed and Ukraine has been removed from the list of non-cooperating countries.

SigmaBleyzer. Driver #6: Financial Sector Development



Summary

- Ukraine has made good progress in most areas of macroeconomic performance, with good economic growth, sound fiscal policies, low inflation, foreign exchange stability, low external debt, and a good balance of payments situation.
- Ukraine has also made progress in improving its business environment.
- But more action is needed to increase confidence and attract increasing amounts of foreign direct investment.

SigmaBleyzer: Average for Nine Drivers

