**Ukraine**

**Macroeconomic Situation**

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### Economic Growth

Ukraine started 2003 with a remarkable rate of economic growth. In fact, in January 2003, real GDP grew by 7.7% compared to January 2002. This high GDP growth rate was caused by good performance in several sectors, including construction (which grew by 24.4% year-over-year in January), manufacturing (13.3% yoy), wholesale and retail trade (8.8% yoy), and transport (8.3% yoy).

![Real GDP and Value Added Growth by Sector in January, % yoy](chart)

*Source: State Statistics Committee*

At the product level, metal production showed one of the highest growth rates in January, at 22.5% yoy. This growth was supported by high world prices for metals. Since metal production represents the highest share of industry, industrial GDP also increased by a relatively high rate of 11.6% yoy in January. Other growth areas included the domestic market-oriented wood processing industry (19.9% yoy) and the chemical industry (15.9% yoy).

Although these numbers are encouraging, the importance of metals and grains confirms the view that the Ukrainian economy is still not making significant progress towards diversification of its output, thus remaining highly vulnerable to changes on the world markets for its traditional commodities. Nevertheless, given an impressive GDP growth in January, the official forecast of 4% GDP growth in 2003 looks realistic.

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### Fiscal Policy

Throughout 2002, the performance of the consolidated fiscal budget was inadequate; the amount of revenue collected over the period constituted only 93% of the annual target. This was due to a large number of tax exemptions and privileges granted by Parliament early in the year, the overly optimistic macroeconomic parameters assumed in the original budget, and poor privatization revenues. On the other hand, fiscal budget expenditures were curtailed drastically, and amounted to only 85% of the expenditures planned for the year. As a result, the consolidated budget had a surplus of UAH 1.7 billion for 2002, with revenues at UAH 60.8 billion and expenditures at UAH 59.1 billion.

Fiscal revenues in 2002 also suffered due to inadequate tax collection. In fact, over the year, the volume of tax arrears enterprises owed to the budget grew by 133%, reaching UAH 14.7 billion. The largest debtors continued to be state-run companies such as Naftogaz Ukrainy (owed UAH 4.1 billion) and Energoatom (owed UAH 628 million). On the other hand, the government continued accumulating debts on VAT refunds to exporters in 2002, which soured relations with the IMF.

Low privatization revenues in 2002 were also responsible for poor fiscal performance. In 2002, the State Property Fund collected only UAH 576 million, or 10% of its ambitious UAH 5.8 billion annual target. The main reason for the shortfall was the failure to sell the telecommunications company, Ukrtelekom, and the energy distributing companies. In 2003, the government expects to receive UAH 2.15 billion of privatization revenue (excluding the uncertain proceeds from Ukrtelecom and obnenergo sales).

Fiscal problems (lower budget revenues and privatization revenue shortfalls) and the ambiguous situation with IMF/World Bank borrowings led the government to seek additional borrowings from private external and internal markets. These funds were used principally to repay external debt obligations. With heavy repayments, the amount of public debt increased only marginally. In fact, during 2002 public debt increased by only 1.5%, or UAH 1.1 billion ($213 million), to a total of UAH 75.7 billion as of the end of 2002. Domestic debt grew by UAH 500 million to UAH 21.4 billion, while the stock of external debt increased by about $100 million to $8.08 billion. The composition of external debt changed somewhat as Ukraine managed to reduce its debt to the IMF by 3.7% to $2.07 billion in 2002. Despite borrowings, Ukraine’s public debt burden remains modest (at an estimated 37% of GDP) compared to other B-rated countries (e.g., Russia with public debt at 47% of GDP).

Although the overall size of public debt remains reasonable, annual debt service obligations over the next three years will be increasing. External debt repayments growth will reach its peak of $1.8 billion in 2003. In

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### Direct Public Debt Dynamics in 2002

*Source: Ministry of Finance*
2003, interest and principal public debt payments are forecast at UAH 11.6 billion, out of which UAH 2.5 billion should be paid on internal obligations and some $1.6 billion should go for external debt repayment and service. In addition, the government will also need to seek financing for its fiscal budget deficit of UAH 2 billion in 2003. The approved 2003 budget foresees revenues at UAH 50.02 billion and expenditures at UAH 52.06 billion, thus generating a deficit that would amount to 0.8% of GDP. So far, the ability of the government to meet its debt obligations has depended primarily on its fiscal performance to generate sufficient local currency savings. Foreign exchange has not been a constraint, given the remarkable growth of international reserves held by the NBU (National Bank of Ukraine).

Monetary Policy

Following a relatively high inflation rate of 1.4% in December, consumer prices increased by 1.5% in January 2002 (or 20% on an annual basis) as earlier declines in food prices reversed. Over the month, food prices grew by 2%, while services and non-foods prices posted growth rates of 0.8% and 0.1% respectively. These rates are above the Ministry of Economy forecast of 1.6% CPI growth in the first quarter of 2003. 2003 inflation is projected at 6%. In 2002, consumer prices dropped by 0.6% yoy, following an inflation rate of 6.1% yoy in 2001.

Overall, the consumer price index is quite sensitive to food prices, since this group’s share remains the largest of the total consumer basket (about 64%). In 2002, a rich harvest and recovering livestock farming were responsible for declining prices for bread, cereals and meat. At the same time, prices of services and non-foodstuff items grew by 3.4% yoy and 1.6% yoy respectively in 2002. The increase in service prices was attributed to a 9.5% yoy increase in communication tariffs.

Monetary policies were expansionary during 2002. The money supply grew by 41.6%, while base money increased by 33.6% and cash in circulation expanded by 37.1%. According to NBU’s calculations, the monetization of the GDP grew from 19.2% of GDP to 24.9% of GDP in 2002. Due to fears of inflationary pressures, the NBU has been following a tighter monetary policy since January 2003. During January, money supply M3 dropped by 2.6%. Cash in circulation was down by 6.5%, while base money declined by 3.3% month-over-month. For 2003, the NBU expects M3 growth of growth by 22-27%, while the monetary base is expected to expand by 17-20%.

During January, the gross international reserves of the NBU increased by $158 million, reaching $4.6 billion by the end of the month. Throughout 2002, the NBU managed to increase its international reserves by 42%. The NBU expects gross international reserves to further expand by $850 million (19%) in 2003.

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taking 17.8% of Ukrainian products. Among the other major export destinations are Turkey with 6.9%, Italy with 4.6%, Germany with 4.3%, China with 3.9%, and the UK with 3% of total exports. Exports to the US were only 2.9% of total exports. On the import side, Russia remains the largest supplier of imports, accounting for 37.2% of all Ukrainian imports, principally in oil and gas products. Other major import suppliers to Ukraine include Turkmenistan (11.1% of imports), Germany (9.8%), and Poland (3.2%).

Trade of goods and services also performed well in 2002. The surplus in goods and services reached $3.5 billion in 2002, compared to a surplus of $2.9 billion in 2001. Exports of goods and services increased by 11.1% to $22.0 billion, whereas imports grew by 9.4% to $18.5 billion.

International Programs

Ukraine’s relations with international financial organizations are still ambiguous. An IMF mission is currently visiting Ukraine to continue negotiations on possible cooperation with Ukraine on a precautionary stand-by program. The IMF extended fund facility program was suspended in September 2002 due to slow reform progress, especially in the area of tax privileges and repayment of VAT arrears. Another issue for discussion is the adequacy of the 2003 fiscal budget, and the IMF may require Parliamentary approval of amendments to the 2003 budget.

Resumption of cooperation with the IMF is one of the pre-conditions set by the World Bank for disbursing the Second Programmatic Adjustment Loan (PAL–2). The total PAL loan amounts to $750 million and is a key part of the World Bank assistance strategy for 2001–2003. Between 2003 and 2008, the World Bank plans to disburse about $1.5 billion to Ukraine. Except for the IMF condition, the World Bank has indicated that it is satisfied with Ukraine’s fulfillment of its other conditions.