Economic Growth

In 2003, the Ukrainian economy performed remarkably well, posting a 9.3% real GDP growth rate and exceeding even the most optimistic expectations. Throughout the year, industry and construction demonstrated impressive rates of growth, compensating for a shortfall in agriculture.

The impressive performance of the industrial sector in 2003 was overshadowed by poor agricultural output. In fact, the agricultural sector posted a 9.5% yoy decline for the year. Bad weather was the major single cause of the worst grain harvest in 50 years. In 2003, only 20.2 million tons of grain was harvested, compared to 38.8 million tons harvested in 2002.

During January 2004, the expansion of the economy continued, with GDP growing by 9% yoy and industrial output increasing by 16.1% yoy. For 2004, the government expects GDP growth to reach 6.0-6.5%, supported by an expected 10% expansion of industrial production. The agricultural sector is also expected to recover. Based on the current area under cultivation and the state of the crops, current indications are that the total grain harvest in 2004 could reach 35 million tons.

During 2003, value-added growth in the construction, metallurgy and chemicals, whose output increased by 20% yoy. In 2003, strong external demand, output of the food industry and lower sensitivity of Ukrainian exports to the external environment for all businesses. In particular, Parliament extended the tax privileges enjoyed by agricultural producers for one more year, until the end of 2004. This decision was aimed at compensating for the unfavorable weather condition in 2003. Also, Parliament has recently decided to exempt domestic automobile producers from VAT until 2009.

Fiscal Policy

The robust economic growth in 2003 supported good fiscal performance during the year. The consolidated fiscal budget ended the year with a relatively small deficit of UAH 490 million ($82 million), which is much better than the originally planned result. According to the preliminary data report, consolidated budget revenues grew by 24% yoy to UAH 75.2 billion ($14.1 billion), and expenditures increased 26% yoy to UAH 75.7 billion ($14.2 billion.)

Higher than expected economic growth helped fiscal authorities to over-fulfill their tax collection targets. Receipts of corporate profit and personal income taxes were the major sources of budget revenues. At the same time, the government reduced expenditures during the year, trying to alleviate risks over deficit financing. With significant under-spending during the year, the government spent the largest amount of state funds in December (more than UAH 12 billion), compared with average monthly fiscal spending at UAH 5-6 billion.

Another positive development was that the State Property Fund managed to fully execute the privatization revenue target for 2003. By the end of the year, privatization revenues reached UAH 2.18 billion ($410 million) in contrast to a low $100 million collected from the sale of state property in 2002. Despite the fact that privatization performance could be considered successful, the government did not manage to progress with Ukrtelecom and energy sector privatization, reflecting a slow pace of structural reforms in the country.

The outlook for the 2004 fiscal budget is positive, though fiscal discipline may get worse on the eve of presidential elections. From the beginning of 2004, new tax laws envisioning a reduction of income taxes came into force. Simultaneously, a number of exemptions were abolished in order to expand the taxation base. These positive actions of the government were praised by the international financial organizations. However, many tax privileges have yet to be annulled to create a fair competitive environment for all businesses. In particular, Parliament extended the tax privileges enjoyed by agricultural producers for one more year, until the end of 2004. This decision was aimed at compensating for the unfavorable weather condition in 2003. Also, Parliament has recently decided to exempt domestic automobile producers from VAT until 2009.

Public Debt Dynamics, 2003-04

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The external debt increased by almost 6% to $10.7 billion equivalent (about 30% of estimated GDP) at the end of January 2004.

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through the sale of government bills. Over the year, domestic debt dropped 4% to $3.05 billion. Strong macroeconomic fundamentals and prudent public debt management contributed greatly to the upgrade of Ukraine’s sovereign credit rating. In 2003, most international credit rating agencies improved the country’s rating by several notches.

In 2004, Ukraine’s public debt is likely to increase further as the government plans to resort to external borrowing to cover its fiscal deficits and meet its external obligations over the next two years. In particular, the 2004 budget envisages $1.2 billion in external borrowing.

At the end of February 2004, the government issued $600 million of Eurobonds, in order to take advantage of favourable international debt market conditions. It appointed Merrill Lynch and International and Dresdner Bank AG as lead managers of this issue. The maturity of the recently issued Eurobonds is 7 years, and the yield is lower than the previous issues at 6.785%. International rating agencies Fitch and S&P assigned B+ and B ratings to the new placement of Ukraine’s Eurobonds, respectively. In 2004, interest and principal public debt payments are planned at $2.43 billion, out of which $1.53 billion should be paid on external obligations. In addition, the government will also need to seek financing for the budget deficit of UAH 3.4 billion in 2004.

Monetary Policy

After a marked acceleration over the last quarter of 2003, consumer prices decelerated slightly in January 2004. During the month, the consumer price index (CPI) increased by 1.4% month-over-month, thus bringing the annual inflation rate to 8.1% yoy. The growth of food prices slowed to 10.2% yoy as bread and cereals price growth eased. In January, services tariffs grew to 7% yoy, while non-foods prices growth remained at a relatively low 1.7% yoy. The sharp increase in prices for services was explained by higher bills for housing and utilities due to colder weather this year.

For all of 2004, the government forecasts an inflation rate of 5.8-6.3%. To achieve this result, the government plans to preserve price controls for certain groups of goods. At the same time, the National Bank of Ukraine (NBU) is less optimistic about CPI growth. The NBU expects that inflation during the first half of 2004 may reach 5.5% year-to-date (or 11.3% on an annual basis) due to the prolongation of high food prices from last year. The central bank authorities intend to switch to inflation targeting in 2004, though the discount rate has remained unchanged in January and February.

Throughout 2003, the NBU maintained a policy of exchange rate stability vis-a-vis the US dollar. For this purpose, and given the weakness of the US dollar, the NBU’s monetary stance remained relatively loose. Therefore, the growth of monetary aggregates remained high in 2003 as well as at the beginning of 2004. In January, monetary supply (M3) growth picked up to 47.3% yoy from 46.5% in December. The monetary base growth also increased to 30.2% yoy in January compared with 30.1% yoy growth a month before. In monthly terms, however, monetary aggregates posted a seasonal decline mainly due to lower business activity at the beginning of the year.

During 2003, the NBU more than doubled the amount of its international reserves by making uninsured purchases of foreign exchange on the local market. Over the last year, gross international reserves grew by 38% yoy to $6.94 billion as of end-2003. In the first two months of 2004, the NBU gross reserves reached $7.2 billion, having increased by $260 million since the beginning of the year. By the end of 2004, the NBU targets to increase its gross reserves to $8.5 billion, which is quite realistic, provided strong export performance continued through the current year.

Due to the NBU’s buyout of excess foreign exchange, the Ukrainian hryvnia posted only slight nominal appreciation against the US dollar in 2003. The official hryvnia exchange rate appreciated 0.62% yoy to 5.331 UAH/USD by year end. At the same time, the hryvnia/euro rate increased by 20.4% to 6.66 UAH/EUR in 2003, reflecting the high euro value on international markets. In January 2004, the hryvnia rates against major world currencies remained almost unchanged relative to end-of-2003 values.

International Trade and Capital

The trade of goods and services account posted a $2.92 billion surplus in 2003, compared to $3.5 billion in 2002. Exports of goods and services increased 24% yoy to $27.3 billion, whereas imports expanded 32% yoy to $24.4 billion. While the merchandise trade balance shrank, the trade of services surplus grew to $2.85 billion, primarily on account of increased volumes of transport services exports.

In 2003, Ukraine’s surplus in its trade of goods account declined to $39 million, compared to a trade surplus of $900 million in 2002. In fact, despite robust export growth underpinned by strong world demand for Ukraine’s traditional commodities, imports grew outpaced exports expansion significantly. During the year, exports 2003 witnessed an explosive growth in domestic credit by the banking sector. During the year, commercial banks lending surged to a high 65% yoy underpinned by rapid growth of deposits and excessive liquidity of the banking system. In January 2004, the growth of bank lending to the private sector grew by 68% yoy. At the same time, the average lending rate fell by 10 basis points to 15.1% annually in January 2004, thus indicating improved access to credit resources for the private sector. Healthy growth of household income supported 63% yoy growth of deposits in January. Inflation acceleration contributed to an increase of the average deposit rate to 7.5% annually over the same period.

Exceeding initial expectations, the consumer price index (CPI) grew by 8.2% yoy in 2003, compared with a 0.6% deflation in 2002. The higher-than-expected inflation in 2003 was mainly caused by the extremely poor wheat harvest, which led to a sudden increase in bread prices.

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increased by 28% yoy to $23.1 billion, while imports increased by 30% to $23.0 billion. The decline in the trade surplus was due to an acceleration of imports induced by high GDP growth. Strengthened investment demand from rapidly growing industries seeking to renovate their outdated capital assets is the most likely explanation for imports acceleration. Nevertheless, export dynamics remained positive as Ukraine’s traditional exports of ferrous metals and chemicals grew by 25.4% yoy and 39.1% yoy, respectively. Solid expansion in machine building throughout the year supported growth of machinery exports, which sped up from 3% yoy in 2002 to 32% yoy in 2003. As an indicator of a gradual shift in the goods export structure towards higher value added products, the share of machinery and equipment in total exports grew to 18.1% in 2003, from 9.8% a year before. 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 2003, energy resources imports growth continued to slow down (to 18% yoy), while machinery imports kept accelerating, posting 39% yoy growth.

During 2003, the geographical breakdown of Ukraine’s foreign trade continued to change gradually. Trade turnover with Europe has been growing faster than with Russia, which still remained Ukraine’s biggest single partner, accounting for 38% of all imports and 19% of all exports. In 2003, the rest of Europe accounted for 36% of Ukraine’s imports and 19% of all exports. In 2003, energy resources imports growth were the two biggest items contributing to total imports growth. In 2003, energy resources imports growth continued to slow down (to 18% yoy), while machinery imports kept accelerating, posting 39% yoy growth.

Since 1991, the cumulative FDI stock has reached just $6.7 billion or about $140 per capita term, which is still low compared to corresponding figures in other transition economies. Of the cumulative figure, the largest amount of FDI originated from the USA (16.1% of the total), Cyprus (11.7%), and the UK (10.3%). 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.

International Programs

At the end of 2003, Ukraine’s relations with international financial organizations broke their deadlock. Late in December, the World Bank disbursed $75 million of the Second Programmatic Adjustment Loan (PAL-2). The World Bank Board approved the loan for Ukraine following the government’s demonstration of improved fiscal discipline, improved tax enforcement, reduced arrears in social protection payments, completed audit of the state oil and gas company Naftogaz, and progress with tax reform, including elimination of certain tax privileges. The remaining $175 million of the loan is planned to be disbursed 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 debts restructuring, continue suspended privatization of remaining state-owned oblenenergos and further reduce tax exemptions. All of the above reforms are meant to improve financial discipline, regulatory policies, property rights, public sector accountability, and management of social and environmental risks.

Ukrainian officials have yet to reach an agreement with the IMF on resuming cooperation. It is expected that the IMF will make a decision on a precautionary stand-by program for Ukraine in February-March 2004. The IMF program would be for 15 months, during which time Ukraine could use funds of up to about $800 million if the need arises. Although back in December 2003, the IMF stated that it did not see major obstacles to the signing of the agreement in the near future, the Ukrainian government still has to properly address the problem of VAT refund arrears in order to reach common ground with the IMF. As a positive development on Ukraine’s collaboration with the European Union (EU), EU and Ukrainian representatives met in Kyiv to discuss the Ukraine-EU Action Plan, which outlines the criteria for the country to open negotiations on signing a Stabilisation and Association Agreement with the EU. Prompt finalisation of the document would allow Ukraine to make significant progress with the EU. Meanwhile, the EU has extended EUR20 million to finance construction of a nuclear safety shield for the Chernobyl nuclear power plant. In total, the EU grant for nuclear safety constituted EUR100 million, which have to be allocated by the EU. Ukraine has already received two tranches of the nuclear safety grant worth EUR60 million.

Other Developments

Following a positive evaluation of Ukraine’s actions to prevent money laundering by a mission of the Financial Action Task Force on Money Laundering (FATF), the FATF mission has approved Ukraine’s exclusion from the blacklist of non-cooperative countries in February. The FATF mission visited Ukraine in January, evaluated progress in the implementation of the adopted anti-money-laundering legislation, and expressed general satisfaction with the legal framework created by the government. In particular, Ukrainian authorities adopted a law on prevention of illegal income legalization, defining the key commercial banks should identify their customers and report information about them, actions to be conducted to prevent operation of fictitious enterprises, rules for economic operations involving customers situated in offshore zones, etc. Also, the criminal code and the law on banking were amended to fulfill all the requirements of the FATF. Recently, the government announced its intentions to restrict foreign investment made with money of unconfirmed origin. This is envisaged by the Program for Preventing Illegal Income Legalization for 2004. The Ministry of Economics, the Ministry of Finance, the NBU, and the State Securities Commission have to propose amendments to the foreign investment law that would limit illegal funds being invested into Ukraine. The program also aims at cutting off ties with offshore zones.

The process of Ukraine’s integration into the World Trade Organization (WTO) is proceeding, though at a slow pace. Ukraine is expected to join the WTO by the end of 2004. So far, Ukraine has signed 19 of the 22 agreements on mutual market access that are necessary to become a member of the WTO. In December, Ukrainian officials reached agreements on mutual market access and signed corresponding documents with Brazil, Israel, Poland and Estonia. According to earlier announced plans, a bilateral agreement with the US has to be signed soon after the US Congress lifts trade sanctions under the Jackson-Vanik amendment, which would significantly improve trade relations between the two countries.