Economic Growth

Ukraine continues to enjoy rapid GDP growth, stimulated by strong external and domestic demand. Ukraine’s economic output soared in April, following a well-established upward trend since the beginning of the year. Real GDP growth in April reached a record high rate of 13.3% year-over-year (yoy), bringing the cumulative figure to 11.5% yoy. Such a leap forward was made thanks to marked acceleration of value-added growth in construction and trade, which compensated for a slowdown in industrial expansion.

Fiscal Policy

The state budget posted a deficit of UAH 209 million ($39.3 million) for January-April, which is equivalent to about 0.2% of period GDP. Revenues made up UAH 18.06 billion ($33.44 million). This data indicates further deterioration of fiscal discipline in April, as it was reported earlier that the state budget was already running a deficit in March. However, budget implementation and expenditure control are expected to strengthen as a result of the introduction of special VAT accounts as soon as the Rada approves the corresponding bill. This will improve VAT administration since all VAT payments and reimbursements are to be carried out through taxpayers’ individual VAT accounts, thus eliminating the possibility of getting illegal VAT refunds. In addition to the introduction of VAT accounts, the draft law submitted by President Kuchma for the Parliament’s approval envisages a reduction in the VAT rate from 20% to 15% starting in 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 980 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 a unit of the state telecom Ukrtelecom. The largest privatization tender of 2004, this sale is scheduled for June 2004, and the expected revenue for the budget is about $1 billion.

During January-April 2004, the amount of public debt (internal and external) increased by 0.8% to $14.7 billion equivalent. As a share of GDP, this is relatively low compared to other transition economies in the region. During March and April, the stock of external debt declined 1.7% to $10.66 billion equivalent. The reduction took place as the government spent some $500 million to meet peak payments on external obligations due in March and April. Overall, the 2004 budget envisages $1.2 billion in external borrowing and $1.53 billion in external debt repayment and service.

Monetary Policy

Retail price growth has been slowing since the beginning of the year, while producers’ inflation is on the rise. In April, Consumer Price Index (CPI) growth increased to 0.7% month-over-month, which is relatively low for April. As a result, annual growth of consumer prices was 6.4% yoy in April as the growth of food prices picked up slightly. During the month, food prices rose by 8.3% yoy, having accelerated from 8.0% yoy in March. Non-foods prices growth increased to 2.2% yoy in April. In contrast to food and non-food prices, services tariffs growth decelerated. In April, services tariffs growth slowed to 6.2% yoy, after 7.1% yoy growth a month before. The end of the heating season was the main reason for the deceleration.

Meanwhile, sharp acceleration of producers’ inflation raises concern about the stability of prices and economic growth over the medium term. In April, the producer price index (PPI) increased significantly to 18.4% yoy from 15% yoy a month before. The highest growth in prices was observed in resource-intensive industries like metal processing, coke and oil refining, and mining. Acceleration of wholesale producer prices reflects rapid growth of world prices of oil and gas and the inability of domestic enterprises to accommodate the rapidly growing demand for their output. Slower growth of prices in light industry and...
food processing suggest only gradual spillover of PPI growth into the retail market. A large disparity between growth rates of consumer and producer prices provides evidence of non-market regulating measures executed by the government. Recently, the government revised its forecast of the consumer inflation rate upwards from 5.8-6.3% to 8% eopor.

By product breakdown, metals exports remained among the largest contributors to the overall growth of merchandise exports. These items’ trading volume expanded by more than 40% yoy in January-March, while their share in total exports made up 36%. Over the same period, exports of chemicals grew by 50% yoy and increased to almost 9% of total exports. Export of machinery and transport equipment was also on the rise (up 78% and 130% yoy) due to robust economic growth in CIS countries, which are the main consumers of Ukrainian produced machines. 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 transport equipment and of energy resources were the biggest items contributing to total import growth. In January-March, growth of energy resources imports, which account for 38% of total imports, was 23% yoy (from 15% in February). Machinery and transport equipment imports increased by 90% and 96% yoy respectively, indicating marked growth of investment demand in the country.

A regional breakdown shows that Ukraine’s foreign trade still remains biased towards Russia, especially 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 15.8% of all exports.

Growth of disposable income and increasing confidence in the banking sector resulted in sustainable and rapid growth of domestic deposits with commercial banks. In April 2004, bank deposits grew by 55.2% yoy. Excessive liquidity of the banking system fueled by high deposit growth and strong money demand in the country were the driving forces of lending expansion. In April, commercial bank lending to the real sector increased by 59% yoy, having declined from 63% yoy in March. These high rates of lending growth have caused concerns that the banking sector may be vulnerable to increases in the level of non-performing loans. In other countries, rapid lending expansion and high non-performing loans have led to financial crises. The NBU is aware of these risks and is taking measures to prevent future problems, including the more stringent application of prudential supervision rules. Interest rate dynamics reversed in April; the cost of loans began to rise, breaking the declining trend observed since November 2003. The average lending rate increased by 60 basis points in April to 15.3% annually, while the average deposit rate increased 10 basis points to 7.6% annually.

International Trade and Capital

Ukraine’s traditional export commodities still remain in a great demand, thus explaining remarkably strong export performance. At the same time, strong GDP growth is fuelling import expansion. In the first quarter of 2004, 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 last year.

Growth of monetary aggregates continued to gradually slow in April despite fairly large export-related foreign currency inflows. Over the period, money supply (M3) grew by 46% yoy, which is still quite high. However, strong money demand fuelled by remarkably high rates of economic growth can easily absorb excess money supply. During the rest of the year, the NBU plans to bring monetary aggregates growth in line with the NBU’s annual growth targets of 26-32% yoy. Successful export performance allowed the NBU to further accumulate its gross international reserves to about $8.1 billion at the end of April. The surplus of the NBU’s interventions on the interbank foreign exchange market prevented the hryvnia from significant nominal appreciation. This allowed the NBU to keep the hryvnia exchange rate at a competitive level vis-a-vis the Euro, thus facilitating robust export growth. In April, the official hryvnia exchange rate appreciated by only 0.01% month-over-month to 5.329 UAH/EUR.

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The rest of Europe has become 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 goods were Germany (9.8% of exports and 8.9% of imports) and Italy (4.6% of exports and 2.5% of imports).

Due to favorable external conditions, the outlook for Ukraine’s foreign trade development in 2004 is positive. However, changes in trade policies of Ukraine’s trading partners may have ambiguous effects. Following approval of the creation of Common Economic Area (CEA) by Parliament, Ukraine and Russia started negotiations on the removal of existing trade limitations. In particular, Russian authorities will possibly cancel VAT on oil exports to Ukraine; this action could substantially ease the terms of trade for Ukraine. At the same time, the recent EU enlargement is likely to result in temporary negative trade losses for Ukraine as it cancels free trade agreements with Baltic countries and some special trade provisions with neighbouring Poland, Hungary and the Czech Republic.

Net FDI Flows, USD mn

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Source: State Statistics Committee

Solid macroeconomic performance led to a robust inflow of foreign direct investment (FDI) to Ukraine. Over the first quarter of 2004, net FDI inflow amounted to $216 million. However, this amount is about 28% less than over the same period last year. Of the total inflow, the largest volume of FDI originated from Cyprus (about $150 million), suggesting that Ukrainian capital that had earlier flowed out of the country is gradually returning back. The distribution of FDI across different sectors of the economy has become more diversified. In January-March 2004, foreign investors preferred to invest in services rather than trade. Over the period, the most attractive sectors for FDI were real estate services, financial services, and transport and communications, which received about 40% of the total FDI inflow. Wholesale trade and the food industry remained quite attractive for foreign investors and absorbed about 20% of the total net FDI inflow in the first quarter of 2004. The rapidly expanding machine-building and metallurgy industries are of growing interest to foreign investors and received 10% of the total net inflow over the period. So far, the cumulative FDI stock has reached $6.95 billion, or about $146 in per capita terms, which is still low compared to corresponding figures to other transition economies. Of the cumulative total, the largest amount of FDI originated from the USA (13.2% of the total), Cyprus (15%), and the UK (10.4%). The outlook for FDI in 2004 is less optimistic because of the upcoming presidential elections, which usually make foreign investors more cautious in making investment decisions.

International Programs

As reported earlier, the IMF resumed its cooperation with Ukraine under a Precautionary Stand-By Program at the end of March. The IMF program is for 12 months, during which time Ukraine could use funds amounting to $607 million or 26% 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 visited Ukraine to monitor the progress on structural reforms. An important issue for the IMF officials to monitor remains the progress in copaying with the backlog of VAT refund arrears. However, the Ukrainian authorities still have not enacted legislation that improves VAT administration and VAT refund management.

Ukraine still has much to do in order to qualify for disbursement of the remaining part of the Second Programmatic Adjustment Loan (PAL-2) from the World Bank. After disbursing $75 million of the PAL-2 late in December 2003, the World Bank planned 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 oblenenergos, and establish unified registration for land and real estate ownership.

Other Developments

As a long awaited move, the government announced the creation of the Foreign Investment Agency in May 2004. The Agency will be a state enterprise, in which the state will hold a 51% stake: The State Property Fund (SPF) will act as the founder, later on passing its authority to the Ministry of Economy. Experience in other countries shows that an investment promotion agency can be effective in influencing the decision to invest in a country, and may bring substantial increases in FDI inflows provided it operates efficiently. Among the major roles investment promotion agencies usually play are effective dissemination of information about the business environment and opportunities among prospective investors, and coordination of activities aimed at improving the business environment in the country. To ensure effectiveness, the agency must be transparent and must be trusted by the investment community, including foreign investors already operating in the country. The agency must also have a business orientation, strong links with the private sector, and (simultaneously) be supported by the highest levels of the government.