Summary

- In the first quarter of 2005, the rate of economic growth slowed to 5.4% yoy.
- Fiscal performance has been successful so far. The consolidated budget reported a 3.8% of GDP surplus in January-March.
- The Ministry of Finance sold UAH 2.2 billion worth of T-bills in January-March, reducing its borrowing costs from over 10% to an average of 5%.
- The National Bank of Ukraine allowed for a 4% nominal appreciation of the hryvnia, making its forex purchases less inflationary. The official hryvnia rate went down to 5.05 UAH/USD.
- Consumer inflation is on the rise, reaching 14.7% in April due to increasing food and gasoline prices.
- The NBU cancelled regulation #482, which called for a complicated procedure of investing in and divesting from Ukraine by non-residents.

Economic Growth

Deceleration of Ukraine's GDP growth continued in March. Over the month, real GDP grew by 5.2% yoy, bringing the cumulative figure to 5.4% yoy in the first three months of 2005. The major contributors to this GDP growth were industry, transport and agriculture. Agricultural production rebounded by 5.1% yoy in January-March compared to an almost equivalent decline during the same period in 2004. In contrast to last year, wholesale and retail trade performance turned out to be less impressive, as added value increased by a modest 3.1% yoy. At the same time, construction continued to stagnate after the explosive growth demonstrated last year. In January-March, value added in construction declined 5.9% yoy due to the finalization of big construction projects on two nuclear power plants and lower public expenditures on infrastructure projects.

Fiscal Policy

Supported by a robust rate of economic growth and improved tax enforcement, the government has demonstrated excellent fiscal performance. In the first quarter of 2005, the consolidated budget posted a rather high surplus of almost UAH 3.1 billion ($605 million), which is equivalent to 3.85% of period GDP. In real terms, consolidated budget revenues increased by an impressive 31% yoy to reach UAH 25.5 billion ($5.1 billion), while expenditures picked up by 23% yoy to UAH 22.4 billion ($4.4 billion). Growth rates of tax proceeds indicate considerable improvement in tax administration and a reduction of the shadow economy. In January-March, collections of corporate income tax and import duties grew 38% yoy and 39% yoy in real terms, respectively. Value added tax receipts increased 57% yoy to UAH 6.8 billion, but this success should be considered with caution. Fiscal authorities reported a temporary accumulation of VAT refund arrears in the amount of UAH 840 million, but they claimed that this problem will be addressed soon. Currently, the key budget challenge for the government is to collect enough budget revenue to be able to finance its debt obligations and substantial social expenditures, which increased 42% yoy in January-March.

In 2005, the government expects economic growth to reach 8.2%, which is assumed in the 2005 State Budget. However, international organizations and independent analysts forecast a lower rate of GDP growth at 7%.

Monetary Policy

Mounting inflationary pressure and a robust inflow of foreign exchange led the National Bank of Ukraine (NBU) to allow for a nominal appreciation of the hryvnia at the end of April. In this way, the NBU tried to make its forex purchases less inflationary. Consumer prices continued to follow a steady increasing growth path in March-April. In April, the consumer price index reached 14.7% yoy, higher than the 13.3% yoy growth reported in February. Expansionary fiscal policy encouraged consumption (especially of lower value added goods) and enterprises. The decline in oil-refining continued in March, although at a slower pace. Over the month, output in oil-refineries shrunk by 1.9% yoy after an almost 4% yoy decline in February. At the same time, output in food processing kept growing at healthy rates in 2005. In March, food processing output picked up 16% yoy, encouraged by the good harvest and robust income growth of households. Strong external demand supported 14.8% yoy growth in chemicals. After a sharp slowdown in the beginning of the year, production expansion in machine building accelerated to 18.6% yoy in March compared to 11% yoy in February.
income groups), which immediately translated into higher food prices (the weighting component in the consumer basket). Over the month, food prices grew by 18.8% yoy primarily on account of 47.4% and 27% yoy growth in meat and milk prices, respectively. Non-food prices accelerated in April to 6.3% yoy mainly due to a sharp increase in gasoline prices. The situation on the gasoline market remains tense despite the government negotiated fixation of gasoline prices with major players on the market. Recently, the market has suffered from the oil supply shortage, which the government promised to address shortly. At the same time, service tariffs growth eased to 6.3% yoy despite the higher pace of transportation tariffs growth. The producer price index (PPI) continued to gradually decelerate, reaching 20.9% yoy in April. However, high world prices on energy resources and increased rents for extracting natural resources set by the 2005 Budget Law may reverse the decelerating producer inflation.

Monetary aggregates growth continued to accelerate in April as the NBU continued to buyout excess supply of foreign exchange on the interbank market. In April, money supply (M3) growth picked up to 39.4% yoy supported also by robust expansion of deposits (47% yoy). Excessive liquidity of the banking system allowed commercial banks to boost their lending activities. The lending volumes to the real sector rebounded by 32% yoy, while the average cost of loans equals 14.7% per annum, on a par with the current inflation rate. Deposit rates declined to 8.7% annually, which is lower than the rate of consumer inflation forecasted for 2005. Thus, it may be another consumption stimulating factor along with the substantial increase of social payments out of budget.

Robust inflow of foreign exchange into the country associated with successful export performance and inward foreign capital flows were at the root of hryvnia appreciation. In April, the hryvnia appreciated 4.4% against the dollar. Thus, the official hryvnia rate went down from 5.299 UAH/USD to 5.05 UAH/USD. This allowed the NBU to further accumulate its international reserves with a lower inflationary impact. In March-April, gross international reserves increased by $2 billion and reached $13 billion by the end of April. During the same period, the NBU bought out $2.6 billion on the forex market.

International Trade and Capital

In the first quarter of 2005, export performance remained strong although imports accelerated significantly. Merchandise exports expanded 16.8% yoy to $8.3 billion in January-March, while goods imports increased by 18.5% yoy to reach $7.5 billion. As a result, the trade of goods surplus increased by a modest 3.8% yoy, reaching $860 million. By product breakdown, metals exports remained among the largest contributors to the overall growth of goods exports, though the pace of metals export expansion dropped from 60% yoy to slightly above 40% yoy. The recent appreciation of the hryvnia is likely to negatively affect export performance, while cheaper imports will stimulate investment goods purchases abroad. Thus, trade balance may soon turn out to be negative.

Other Developments and Reforms Affecting Investment Climate

The investment climate in Ukraine benefited greatly from the abolishment of a regulation that created serious barriers to foreign investment inflow into Ukraine. On April 29, 2005, the National Bank of Ukraine cancelled its Resolution 5482 stipulating a complicated procedure of investing to and divesting from Ukraine by non-residents. In particular, this regulation adopted on October 14, 2004 discouraged foreign investments into Ukraine because it required the opening of multiple bank accounts and multiple foreign exchange conversions in order to invest in Ukrainian companies, or repatriate investment profit.