

Monthly Economic Monitor Ukraine

- The formation of the new Cabinet was almost completed after several other appointments in June.
- Over the January to May 2001 period the real GDP growth reached 9.0% yoy cum. supported by an impressive 18.8% growth of industrial production. Internal factors, first of all domestic consumption, are at the core of this continuing tendency.
- During the first four months of 2001 the merchandise trade expanded by 8.7% yoy. However, new trade regulations may soon cause different results.
- Parliament passed the resolution "On Major Budget Policy Directions for 2002" as well as a new edition of the Budget Code including the President's amendments. Still, the implementation of tax reform remains an unsolved problem.
- The NBU cut the discount rate again (from 21% to 19%) raising concerns among commercial bankers. The new reserve requirements mechanism is claimed to have caused a sudden hike in inter-bank rates.

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Population: 49.4 m
Industry/GDP: 30%
Agriculture/GDP: 11%
Investment/GDP: 17%
Export destination: Russia 25%, EU 17%
Import origin: Russia 38%, EU 21%

Politics: Kinakh's Cabinet is almost formed

The formation of the new Cabinet is almost completed, after President Leonid Kuchma appointed several other officials. Among the appointments were the two Vice Prime Ministers, on agricultural policy and on economic policy. Leonid Kozachenko, a former head of the Ukrainian Agrarian Confederation, was appointed to the first post, and the ex-Minister of Economy, Vasyl Rohovy, to the second. Besides developing general economic policy, Rohovy will also be involved with monitoring the privatisation process. There has been no decision as yet about a new Minister of Economy nor about the creation of the Ministry for EU Integration. In addition, the President appointed Yuriy Yehanurov (previously First Vice Prime Minister in Yuschenko's Cabinet) the First Deputy Head of the Presidential Administration. Yekhanurov will be responsible for personnel and for co-operation with the regions.

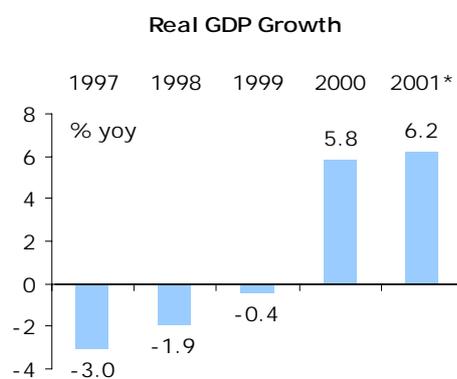
On June 21, Parliament adopted the first three of eight volumes of the Civil Code, including the general provisions and the parts concerning the personal property rights of natural persons, ownership and other rights. Also, Parliament has passed a new Commercial Code in second reading. The Code regulates economic activity of business entities in Ukraine. This event is an important move to reforming Ukraine's legislation, resulting from Parliamentary Assembly's of the Council of Europe pressure on Ukraine in April 2001.

Parliament has passed a law in first reading, which sets a moratorium on the involuntary selling of enterprise assets to settle debts in cases where the state ownership exceeds 25%. This is a consequence of the scandal caused by the sale of Donbasenergo's property for its debts.

Real economy: 2000 GDP growth figure downgraded to 5.8%

The official GDP growth figure for 2000 was downgraded from 6.0% to 5.8% yoy due to the transfer of the proceeds from the sale of bombers to Russia from 2000 to 1999.

During January-May 2001 the GDP grew by 9.0% cum. yoy (10.9% yoy in May), industrial output rose by 18.8% and agricultural production by 6.1%. The continued growth in all sectors of the economy underlines the existence of an important shift from external to internal growth factors such as domestic consumption and investment. Macroeconomic stability, a low inflation rate and a



Source: Derzhkomstat
* official forecast

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stable Hryvnia exchange rate during the first half of 2001 all had positive effects on the investment climate and are conducive to still further accelerating rates of growth in production and agriculture. Sustaining the economic growth started in 2000 and promoting rapid reforms aimed at raising the general welfare should become the first priorities for Ukraine's leadership. Quick and consistent tax reform is also of paramount importance.

Sectoral trends: Privileged energy imports for agriculture were cancelled

Energy. At the end of June Parliament cancelled the privileges on diesel fuel imports for agricultural enterprises that had only been approved at the beginning of this year. These privileges envisaged the exemption (from February to September 2001) of diesel fuel imports from VAT, from EUR 30 per ton of excise, and from EUR 1.5 per ton duty. While these exemptions were in force the Ukrainian oil refineries could not compete with the cheap imported fuels and lobbied to have these privileges abolished. At the same time, Government exempted oil and gas imports from Russia from VAT.

Privatisation. About UAH 1.25 bn in budget revenues were generated from the privatisation of state property during the period January-May 2001, that is UAH 687 m less than had been planned for this period. The shortfall in privatisation receipts has reached UAH 800 m in June, which increases the risk that the government's revenues in 2001 will show a significant shortfall, unless offset by revenue increases in other areas. In June, the IMF representatives evaluated the economic situation of the country and suggested that budget expenditures for fiscal year 2001 be reduced by UAH 2 bn to compensate for the shortfall in privatisation receipts.

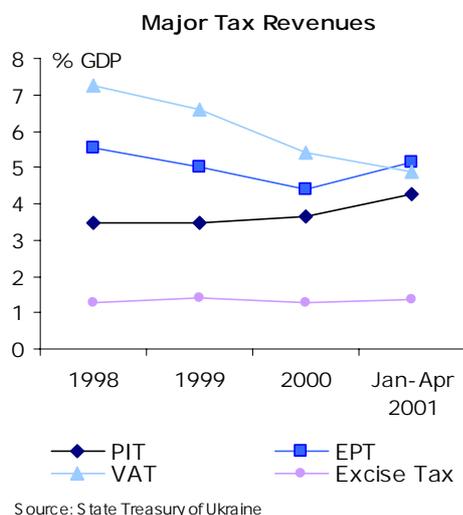
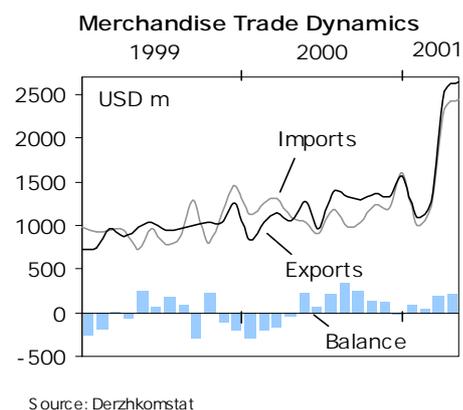
External Sector: Merchandise trade grows, while disputes concerning new trade restrictions expand

The merchandise trade grew by 8.7% yoy resulting in a USD 393 m surplus over the first four months of 2001 - this in contrast to a USD 611 m deficit for January to April 2000. A 21.1% yoy increase in exports and a simultaneous 2.1% decline in imports primarily explain the surplus. These indicators differ from the official forecast for the whole 2001 that envisaged growth rates for exports and imports to be 5.0 and 5.6% yoy respectively. The significant fall of barter operations to 0.6% of total exports and to 0.3% of imports (2.4% and 1.5% in 2000 respectively) represents a very positive tendency.

Owing to IMF pressure, Ukraine has reduced the sunflower seed export duty from 23% to 17% and made it seasonal. However, this still falls short of the not-more-than-10% level demanded by the IMF. At the same time Ukraine has imposed new trade restrictions on several import items. It may also introduce measures to answer Russia's foreign trade restrictions effective July 2001. According to official estimates these measures might result in a 20% contraction of Ukrainian exports to Russia and 5.1% fall of total merchandise exports.

Fiscal policy: The basis for Budget 2002 is being created

This month Parliament approved several pieces of legislation preparatory to drafting Budget 2002. On June 21, the new edition of the Budget Code was adopted including all amendments suggested by the President. In particular, the regulation was withdrawn, which was to direct all tax and fee revenues, except for local tax revenues, to the Budget of the Autonomous Republic of the Crimea. Parliament also passed the resolution "On Major Budget Policy Directions for 2002", which envisages a zero budget deficit, a social orientation of the budget, a ban on non-monetary transactions, and includes a list of all expenditure items not subject to change.



The delay with tax reform continues to be an unresolved issue for the budget and the economy as a whole. The Tax Code is not likely to be completely adopted this year. Instead, an alternative "Small Tax Code" was developed. It is based on a reduction of the enterprise profit tax (EPT) from 30 to 20%; the VAT from 20% to 17%; and the introduction of the two personal income tax (PIT) rates: 10% and 13%. Compensation for probable budget shortfalls is a major problem in finalising the budget. Another threat to budget revenues comes from the rising tax privileges that, according to the State Tax Authority, increased during the first half of this year. Writing off 92% of the fines and penalties for a sum of UAH 11 bn and tax arrears amounted to UAH 7 bn is a recent example.

Monetary policy: Further decrease of the discount rate may turn negative for the banking sector

On June 11 the NBU decreased its discount rate from 21% to 19% p.a. This reduction was the third this year. The commercial bankers have expressed some reservations. They believe that the required concurrent decline of the credit and deposit rates could impede the positive development of consumer deposit growth and hurt the profitability of the banking sector. The growth rate of total bank credit fell from 7.4% mom in March to 5.4% in June. It is not clear if lower rates for credits will lead to still more credits for the economy. Frequent changes of basis rates also complicate financial planning for the commercial banks

According to preliminary estimates by the National Bank of Ukraine, the monetary base grew by 13.2% cum. (35.4% yoy) and the broad aggregate M3 by 15.2% cum. (36.4% yoy) since the beginning of the year by July 01. The inflation in June comprised 0.6% mom (11.6% yoy) and totalled 5.3% cum. since the start of 2001. Concerns about the sustainability of current rapid economic growth of about 10% yoy have also their reflection in monetary sphere. The monetary policy of the NBU, aimed at decreasing the inflation rate, can still be criticized for being discretionary and hard to forecast.

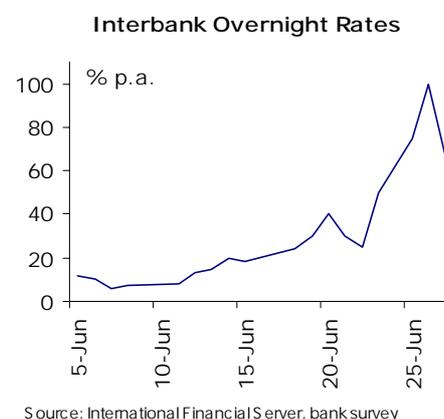
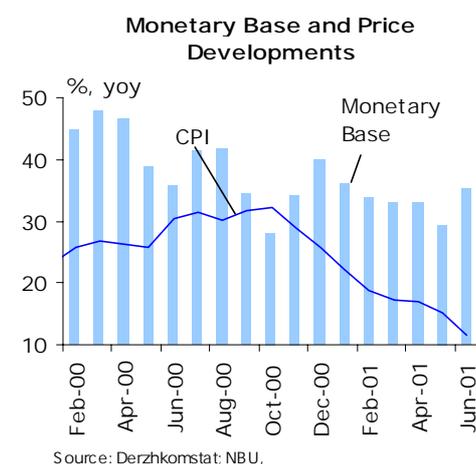
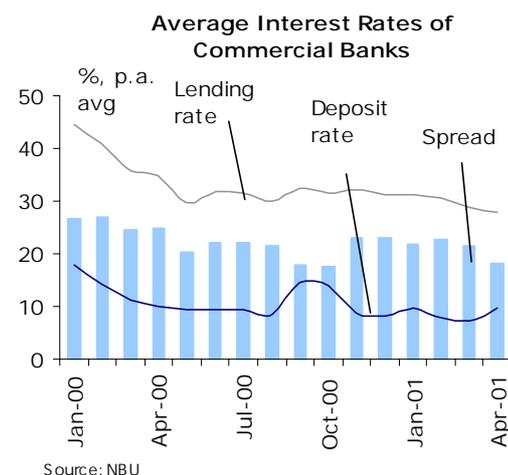
Financial markets: Unexpected hike in inter-bank rates associated with new reserve requirements mechanism

Banking sector. During June the inter-bank market has seen an almost ten-fold increase of interest rates. The overnight rate, starting at 10% p.a. at the beginning of month, kept increasing continuously, especially sharply during last week when reaching 100% p.a. Such changes are associated with the high demand for money from commercial banks, which have to comply with the reserve requirements evaluated once a month by the NBU. The NBU has refused to change this new mechanism despite some fund deficits in the inter-bank market at the end of June. Instead, the NBU advised the banks to co-ordinate their active operations with the existing reserve requirements procedure.

Provided Ukraine complies with the World Bank's conditions, it could receive the first tranche of the WB's Programmatic Systematic Loan by September. The financial sanitation of Bank "Ukraina" is first among these conditions. As of the end of June, the Government of Ukraine passed the decree, which allows issuing state domestic bonds (OVDP) in exchange for bank assets. The decree is subject to consideration by the Parliament in July. The WB proposed to make USD 15-20 m available for retraining "Ukraina's" personnel.

The EBRD has opened a USD 4 m credit line for four years at the annual interest rate of LIBOR+4% for the Microfinance Bank. This should enlarge the financing opportunities for smaller enterprises, thus contributing to the development of this sector.

Foreign exchange market. The exchange rate of Hryvna was gradually, but confidently revaluating from 5.41 to 5.37 UAH/USD since the beginning of the year. The Government is committed to track the influence of the exchange rate on exports and on general economic development in Ukraine




Economic Trends

		Q2 00	Q3 00	Q4 00	Q1 01	Q2 01	Feb	Mar	Apr	May	June
GDP growth (real)	% yoy	4.5	5.1	8.9	7.7	...	6.2	7.8	10.8	10.9	...
GDP growth (real)	% yoy cum.	5.0	5.0	5.8	7.7	...	7.6	7.7	8.5	9.0	...
Industrial production (real)	% yoy cum.	7.5	13.0	...	17.4	...	16.7	17.4	18.4	18.8	...
Agricultural production (real)	% yoy cum.	-4.9	1.3	9.2	5.1	...	1.0	6.1	6.0	6.1	...
CPI	% yoy eop	30.3	31.7	25.8	17.3	11.6	18.9	17.3	17.0	15.1	11.6
PPI	% yoy eop	22.6	19.9	20.8	12.8	9.2 *	16.4	12.8	10.8	10.1	9.2 *
Exports (gs, USD)	% yoy cum.	16.4	20.1	...	15.8	...	26.3"	25.8"	27.2"	...	...
Imports (gs, USD)	% yoy cum.	19.8	16.0	...	-5.4	...	-6.8"	-3.7"	0.0"	...	...
Merchandise trade balance	USD bn	0.24	0.29	0.22	0.24	...	0.06	0.19	0.20	...	...
Current account	USD bn eop	0.49	1.30	0.29	0.28	...	...	...	...	...	...
Current account	% GDP	6.8	13.9	3.0	3.5	...	...	...	...	...	...
Official reserves	USD bn eop	0.81	0.83	1.63	...	2.00	1.78	...	1.81	1.86	2.00
Monetary Base	% yoy eop	35.7	34.5	39.9	33.1	35.4	33.6	33.1	32.9	29.5	35.4
Lending rate (in UAH)**	% pa, eop	31.7	32.5	31.2	30.3	...	30.7	28.8	27.8	...	...
Exchange rate	USD aop	5.44	5.44	5.44	5.43	5.41	5.43	5.42	5.42	5.41	5.40
Exchange rate	EUR aop	5.15	4.76	4.72	5.01	4.73	5.01	4.94	4.82	4.76	4.61

SOURCE: Derzhkomstat, Ministry of Finance, NBU, Deutsche Bank Research, European Central Bank, own calculations

* Monthly figures applying only to merchandise exports and imports (source: Derzhkomstat)

* Forecast

** Weighted average for different maturities (source: NBU)

Key Economic Indicators

		1995	1996	1997	1998	1999	2000
Nominal GDP	USD bn	37.0	44.6	50.2	41.9	30.8	32.2
GDP growth (real)	% yoy	-12.2	-10.0	-3.0	-1.9	-0.4	5.8
Industrial production	% yoy	-24.5	-0.6	-1.2	-1.7	2.2	12.9
Agricultural production	% yoy	-4.6	-9.5	-1.9	-9.8	-6.9	9.2
Private consumption	% yoy	-1.6	-9.2	0.5	2.0	1.5	5.0 *
CPI	% yoy aop	28.2	23.6	15.9	10.6	22.7	28.2
CPI	% yoy eop	181.4	39.7	10.1	20.0	19.2	25.8
PPI	% yoy aop	488.9	52.1	7.7	13.2	31.5	20.8
Exports (gs, USD)	% yoy	-0.9	23.4	0.0	-13.4	-7.9	19.6 †
Imports (gs, USD)	% yoy	-4.0	24.2	2.0	-14.0	-19.1	15.0 †
Terms of trade	% yoy	-6.5	2.6	6.3	1.5	-10.6	2.2
Current account	USD bn	-1.2	-1.2	-1.3	-1.3	0.8	1.9
Current account	% GDP	-3.1	-2.7	-2.7	-3.1	2.7	5.8
FDI (net)	USD bn	0.3	0.5	0.6	0.7	0.5	0.6
Gross official reserves, net gold	USD bn	0.9	1.9	2.3	0.6	1.0	1.6
Fiscal balance	% GDP	-7.3	-4.5	-6.6	-1.9	-1.3	0.7
Total public debt	% GDP eop	41.7	25.0	30.4	51.5	62.8	44.1
External debt (total)	% GDP eop	27.0	20.5	19.4	38.4	51.0	32.2
Monetary base	% yoy eop	132.3	38.0	44.6	21.9	39.3	39.9
Exchange rate	USD aop	1.5	1.8	1.9	2.4	4.1	5.4
Exchange rate	USD eop	1.8	1.9	1.9	3.4	5.1	5.4
Exchange rate	EUR aop	1.9	2.3	2.1	2.8	4.4	5.0
Exchange rate	EUR eop	2.3	2.4	2.1	4.0	5.1	4.9
Real exchange rate (CPI defl.)	% yoy eop	32.5	31.0	9.8	-14.5	-20.1	12.9

SOURCE: Derzhkomstat, NBU, Deutsche Bank Research, European Central Bank, own calculations

NOTE: Fiscal balance is calculated by State Treasury methodology (privatisation revenues included; Pension Fund excluded)

* Forecast

† Preliminary NBU estimates

Notes:

aop	average of the period	p.a.	per annum
avg	average	eop	end of the period
bp	basis points	gs	goods and services
cum.	cumulative	yoy	year over year change
mom	month over month change		