

Monthly Economic Monitor Ukraine

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2003**

- The President abolished the institution of State Secretaries, restoring the positions of Deputy Minister.
- By the end May more than 40% of the total planned privatisation receipts for the year was transferred to the state coffers.
- Exports and imports of goods grew by almost 28% yoy with imports leading slightly.
- Parliament adopted a law on a flat personal income tax rate at the level of 13% starting 2004.
- The Verkhovna Rada passed amendments to Budget 2003 providing for sources to finance wage increases.
- Corporate bonds were accepted as a collateral for NBU refinancing loans for the first time.

Politics: The president abolished the positions of State Secretaries at the ministries

On May 26 the President of Ukraine Leonid Kuchma signed a decree "On measures to optimise the structure of the central executive bodies" abolishing the positions of State Secretaries at the ministries and restoring the positions of Deputy Minister. The motivation behind this decree was to improve the performance of the executive branch; however, the very same rationale had also been used when the positions of State Secretaries were originally created. This effort seems to be one of the sporadic attempts to reform the executive power, but the needed coherent administrative reform is still not forthcoming in Ukraine.

On May 25, the Council of National Security and Defence of Ukraine recommended to send Ukrainian troops to join the international forces in Iraq. The Head of the Council suggested sending about 1600 to 1700 soldiers with a peacekeeping and humanitarian mission. For the troops to be sent, a special decree of the President of Ukraine, ratified by the Verkhovna Rada, is required. During the war Ukraine had already sent a bacteriological and chemical protection unit to Kuwait.

The fifth Pan-European Conference of Environment Ministers "Environment for Europe" was held in Kyiv from May 21 to 23. Several important protocols and conventions were signed including the so called the Carpathian Convention concerning the ecologically non-exhausting use of the Carpathians.

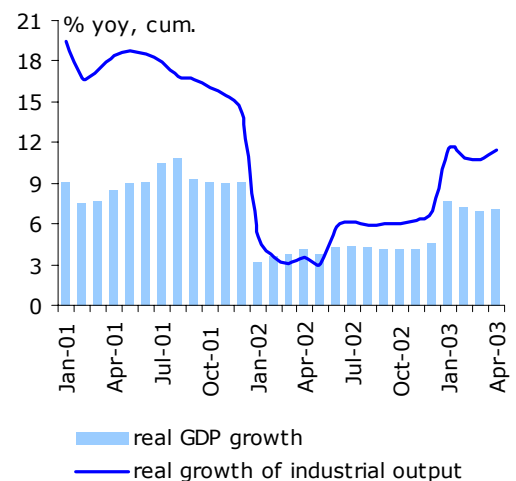
Real economy: The high GDP growth continues

From January to April 2003 the real GDP increased by 7.1% yoy maintaining its high growth rate. Manufacturing, construction, transport, and the production and distribution of energy, water and gas remained major contributors to the growth, while the growth of value added in agriculture approached zero. The acceleration to 7.5% yoy of the value added growth in the transport sector compared with 0.9% yoy in the respective period of 2002 clearly indicates some recovery of Ukraine's infrastructure. This growth can be explained by an expansion of transit services, as well as a general increase of economic activity in the country.

The industrial output grew by 11.4% yoy in the first four months of the year due to expansion in the food and chemical industries, metallurgy and machine building. While the growth in the food industry remained fairly stable, the metallurgy and chemical industries were much more volatile due to their dependence upon external demand. Current favourable external conditions cause upturns in these industries, resulting in a high growth rate for manufacturing as a whole. Another important component of

Population: 48 m
Industry/GDP: 30.5%
Agriculture/GDP: 13.4%
Investment/GDP: 20.3%
Export destinations: Russia 22%, EU 17%
Import origins: Russia 34%, EU 20%

GDP and Industrial Output



Source: Derzhkomstat

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industrial growth remains machine building, which increased by 21.1% yoy cum., twice that of the respective period in 2002.

Sectoral trends: The privatisation process revived

Privatisation. The 25% state-ownership in the Nikopol Ferroalloy Plant was sold to Prydniprovyie bringing UAH 205 m into state coffers. Only this company met the State Property Fund (SPF) requirements and was allowed to take part in the privatisation process, while other interested parties were ruled out because of strategic investor considerations. An auction did not take place since only one contestant remained. As a result, the price was based on an evaluation by experts, limiting the potential privatisation receipts.

About UAH 0.9 bn of privatisation receipts, including funds from the UMC sale, were transferred to the state coffers as of the end May, accounting to more than 40% of the annual plan. This is significantly higher than during the respective period of the previous year when only UAH 0.3 m were collected. Given the present tendency to offer large holdings of some very attractive state-owned companies, such as the Ukrainian metallurgical plant Petrovskogo and the oil-processing company Ukrtatnafta, the privatisation target for 2003 will likely be met.

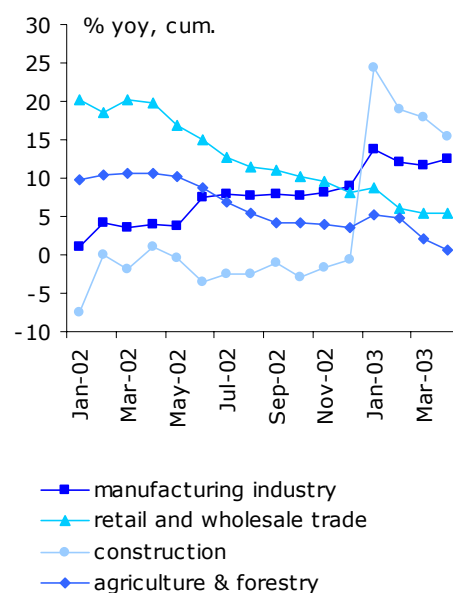
Energy. The European Commission will provide a grant of EUR 2 m for technical assistance to carry out a feasibility study concerning extension of the Odessa-Brody pipeline to Plock (Poland). Also, the EBRD expressed its readiness to provide USD 450 m for the construction of the Brody-Plock oil pipeline, allowing Caspian region oil exports to reach Poland, Germany and the Baltic states. Ukraine completed construction of the Odessa-Brody section, intended to bring Caspian oil to Ukraine, in 2001. However, Ukraine failed to secure any contracts with Caspian region oil exporters to pipe oil from Odessa to Brody. At present, some Russian oil is pumped in the reverse direction, and Ukrtransnafta signed a protocol of intention for transporting Russian oil from Brody to Odessa, which would take up the entire capacity of the pipeline. If this reverse exploitation of the pipeline continues, Ukraine would lose the opportunity to transport higher-quality Caspian oil and to diversify its oil imports.

Agriculture. Parliament adopted a law allowing the import of 360,000 tons of raw cane sugar under a 1% preferential tariff rate, but not less than EUR 6 per ton, from May 15 till September 1, while the current tariff rate is EUR 300 per ton. Because of high domestic sugar prices, this decision will bring profits to the importers and processors of raw cane sugar. The consumers may not benefit however, since the state authorities and market agents hope to help the sugar production industry maintaining high prices. This policy reflects the strong lobby of sugar-beets producers. It is costly for consumers and the economy as a whole because Ukrainian sugar produced from sugar beets is more expensive than cane sugar. It would be better to introduce a permanent reasonably low import tariff, rather than to decide every year whether to allow preferential raw cane sugar imports and to support inefficient producers at the consumers' expense.

External Sector: Merchandise foreign trade soared

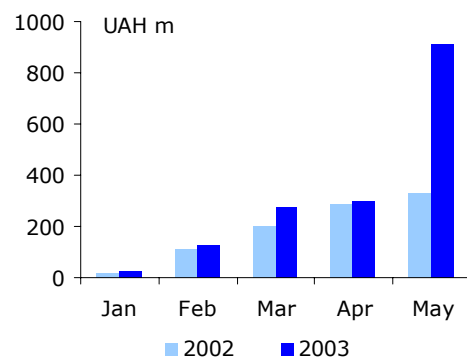
According to Derzhkomstat, both exports and imports of goods grew by almost 28% yoy in dollar terms in the first quarter of 2003, with imports leading slightly. The trade balance remained positive at the level of USD 410 m. In the first three months of 2002 Asian demand was the major driving force of exports, whereas exports to the CIS countries, Europe and America decreased. This year the situation reversed, with exports to Europe increasing by 41% yoy (contributing more than a half to total exports growth), while exports to CIS countries grew by only 5% yoy, and exports to Asia slowed down to less than half (from 36% yoy in the first quarter of 2002 to 17% yoy in 2003).

Growth of Value Added in Selected Sectors



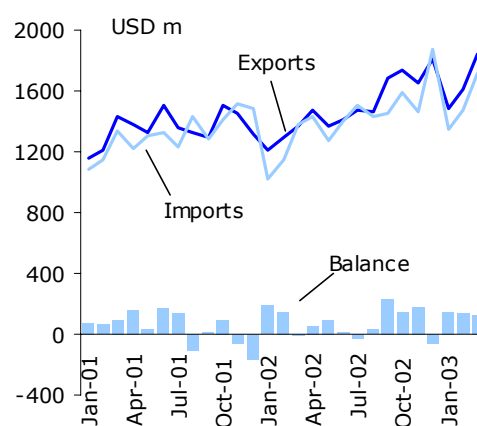
Source: Derzhkomstat

Privatisation Revenues*



Source: State Treasury
*general fund of the budget only

Merchandise Trade Dynamics



Source: Derzhkomstat

Fiscal policy: Personal income tax rate is set at 13%

Parliament adopted a new law on personal income tax (PIT). The law establishes a flat tax rate for personal incomes at the level of 15%. For a transitional period until 2007, a reduced rate of 13% will apply however. The adoption of the law is an important element of tax reform in Ukraine. But its positive effect on private consumption could well be counterweighted - at least in the short-run - by a reduction in state expenditures caused by lower fiscal revenues, which is very likely if the tax base is not widened. It is expected that the introduction of the flat tax rate will promote de-shadowing of the economy, and increase PIT revenues. However, to achieve this goal the payroll tax reform remains essential.

The President signed a law amending Budget 2003. This law foresees increases in central state revenues and expenditures of UAH 2.9 bn, or 5.9% and 5.6% respectively. In particular, the law envisages higher revenues due to higher excise taxes for some alcohol and tobacco products, rent payments for oil and gas extraction, and net revenues of the National Bank. These resources will be directed to agriculture and to the financing of wage increases for state employees. Thus, this law finally defines the source for financing the minimum wage of UAH 185 that was legislated in January 2003. Moreover, it postpones from July 2003 to December 2003 the introduction of the minimum wage increase to UAH 237.

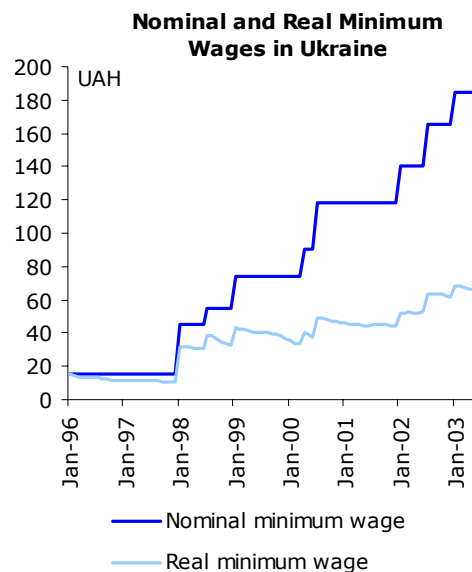
Monetary policy: New collateral for NBU refinancing

In May the NBU announced that the new corporate bonds of the South-Western Railway (SWR) - a regional unit of the State Railway Administration (Ukrzaliznytsja) - would be accepted as collateral for refinancing loans. The amortised bonds mature in 3 years and carry a 12% annual coupon rate, 5 percentage points below the average market rate. The total amount of the issue is UAH 500 m. Bankers emphasized that acceptance of the SWR bonds as collateral for refinancing loans was the key factor for a successful issue. The NBU officials state that in this way the NBU promotes the development of the corporate bonds market. However, it remains unclear what criteria were used by the NBU to assess the appropriateness of bonds for collateral, taking into account that there is no independent rating agency in Ukraine that could examine the solvency of the issuer. It seems that two other state companies, the national communications operator Ukrtelecom and the national nuclear-energy company Energoatom, are going to follow the successful experience of the SWR and get cheap funds by issuing bonds with similar features for amounts totalling UAH 700 m and UAH 500 m respectively. Management of the companies expressed confidence that their bonds would be accepted as a collateral for refinancing, too.

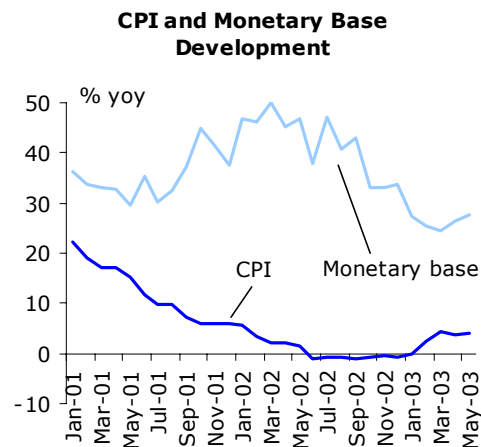
The stabilization of prices for grain products, together with the seasonal reduction of other food product prices, which usually starts in May, contributed to the slowdown of inflation to zero level in mom terms. Due to a statistical base effect the CPI grew by 3.9% yoy. The monetary base increased by 27.8% yoy.

Financial markets: The projected UAH/USD exchange rate was further revised

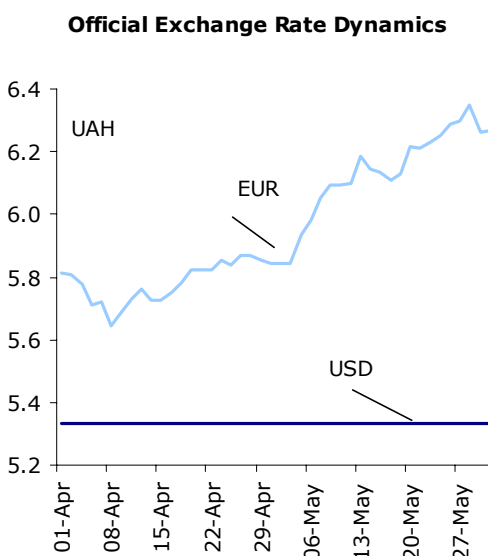
Foreign exchange market. The NBU Council again reviewed the projected level of the average UAH/USD exchange rate for 2003 and decreased it to 5.36 UAH/USD aop. According to the Head of the NBU Council, Anatolij Halchinsky, this revision of the nominal exchange rate resulted from especially favourable dynamics in the balance of payment. With a continuous inflow of foreign currency, the lower depreciation of hryvnia will allow the NBU to reduce the monetary pressure while continuing to accumulate foreign reserves. At the same time, the revision will have a stabilizing impact on an important indicator for exporters, the real effective exchange rate, by smoothing the abrupt upsurge caused by the recent rapid appreciation of the euro.



Source: Derzhkomstat, Ukrainian legislation



Source: Derzhkomstat, NBU



Source: Ukrainian financial server



Economic Trends		Q1 02	Q2 02	Q3 02	Q4 02	Q1 03	Jan	Feb	Mar	Apr	May
GDP growth (real)	% yoy	4.1	4.7	4.3	6.1	7.0	7.7	6.7	6.6	7.4	...
GDP growth (real)	% yoy cum.	4.1	4.4	4.3	4.8	7.0	7.7	7.2	7.0	7.1	...
Industrial production (real)	% yoy cum.	3.1	5.8	6.0	7.0	10.7	11.6	10.8	10.7	11.4	...
Agricultural production (real)	% yoy cum.	11.1	9.2	3.0	1.9	1.3	5.2	4.3	1.3	0.6	...
CPI	% yoy eop	2.2	-1.1	-1.1	-0.6	4.3	-0.1	2.5	4.3	3.6	3.9
PPI	% yoy eop	-0.5	4.0	4.9	5.7	9.9	6.8	6.8	9.9	8.9	7.6
Exports (USD)*	% yoy cum.	1.5	2.4	6.9	10.7	...	22.7"	23.8"	27.9"
Imports (USD)*	% yoy cum.	-2.1	0.9	4.7	4.9	...	31.1"	30.0"	28.0"
Merchandise trade balance	USD bn cum.	0.14	0.20	0.37	0.98	...	0.15"	0.28"	0.41"
Current account	USD bn cum.	0.83	1.45	2.21	3.17	...	x	x	x	x	x
Current account	% GDP	10.6	8.3	7.5	7.6	...	x	x	x	x	x
International reserves	USD bn eop	3.11	3.41	4.02	4.42	4.60	4.56	4.71	4.60	4.87	5.30
Monetary Base	% yoy eop	49.9	38.0	42.9	33.6	24.3	27.2	25.4	24.3	26.3	27.8
Lending rate on UAH credits **	% pa, eop	27.7	25.0	20.1	19.5	17.9	18.6	17.7	17.9	18.3	17.9
Exchange rate (official)	USD aop	5.32	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33
Exchange rate (official)	EUR aop	4.66	4.88	5.24	5.33	5.71	5.65	5.75	5.74	5.78	6.14

SOURCES: Derzhkomstat, Ministry of Finance, NBU, IFS, own calculations

" Monthly figures are only for merchandise exports and imports (source: Derzhkomstat).

Quarterly figures are for trade in goods and services (source: NBU).

* Growth rate in dollar terms.

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

°° The value of aircraft complexes transferred to Russia as repayment of a gas debts according to inter-governmental agreement reached in October 1999 totaling USD 274 m is not included.

Key Economic Indicators		1995	1996	1997	1998	1999	2000	2001	2002
Nominal GDP	UAH bn	54.5	81.5	93.4	102.6	130.4	173.0	204.2	220.9
Nominal GDP	USD bn	37.0	44.6	50.2	41.9	31.6	31.8	37.8	41.5
GDP growth (real)	% yoy	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	4.8
Industrial production	% yoy	-12.0	-5.1	-0.3	-1.0	4.0	12.4	14.2	7.0
Agricultural production	% yoy	-3.6	-9.5	-1.9	-9.8	-6.9	9.8	9.9	1.9
CPI	% yoy aop	376.4	80.2	15.9	10.6	22.7	28.2	12.0	0.8
CPI	% yoy eop	181.7	39.7	10.1	20.0	19.2	25.8	6.1	-0.6
PPI	% yoy aop	488.9	52.1	7.7	13.2	31.5	20.9	8.6	3.1
PPI	% yoy eop	172.1	17.3	5.0	35.4	16.0	20.8	0.9	5.7
Exports (gs, USD)	% yoy	2.6	19.1	0.0	-13.4	-7.9	17.9	9.5	10.7
Imports (gs, USD)	% yoy	1.5	17.4	2.0	-14.0	-19.1	18.9	14.1	4.9
Current account	USD bn	-1.2	-1.2	-1.3	-1.3	0.9 °	1.2 °°	1.4	3.1
Current account	% GDP	-3.1	-2.7	-2.7	-3.1	2.9	3.8	3.7	7.5
FDI (net)	USD bn	0.3	0.5	0.6	0.7	0.5	0.6	0.8	0.7
International reserves	USD bn	1.1	2.0	2.4	0.8	1.1	1.5	3.1	4.4
Fiscal balance***	% GDP	-6.9	-5.1	-6.8	-2.7	-2.1	-0.7	-1.9	0.8
Total public debt	% GDP eop	40.9	25.0	30.3	49.4	61.4	44.5	37.4	34.4
External debt (total)	% GDP eop	26.3	20.5	19.4	38.4	50.0	32.5	26.8	24.7
Monetary base	% yoy eop	132.3	38.0	44.6	21.9	39.3	39.9	37.4	33.6
Exchange rate	USD aop	1.5	1.8	1.9	2.4	4.1	5.4	5.4	5.3
Exchange rate	USD eop	1.8	1.9	1.9	3.4	5.1	5.4	5.3	5.3
Exchange rate	EUR aop	1.9	2.3	2.1	2.8	4.4	5.0	4.8	5.0
Exchange rate	EUR eop	2.3	2.4	2.1	4.0	5.2	5.1	4.7	5.5

SOURCES: Derzhkomstat, NBU, IFS, Ministry of Finance, own calculations

*** The fiscal balance is calculated in line with the new methodology introduced in 2002.

"Minus" denotes a budget deficit

° The value of goods transferred to Russia according to the inter-governmental agreement reached in May 1997 on the Black Sea Fleet division totaling USD 726 m is not included

°° The value of the aircraft complexes transferred to Russia as repayment of a gas debts according to the inter-governmental agreement reached in October 1999 totaling USD 274 m is not included.

Notes:

avg	average	ytd	year-to-date
cum.	cumulative	p.a.	per annum
mom	month on month change	eop	end of the period
qoq	quarter on quarter change	aop	average of the period
yoy	year on year change	gs	goods and services