



Monthly Economic Monitor Ukraine

- Yevhen Marchuk, the former Secretary of the Security and National Defence Council, was appointed Minister of Defence.
- Investments in fixed capital grew by 23.1% yoy from January to March 2003.
- The government tries to curb panic on the food market by sales from state reserves and by higher grain imports.
- FDI inflow increased 145% yoy during the first quarter of 2003.
- The Verkhovna Rada passed amendments to the VAT law, reducing the tax rate from 20% to 17% starting January 1, 2004.
- The consumer price index grew by 5.9% yoy mainly due to panic on the food market.
- The NBU intends to refinance purchases of corporate bonds by commercial banks.
- Parliament adopted the law "On mortgage".

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July
2003**

Population: 48 m
Industry/GDP: 30.5%
Agriculture/GDP: 13.4%
Investment/GDP: 20.3%
Export destinations: Russia 17%, EU 20%
Import origins: Russia 35%, EU 23%

Politics: Yevhen Marchuk is the new Minister of Defence

The Minister of Ecology and Natural Resources, Vasyl Shevchuk, and the Minister of Defence, Volodymyr Shkidchenko, were dismissed in June. The Minister of Ecology was discharged for mismanagement of the licensing of natural use extraction, as well as for his stance on building of a transport channel at the Danube – Black Sea junction. The major reason for dismissal of the Minister of Defence was the slow pace of military reform. Yevhen Marchuk, a former Secretary of the Security and National Defence Council, was appointed Minister of Defence. The second post in the Cabinet of Ministers is still open.

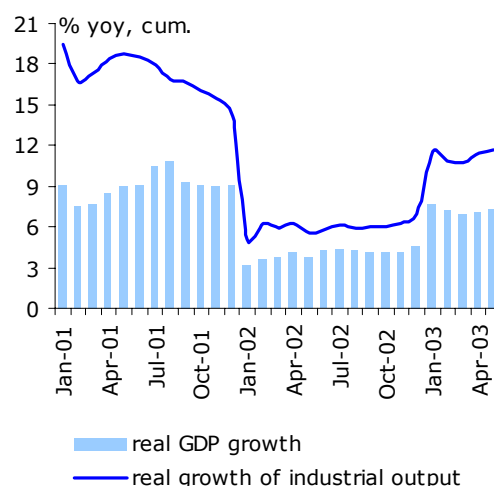
The President of Ukraine submitted a draft law on constitutional reform to the Verkhovna Rada. In line with requests by many parliamentarians, the President omitted proposals for a bicameral parliament, for reducing the number of deputies, and for the adoption of laws through popular referenda. It is still unclear whether this constitutional reform will go forward, since the necessary constitutional majority in the parliament would require significant support from opposition members. As reported earlier, the reform is meant to transform Ukraine into a parliamentary-presidential republic, giving more powers to the parliament of Ukraine. However, upon closer inspection, many powers of the president were not curtailed in the draft, which could reduce the chance of enacting the constitutional amendment by parliament.

Real economy: Investments grew by 23.1% yoy

During the first five months of the year the real GDP grew by 7.3% yoy, primarily because of positive developments in industry, construction and transport. At the same time, the value added growth in agriculture fell to zero, reinforcing expectations for negative growth figures for the second half of the year. While the positive growth in private consumption may be hampered by lower agricultural output and consequently higher prices, persistent growth in investment is expected to continue. Investments in fixed capital increased by 23.1% yoy during the first quarter of 2003, as compared to 9.6% yoy for the same period of the previous year.

The investment activity acceleration was supported by a substantial increase in net profits before taxation in the economy. According to Derzhkomstat, net profits increased by a factor of six from January to April compared to the same period of 2002, and reached almost UAH 6.5 bn. At the same time, the accumulation of inter-enterprise overdue payables and receivables has almost stopped indicating better financial discipline and contract execution in the country.

GDP and Industrial Output



Source: Derzhkomstat

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Sectoral trends: The government tries to curb panic on the food market

Agriculture. The price rises for grain this spring, as well as forecasts of a very poor harvest due to adverse weather conditions created some panic and caused sharp increases in the prices for grain products and sugar at the end of June. To stabilize the food market the government has already undertaken several measures, the most important of which are sales of flour, cereals and sugar from the State Reserve, higher grain imports from Kazakhstan, Russia and the EU, and administrative price regulation for selected products. It is expected that the current year's food grain harvest will reach approximately 3 to 4 m tons, while Ukraine needs approximately 6 m tons. To meet the grain demand for the coming year, the government plans to allow importing wheat and rye at preferential import duty rates.

Energy. In May 2003, the cash payments by the regional power distribution companies (oblenergos) to the wholesale electricity market exceeded 100% for the first time, indicating success with the policy of debt redemption. However, Ukrainian legislation prohibits the regional distribution companies from cutting off electricity to a number of customers (mainly for ecological reasons). Thus, the targeted 100% will not be sustained as long as these oblenergos are not compensated for such electricity supplies. First efforts to solve this problem were made in a law recently adopted by Parliament. This law allows state or local administrations to compensate oblenergos for the non-payment by those listed customers who are not allowed to be disconnected from the electrical grid.

Privatisation. Ukraine failed to privatise state ownership in the Dnipropetrovsk Metallurgical Plant Comintern ("Cominmet"), and in the Dnipropetrovsk Metallurgical Plant Petrovskogo, since no applications were received. The evident lack of investor interest in metallurgical plants can be explained by expected profitability decreases in this industry due to the current less favourable international metal market conditions, and the problematic financial circumstances of these enterprises. Bankruptcy cases were filed against both companies in 2001.

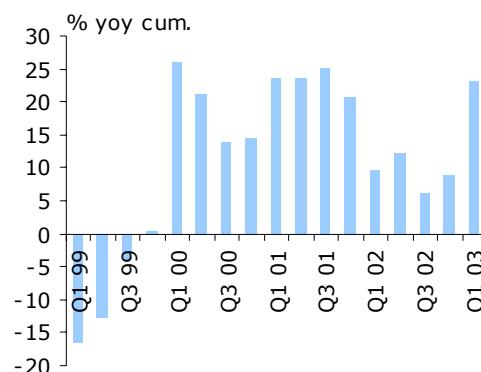
Infrastructure. The Russian telecommunications company MTS executed a call option on the purchase of 26% of UMC shares, thus extending its shareholding to 83.7%. The transaction divested the state of its last shares in one of the two major mobile operators in Ukraine. In the future UMC will provide services under the trademark of its owner - MTS.

External Sector: The inflow of FDI accelerated in 2003

According to the NBU, the current account balance increased by 31% yoy in the first quarter of 2003 due to the growth of exports and the import of goods and services, as well as a stable net inflow of current transfers from abroad. During the first three months the merchandise exports grew by 26.6% yoy thanks to metals and mineral products. At the same time, imports grew by 26.2% yoy due to mineral products, machinery and transport. On the service side, a higher demand for transit services in Ukraine caused a 23.4% yoy growth in railway transportation.

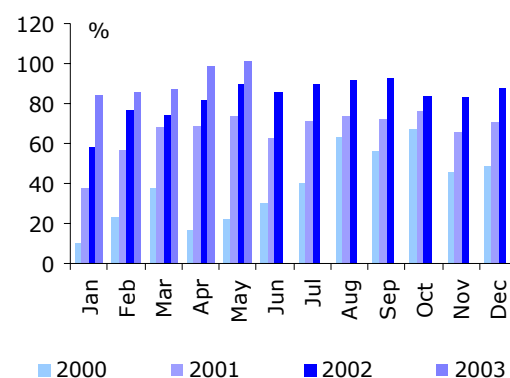
The net inflow of foreign direct investments into Ukraine was USD 299 m, i.e. 145% yoy higher than during the first quarter of the previous year. However, Ukraine also experienced a significant net outflow of portfolio investments amounting to USD 817 m, while the portfolio investments outflow was USD 293 m during the first three months of 2002. A possible explanation for this outflow is capital flight, where residents sell securities to non-residents at much lower prices than those at which they buy them back. To curb this undesirable practice, in February 2003 the NBU introduced licensing procedures for purchases of domestic securities by residents from non-residents.

Investment in Fixed Capital



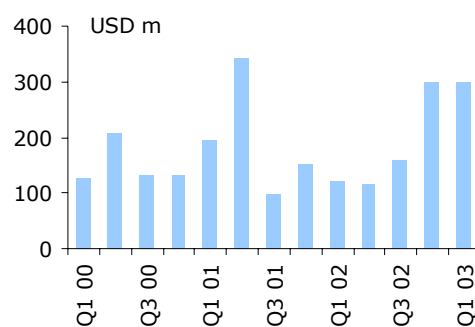
Source: Derzhkomstat

Cash Payments by Oblenergos as % of Electricity Supply



Source: NERC, *Energobiznes*

Foreign Direct Investments



Source: NBU

Fiscal policy: The VAT rate will be reduced in 2004

In June the Verkhovna Rada passed amendments to the VAT law. According to this law, the VAT rate will be reduced from 20% to 17% starting on January 1, 2004 and to 15% in 2005. The law also abolishes some VAT exemptions; the most important of which are on drugs, medical services and on the sale of newly built real estate. However, the deputies failed to abolish the VAT privileges for agriculture. Also Parliament approved the budget resolution for the year 2004. The major parameters of next year's budget are similar to those of 2003. Thus, the revenues of the consolidated budget must not be less than 27.5% of GDP, and the budget deficit must not exceed 0.5% of GDP. It was also agreed that the state debt at the end of the year 2004 should not exceed 35% of GDP. However, there is a risk that the upcoming tax reform will cause significant revenues losses, undermining the overall planned budget structure.

The central state revenues for January to May reached 102% of budget. Although the Ministry of Finance reports that the amount of funds transferred to the expenditure side was close to the plan, the central budget expenditures reached only 91.4%.

Monetary policy: The growth of inflation is mainly due to the food panic

In June the grain market was upset again, but this time consumers evoked the disturbances. The expectation of a poor harvest, primarily for food grain - constantly amplified by the media - has caused panic. An abrupt upsurge in demand for flour, cereals, and related products resulted in a temporary deficit of these goods and a considerable increase in their prices. In response, the government quickly introduced administrative price-regulating mechanisms. Nevertheless, in June consumer prices grew by 0.1% mom instead of showing the usual seasonal reduction. The development of a futures market for major agricultural products should protect the Ukrainian economy from such severe price fluctuations in the future.

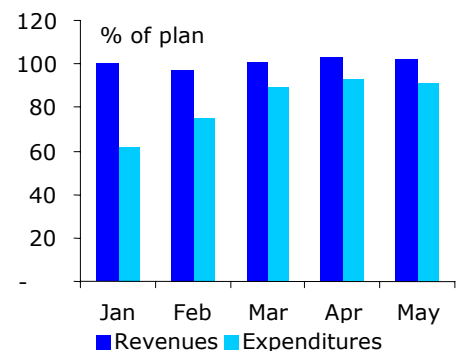
New amendments to the procedure for long-term refinancing will from now on allow banks to issue refinancing loans (with maturities of up to 3 years) to purchase corporate bonds at the primary market. NBU officials claim that along with the permission to use corporate bonds as a collateral, this measure will be another step to foster development of the corporate bond market. However, it is more likely that under political influence on the eve of the presidential elections these refinancing loans will be used to indirectly finance selected enterprises, or that these funds will end up supporting some election campaigns. Moreover, taking into account that the current growth of the money supply already exceeds projected limits (54% yoy versus 31% projected), an intensive use of refinancing mechanisms could lead to an over-expansionary monetary policy and could create additional inflationary pressure.

Financial markets: A law on mortgage was adopted

Banking sector. The Verkhovna Rada adopted the law "On mortgage", the first explicit legislation for this type of financial instrument in Ukraine. Up to now mortgage transactions as such were not legally defined, instead the law on collateral was applied. One important feature of the law is the introduction of agricultural land mortgage, starting in 2005. In general, the law "On mortgage" offers vital preconditions for the establishment of housing finance and a mortgage market in Ukraine, although it is by far not complete. For instance, it does not include regulations concerning mortgage bonds.

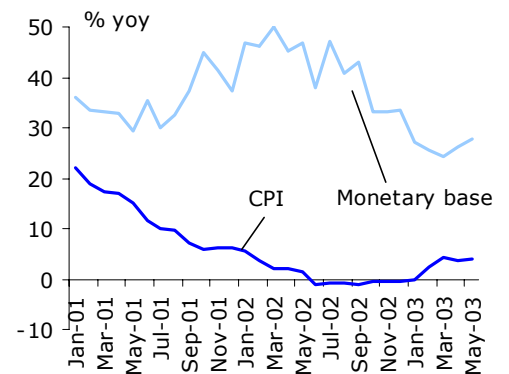
Following long-standing requests of the international financial institutions, the NBU increased the regulatory capital adequacy requirements for commercial banks. As of March 2004 they will be set at the level of 10% instead of the current 8%. This measure will increase the reliability of commercial banks and should lead to higher confidence levels on the part of depositors.

Central Budget Execution Rate in 2003



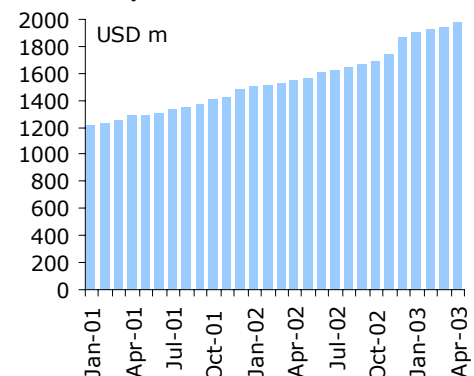
Source: State Treasury

CPI and Monetary Base Development



Source: Derzhkomstat, NBU

Capital of Ukrainian Banks



Source: NBU



Economic Trends		Q1 02	Q2 02	Q3 02	Q4 02	Q1 03	Feb	Mar	Apr	May	Jun
GDP growth (real)	% yoy	4.1	4.7	4.3	6.1	7.0	6.7	6.6	7.4	8.3	...
GDP growth (real)	% yoy cum.	4.1	4.4	4.3	4.8	7.0	7.2	7.0	7.1	7.3	...
Industrial production (real)	% yoy cum.	3.1	5.8	6.0	7.0	10.7	10.8	10.7	11.4	11.7	...
Agricultural production (real)	% yoy cum.	11.1	9.2	3.0	1.9	1.3	4.3	1.3	0.6	0.2	...
CPI	% yoy eop	2.2	-1.1	-1.1	-0.6	4.3	2.5	4.3	3.6	3.9	5.9
PPI	% yoy eop	-0.5	4.0	4.9	5.7	9.9	6.8	9.9	8.9	7.6	5.3
Exports (USD)*	% yoy cum.	1.5	2.4	6.9	10.7	24.6	23.8"	27.9"	27.8"
Imports (USD)*	% yoy cum.	-2.1	0.9	4.7	4.9	22.8	30.0"	28.0"	29.1"
Merchandise trade balance	USD bn cum.	0.14	0.20	0.37	0.98	0.32	0.28"	0.41"	0.41"
Current account	USD bn cum.	0.83	1.45	2.21	3.17	1.08	x	x	x	x	x
Current account	% GDP	10.6	8.3	7.5	7.6	11.9	x	x	x	x	x
International reserves	USD bn eop	3.11	3.41	4.02	4.42	4.60	4.71	4.60	4.87	5.30	6.17
Monetary Base	% yoy eop	49.9	38.0	42.9	33.6	24.3	25.4	24.3	26.3	28.5	34.2
Lending rate on UAH credits **	% pa, eop	27.7	25.0	20.1	19.5	17.9	17.7	17.9	18.3	17.9	17.2
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	5.75	5.74	5.78	6.14	6.23

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