

Monthly Economic Monitor Ukraine

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- The border conflict between Ukraine and Russia over Tuzla Island threatens the relationship between the two countries and endangers the ratification of the Single Economic Space agreement.
- The real GDP growth for the first half of the year was revised upwards from 7.5% yoy to 8.6% yoy.
- Private traders intensified grain imports after the government stepped out of the market.
- The government launched a registration of state-owned stakes in Ukrainian enterprises.
- A favourable world conjuncture and expanding internal investment promote the growth of foreign trade.
- Parliament approved the draft of Budget-2004 in first reading with revenues and expenditures at UAH 61.0 bn and UAH 63.6 bn respectively.
- The demand for foreign cash increased driving the cash exchange rate upwards.
- The NBU exchange rate policy will remain unchanged despite calls by the IMF to allow wider fluctuations of the hryvnia.

Politics: Border conflict between Russia and Ukraine over Tuzla Island

October was marred by a border dispute between Russia and Ukraine over a causeway that Russia unilaterally started from the Tamanskij peninsula in the direction of Tuzla Island in the Kerch Strait. The two countries had failed to demarcate the exact border in that region after the break up of the Soviet Union. As a result, Ukraine insists that Tuzla belongs to it under Soviet-era agreements, while Russia claims that the borders are not yet defined in the region. The Russian authorities claimed that the causeway construction was an initiative of the local authorities, and begun for purely ecological reasons. However, the absence of consultations with Ukraine prior to construction suggests that the causeway construction may be an effort of putting political pressure on Ukraine. Currently, Ukraine controls the Kerch strait, and levies tolls on ships passing between the Sea of Azov and the Black Sea in either direction. Russia insists that both countries should control the strait. The Russian stance and actions on the Kerch strait have had a negative impact on the Russian-Ukrainian relationship, and could endanger ratification of the recently signed Single Economic Space agreement.

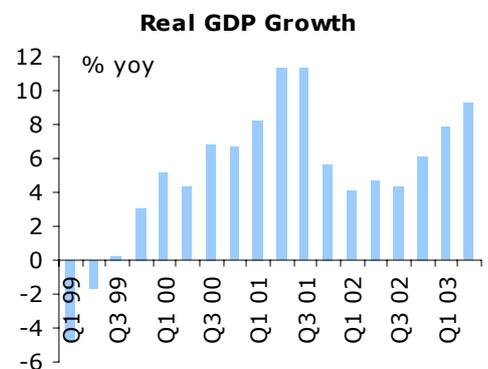
A Ukraine-EU summit, hosted by President Leonid Kuchma, took place in Yalta. The current President of the European Council and Prime Minister of Italy Silvio Berlusconi headed the EU delegation. The main discussions concerned EU enlargement and the program "Wider Europe-Neighbourhood", which should facilitate Ukraine's participation in the internal markets of the enlarged EU.

Real economy: The GDP growth figure for the first half of 2003 was revised upwards

In October, Derzhkomstat revised the rate of the real GDP growth for the first half of the year upward. The increase from 7.5% to 8.6% yoy is attributed to higher than previously estimated economic growth during the second quarter.

According to Derzhkomstat, the real GDP grew by 6.5% yoy between January and September. In September agriculture performed better than in previous months due to a delayed harvesting period and a rather good late grain-crops harvest. As a result, the value added for this sector declined by only 16.7% yoy cum. compared to the 24.6% yoy drop during the preceding eight months. Industrial output

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%



Source: Derzhkomstat

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increased by 15.2% yoy during the first nine months of the year. The main growth contributors were metallurgy, the food industry, and machine building. Despite the tight administrative regulation of the grain-related production, the food industry output increased by 22.8% yoy cum., contributing almost a quarter to total growth. Another third of total industrial growth derived from the machine-building sector. Its output increased by 33.0% yoy cum., largely due to an acceleration of transport equipment production.

Sectoral trends: Private traders intensified wheat imports into Ukraine

Agriculture. The tensions on the grain market have gradually slackened due to saturation of the domestic market with imported wheat that was brought in by private traders. A few months earlier the government had announced its intention to offset a major part of the wheat shortage with imports based on intergovernmental contracts with Kazakhstan and Russia. That move had stifled private sector activities on the import market. However, the government managed to import only 6 thousand tons of Russian wheat out of 3.7 m ton need. This allowed the private sector to become the major player on the import market. In addition to promoting imports, the zero duty on grain imports was extended to July 1, 2004.

Privatisation. The Cabinet of Ministers ordered to draw up an inventory of the state-owned stakes in Ukrainian enterprises and to create a registry. This step is expected to increase the accountability of enterprises, the transparency of their financial transactions, and the efficiency of state property management. The present lack of state supervision of partially state-owned plants allows misuses of power by the management of these firms, hurting the interests of shareholders.

The State Property Fund announced a decision to privatise its 92% stake in the large coal-mining enterprise Pavlogradvugillya. The company controls 14% of total coal extraction in Ukraine, and its assets value is UAH 1.6 bn. The sale of this enterprise is going to be an important step in privatising the Ukrainian coal industry.

Energy. The Ukrainian company Naftogaz Ukrainy and the National Oil Corporation of Libya have signed a memorandum of co-operation. This is a framework document allowing Ukraine to select four oil field blocks in Libya for development and oil extraction. This agreement and recent successes by the company in attracting external financing support the optimistic expectation that Ukraine will be able to diversify its energy sources.

External Sector: High growth in foreign trade persists

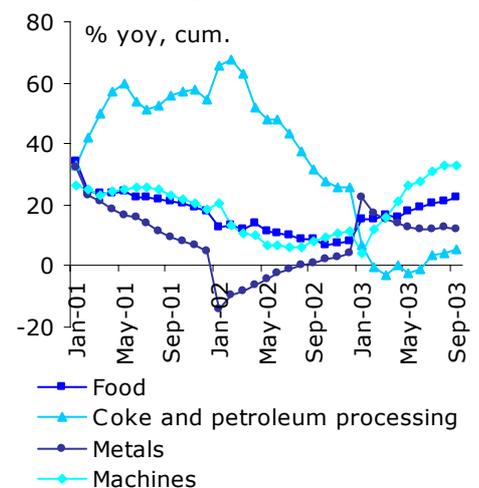
According to the Derzhkomstat, exports of goods grew by 29.1% yoy from January to August, while imports grew by 31.2% yoy. Still, the trade balance for this period remained positive at USD 404 m. A 29% increase in ferrous metal exports, caused by a favourable world conjuncture, made up one third of the total export growth. Another third was due to re-exports of gas and oil. However, the introduction of state registration of oil export contracts and problems with transportation are expected to reduce oil exports as of September.

At the same time, higher investments in the country stimulated increased machinery and transport imports, accounting for almost one third of the total imports increase. Another third was due to increased raw oil imports during the first eight months, caused by an increase in internal demand and higher world prices. However, increased grain imports (by a factor of seven) due to a poor harvest contributed only 3% to total import growth because of the very low share of grain on the structure of imports.

Fiscal policy: The Budget-2004 draft was passed in first reading

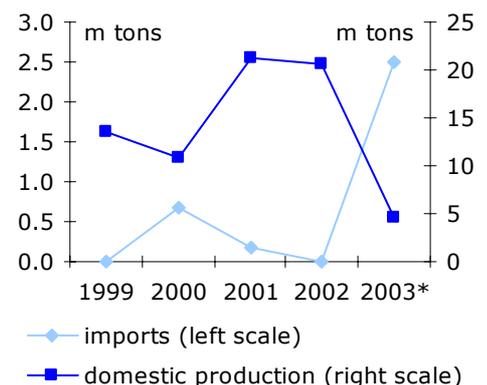
Parliament approved Budget-2004 draft in first reading. Compared to the Cabinet of Ministers' draft, the state's fiscal revenues were

Growth of Output in Selected Industries



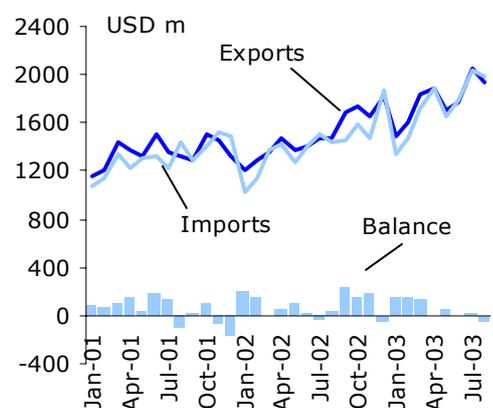
Source: Derzhkomstat

Wheat Market in Ukraine



Source: Derzhkomstat, FAO
* own estimates

Merchandise Trade



Source: Derzhkomstat



increased by 5% to UAH 61.0 bn, and expenditures by 6% to UAH 63.6 bn. To finance these increases, parliament passed in first reading the draft law that eliminates several VAT privileges (mostly related to specific industries), reduces rates of depreciation allowances, and increases excise rates. The final amounts of revenues, expenditures, and the deficit are to be approved during the second reading, scheduled after November 10.

The central fiscal performance during the first nine months remained stable. Revenues reached 102% of the budgeted amount, while expenditures were 9% below target. The surplus was UAH 1.1 bn instead of a planned deficit of UAH 1.4 bn.

Monetary policy: Inflation was caused by non-monetary factors

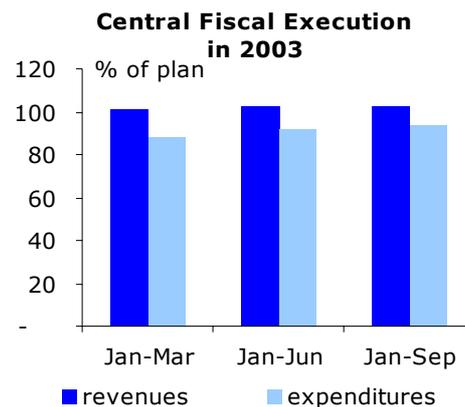
Consumer prices continued to increase, reaching 6.8% yoy in October. One of the major reasons why inflation accelerated was the administrative increase in prices on bread and bread-products, which started in several regions of Ukraine in October and is likely to be followed in other parts of the country in November. Another cause of inflation was a rise in meat and meat products prices. This was caused by a poor grain harvest resulting in higher prices for fodder, and is likely to affect the dynamics of the CPI at least until the next harvest. Although growth of the monetary aggregates remains quite high compared to the inflation rate (in October the monetary base grew by 30.7% yoy, while the money supply increased by 48.1% yoy), the loose monetary policy creates little pressure on inflation due to the continuous expansion of the money demand.

Financial markets: The NBU continues maintaining a stable exchange rate

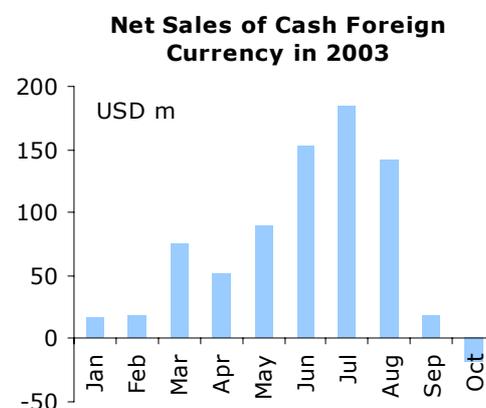
Foreign exchange market. In October for the first time since the beginning of the year, the volume of cash foreign currency purchases exceeded the volume of sales. This fact indicates an increase in the demand for foreign cash, causing gradual appreciation of the US dollar relative to the hryvnia on the cash market. The growth in demand was likely caused by the seasonal desire of the public to replenish their foreign currency holdings after the vacation period. However, political uncertainty around the Tuzla conflict could also have added to the increase in demand at the end-October. The interbank foreign exchange market added to the devaluation pressure on the hryvnia as well. The main forces here were the growth of grain imports and the slow down of oil exports. Nevertheless, the official exchange rate remained stable at 5.33 UAH/USD, reassuring that the cash and interbank foreign exchange markets will return to their previous steady states.

The International Monetary Fund (IMF) has called on the NBU to end its policy of a strict unofficial peg to the US dollar. According to the IMF, the impression that the NBU will constantly guaranty a stable hryvnia exchange rate could prompt irrational loan policies and weaken the Ukrainian banking system. Nevertheless, the NBU does not intend to ease its strict control over the hryvnia/dollar exchange rate. The Governor of the NBU, Serhiy Tihipko, contends that Ukrainians are not yet ready for exchange rate fluctuations, and should a sizeable hryvnia depreciation occur would run towards investing their money in durable goods or hard currencies.

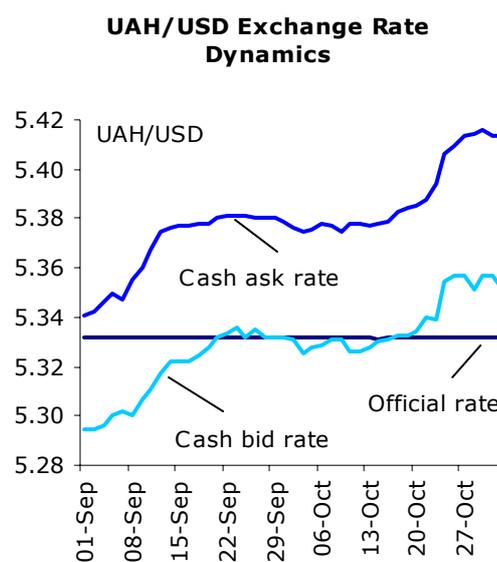
Government debt market. Emerging Markets, an international financial journal, has voted this year's issue of Ukrainian eurobonds to be the best state financial operation of 2003. According to this journal, the volume of the Ukrainian eurobonds orders reached USD 4.9 bn, while the total issue was USD 1 bn. The international rating agencies R&I and Fitch Ratings, which raised the rating of Ukraine's long-term borrowings in foreign currency from B to B+ with a stable outlook, confirmed this positive assessment of the Ukrainian eurobonds issue.



Source: State Treasury



Source: NBU, own calculations



Sources: NBU, Ukrainian financial server



Economic Trends		Q2 02	Q3 02	Q4 02	Q1 03	Q2 03	Q3 03	Jul	Aug	Sep	Oct
GDP growth (real)	% yoy	4.7	4.3	6.1	7.9	9.3	...	-5.6	5.9	15.0	...
GDP growth (real)	% yoy cum.	4.4	4.3	4.8	7.9	8.6	...	5.1*	5.3*	6.5*	...
Industrial production (real)	% yoy cum.	5.8	6.0	7.0	10.7	12.4	15.2	13.8	14.6	15.2	...
Agricultural production (real)	% yoy cum.	9.2	3.0	1.9	1.3	-6.0	-16.6	-33.5	-27.2	-16.6	...
CPI	% yoy eop	-1.1	-1.1	-0.6	4.3	5.9	6.2	7.4	5.8	6.2	6.8
PPI	% yoy eop	4.0	4.9	5.7	9.9	5.3	7.4	5.3	6.8	7.4	7.9
Exports (USD)***	% yoy cum.	2.4	6.9	10.7	24.6	23.8	...	28.8"	29.1"
Imports (USD)***	% yoy cum.	0.9	4.7	4.9	22.8	23.3	...	30.1"	31.2"
Merchandise trade balance	USD bn cum.	0.20	0.37	0.98	0.32	0.29	...	0.46"	0.40"
Current account	USD bn cum.	1.45	2.21	3.17	1.08	1.82	...	x	x	x	x
Current account	% GDP	8.3	7.5	7.6	11.9	9.2	...	x	x	x	x
Gross international reserves	USD bn eop	3.41	4.02	4.42	4.60	6.17	6.63'	6.51	6.85	6.63'	6.89'
Monetary Base	% yoy eop	38.0	42.9	33.6	24.4	34.2	31.0	29.3	32.0	31.0	30.7
Lending rate on UAH credits **	% pa, eop	25.0	20.1	19.5	17.9	17.2	18.1	18.2	18.2	18.1	17.8
Exchange rate (official)	USD aop	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33
Exchange rate (official)	EUR aop	4.88	5.24	5.33	5.71	6.05	6.00	6.07	5.95	5.97	6.23

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

' Own estimate based on net international reserves reported by the NBU

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

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

* Monthly figures do not include the regular quarterly revision of the GDP

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

*** Growth rate in dollar terms.

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