



# Monthly Economic Monitor Ukraine

- In January the President appointed new Ministers of Economy and European Integration, of Agrarian Policy, and of Industrial Policy.
- The Council of Europe threatens to expel Ukraine.
- Preliminary estimates show that the GDP increased by 8.5% in real terms in 2003.
- The Government decided to reimburse VAT to exporters of agricultural and food products despite the provisions of the 2004 Budget.
- The growth rate of goods imports continues to exceed that of exports, but the balance of trade in goods remains positive.
- The year 2003 ended with a central government fiscal deficit of nearly UAH 1 bn, or 0.4% of GDP.
- The NBU reacted to inflation by increasing its overnight rate from 8.0% p.a. to 8.5% p.a.
- The cash foreign exchange market regulation was tightened.

**No.2 (40)  
February  
2004**

**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: President appointed three new Ministers

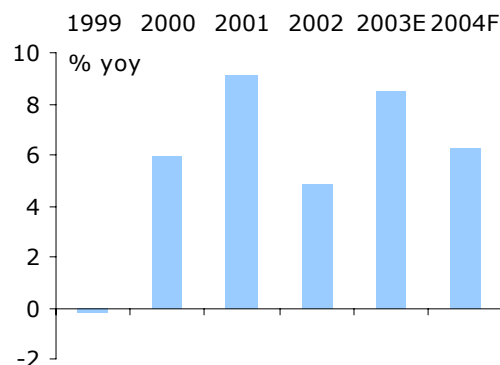
January was marked by the resignations of high-ranking officials, who voiced their opposition to the policy of the coalition government led by Viktor Yanukovich. The Minister of Economy and European Integration Valerii Khoroshkovsky and the head of the State Committee on Entrepreneurship Development and Regulatory Policy (CEDRP) Inna Bohoslovs'ka resigned from their positions. Inna Bogoslovs'ka wrote an open letter accusing the Vice-Prime Minister and Minister of Finance Mykola Azarov of improperly understanding economic policy and of harming business by his actions. Mykola Derkach, formerly Ukraine's ambassador to Lithuania, was appointed the new Minister of Economy, while the post of the Head of the CEDRP remains vacant.

Two other ministers were dismissed on the President's orders. Sergiy Ryzhuk left the post of Minister of Agrarian Policy. Viktor Slayuta, a former Verkhovna Rada deputy and a member of the Agrarian Party, became the new Minister. Olexander Neustroev, former chairman of Nikopolsky Pivdennotrubny Plant's board of directors, was appointed Minister of Industrial Policy, replacing Anatoliy Myalitsa.

The Parliamentary Assembly of the Council of Europe adopted a resolution concerning Ukraine's constitutional reforms. The Assembly threatens to expel Ukraine from the Council of Europe should the country continue to move in the direction of changing its constitution using improper methods, and should it fail to hold presidential elections by October 31, 2004. In December 2003 the Verkhovna Rada had adopted a law on constitutional amendments in first reading, which envisages among other points that starting in 2006 the President would be elected by Parliament. Also, the Constitutional Court had decided that the current president could participate in the forthcoming presidential election, although he has already served two terms since 1994. The expulsion of Ukraine from the Council of Europe would seriously worsen Ukraine's foreign position with negative political and economic consequences for the country.

The President of Russia, Vladimir Putin, visited Ukraine. This visit was dedicated to the discussion of important bilateral issues, such as the creation of an international gas consortium, which would manage Ukraine's gas transit capacities, as well as the issue of the Odessa-Brody pipeline. However, no official decisions were taken, and it is unlikely that the visit contributed much to the concordance of opinions concerning these long-standing issues.

## Real GDP Growth



Source: Derzhkomstat  
 E -- estimate by Derzhkomstat; F -- own forecast

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**Real economy: According to preliminary estimates, the real GDP grew by 8.5% in 2003**

According to Derzhkomstat’s preliminary estimates, the GDP grew by 8.5% in real terms in 2003. However, the final GDP figure is likely to be higher, since the cumulative increase in the real GDP between January and September had already been revised upward to 7.8% yoy from the previous 6.5% yoy. In 2003 the highest growth of value added was observed in construction. It increased by 23% caused by growing investment and by the low base of the previous year, when a 1.4% decline of construction had been registered.

The industrial output increased by 15.8% in 2003, compared to a 7.0% growth for the year before. Production grew in all sectors – extractive and manufacturing industries, as well as production and distribution of water, gas, and electricity, but the highest rise was in manufacturing (18.2% compared to 8.9% in 2002). The largest contributors to growth were metallurgy, machine building, and the food industry, all of which more than doubled their growth rates.

The only sector to weaken in 2003 was agriculture with an output decline of 10.2%. The poor grain harvest caused a 14.9% reduction in plant growing, while animal husbandry dropped by 3.0%.

**Sectoral trends: The government will reimburse VAT to exporters of agricultural and food products**

**Agriculture.** According to the 2004 State Budget Law, agricultural and food industry producers are now exempt from VAT payments. As a result, exporters of these products are no longer eligible for VAT refunds. To prevent losses by exporters and producers, the Cabinet of Ministers together with the State Tax Administration decided on VAT refund for all exporters of commodity groups 1-24 (agriculture and food products) until the Verkhovna Rada will settle the issue.

**Energy.** The President of Ukraine issued a decree ordering the Cabinet of Ministers to create a state joint-stock company “Energy Company of Ukraine”. It is planned that all state enterprises in the power generation and distribution sectors should be united under the roof of the newly created holding. The ongoing trend towards concentration of state presence on the energy market defeats moves towards privatization of generating and distribution capacities and endangers meaningful reforms in the sector.

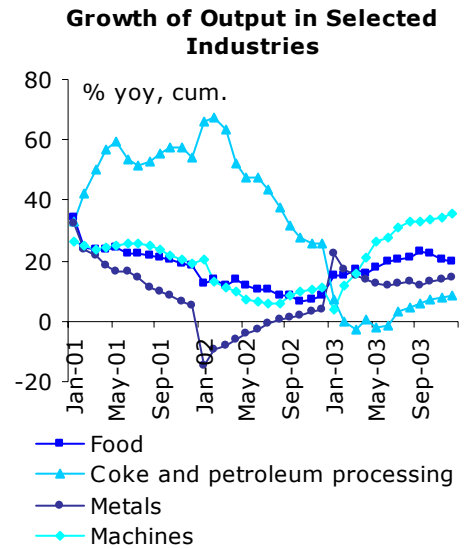
**External Sector: The balance of trade in goods worsened, but remained positive**

According to Derzhkomstat, goods exports increased by 27.9% yoy in dollar terms between January and November, and imports grew by 33.6% yoy. While import growth has been exceeding export growth since the beginning of the year, the trade balance of goods remained positive at USD 335 m, but declined compared to the USD 1039 m registered at the same time the year before.

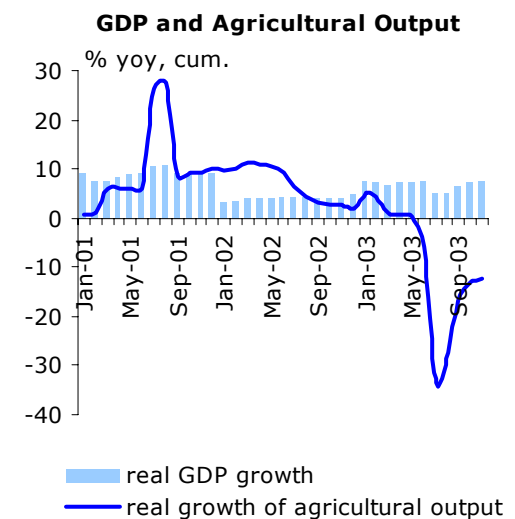
Rising sales abroad of mineral and chemical products, ferrous metals, and machinery and transport equipment accounted for the growth in aggregate exports. Due to a very poor grain harvest, grain exports dropped by 59%, compared to the same period in 2002 when they had more than doubled. At the same time, imports of grain increased from USD 22.2 m to USD 374.7 m, making Ukraine a net grain importer. In response to growing aggregate domestic demand, imports of mineral and chemical products, as well as machinery and transport equipment accelerated.

**Fiscal policy: The year 2003 ended with a central government fiscal deficit of nearly UAH 1 bn**

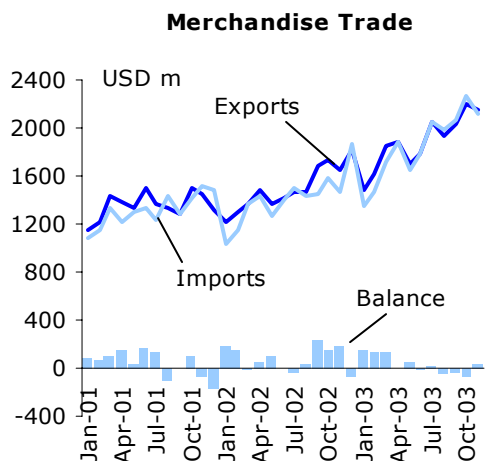
According to preliminary information, the central government’s fiscal revenues in 2003 were 3% higher than projected. The fiscal expenditures, on the other hand, were held at the projected annual level, although they were below projections throughout the year, except for December. Due to large expenditures made in December,



Source: Derzhkomstat



Source: Derzhkomstat



Source: Derzhkomstat

the central government's fiscal balance turned from a surplus to deficit of close to UAH 1 bn, or 0.4% of GDP for the whole year. The deficit was financed from privatization revenues, the issue of eurobonds, and from the USD 70 m tranche of the World Bank's Second Programmatic Adjustment Loan (PAL-II), approved in December and covering a total amount of USD 250 m.

By the end of December, a significant part of VAT refund arrears was repaid, thus the stock of arrears reduced approximately to UAH 1.8 bn, i.e. below UAH 2.4 bn amount put by the IMF as one of the conditions for signing Precautionary Stand-By Arrangement. Also, the government announced about conversion of the rest of overdue arrears into bonds, which allows fulfilling another IMF condition that overdue VAT refund debt is to be eliminated in the first half of 2004.

**Monetary policy: The NBU increased its overnight rate**

In January the NBU increased its overnight (lombard) rate from 8.0% to 8.5% p.a., but kept the refinancing rate at the level of 7.0% p.a. The increase in the overnight rate was a reaction of the monetary authorities to the higher than expected inflation, which reached 8.2% for 2003. The Governor of the NBU, Sergiy Tihipko, stated that further increases in the rate are not likely this year, since the real value of funds leaving the central bank is now positive and inflation in 2004 is expected to be lower than in 2003. Although the change of the overnight rate is small, it may spill over into interest rates on bank loans when taking the growing banking sector use of the NBU's standing facilities into account. The reduction of bank lending rates has continues, although at a slower pace. In 2003 the average interest rate on bank loans in national currency fell by 1.7 percentage points from 19.6% p.a. to 17.9% p.a., in contrast to a decline of 8.1 percentage points in 2002.

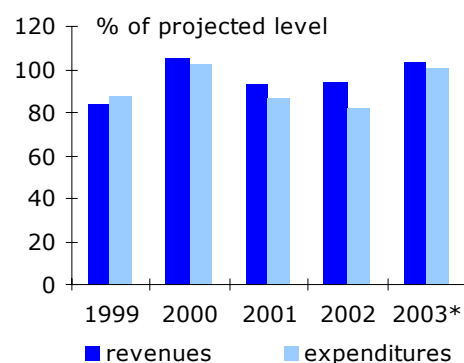
In January the monetary base increased by 30.0% yoy, while money supply grew by 47.3%. Inflation declined slightly to 8.1% yoy. It is expected that inflation will decelerate further this year and will be 6.6% yoy by the end of 2004.

**Financial markets: The NBU tightened the regulation of the cash foreign exchange market**

**Foreign exchange.** In January the NBU introduced a tighter regulation of the cash foreign exchange market. In particular, an exchange point will be closed after two violations of the regulations per year (instead of three), and the NBU will conduct unannounced examinations of exchange points with an average monthly turnover above UAH 100,000. Further, starting in March the exchange rate established at an exchange point starting from 8 p.m. to the beginning of the next trading day may not differ from the official exchange rate by more than 3%. Also, during any trading day an exchange point is not allowed to change its exchange rate more than once. The decree is intended to reduce the volume of illegal operations with foreign cash and to prevent cheating with exchange rates. However, the trading day restriction on the exchange rate flexibility is likely to contribute to higher bid-ask rate spreads, especially for the euro/hryvnia exchange rate, since exchange points will have to account for additional risks when their ability to react to changes in the exchange rates on world markets is limited by the one-change-a-day rule.

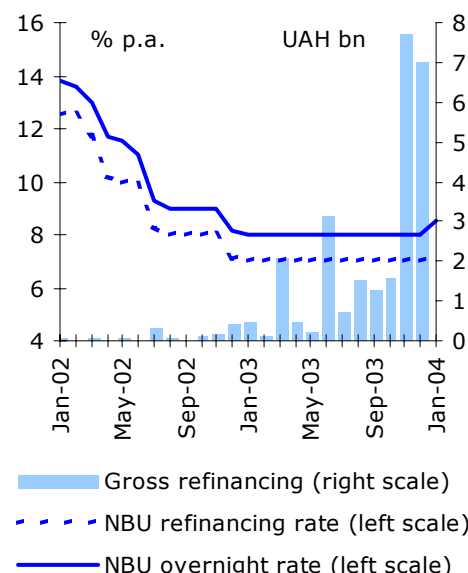
In addition, the Governor of the NBU, Sergiy Tihipko, announced that the NBU is not going to continue the active liberalization of the non-cash foreign exchange market in 2004. Last year the NBU increased the limits of the banks' open currency positions, simplified foreign currency purchases on the non-cash market, and permit conducting forward operations with hard currencies on international markets. Despite frequent calls by foreign traders to reduce the 50% level of obligatory sales of foreign currency receipts, this regulation was not eased in 2003 and - according to Sergiy Tihipko - neither will it in 2004.

**Execution Rate of Central Fiscal Revenues and Expenditures**



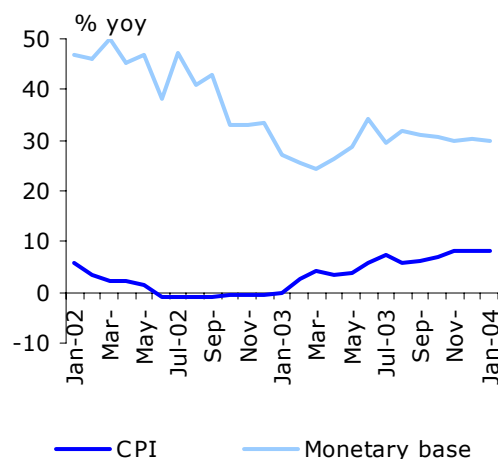
Source: State Treasury, Ministry of Finance  
Note: \* - preliminary

**NBU Rates and Volume of Gross Refinancing**



Source: NBU

**CPI and Monetary Base**



Source: Derzhkomstat, NBU



| <b>Economic Trends</b>         |             | <b>Q3 02</b> | <b>Q4 02</b> | <b>Q1 03</b> | <b>Q2 03</b> | <b>Q3 03</b> | <b>Oct</b> | <b>Nov</b> | <b>Dec</b> | <b>Jan</b> |
|--------------------------------|-------------|--------------|--------------|--------------|--------------|--------------|------------|------------|------------|------------|
| GDP growth (real)              | % yoy       | 4.3          | 6.1          | 7.9          | 9.3          | ...          | 12.3       | 12.1       | ...        | ...        |
| GDP growth (real)              | % yoy cum.  | 4.3          | 4.8          | 7.9          | 8.6          | 7.8          | 7.2*       | 7.7*       | 8.5*       | ...        |
| Industrial production (real)   | % yoy cum.  | 6.0          | 7.0          | 10.7         | 12.4         | 15.2         | 15.7       | 15.5       | 15.8       | ...        |
| Agricultural production (real) | % yoy cum.  | 3.0          | 1.2          | 1.3          | -6.0         | -16.6        | -13.1      | -12.3      | -10.2      | ...        |
| CPI                            | % yoy eop   | -1.1         | -0.6         | 4.3          | 5.9          | 6.2          | 6.8        | 8.1        | 8.2        | 8.1        |
| PPI                            | % yoy eop   | 4.9          | 5.7          | 9.9          | 5.3          | 7.4          | 7.9        | 9.4        | 11.1       | 12.4       |
| Exports (USD)***               | % yoy cum.  | 6.9          | 10.7         | 24.6         | 23.8         | 23.7         | 27.7"      | 27.9"      | ...        | ...        |
| Imports (USD)***               | % yoy cum.  | 4.7          | 4.9          | 22.8         | 23.3         | 25.1         | 32.9"      | 33.6"      | ...        | ...        |
| Merchandise trade balance      | USD bn cum. | 0.37         | 0.98         | 0.32         | 0.29         | 0.12         | 0.31"      | 0.34"      | ...        | ...        |
| Current account                | USD bn cum. | 2.21         | 3.17         | 1.08         | 1.82         | 2.49         | x          | x          | x          | x          |
| Current account                | % GDP       | 7.5          | 7.7          | 11.9         | 9.2          | 7.5          | x          | x          | x          | x          |
| Gross international reserves   | USD bn eop  | 4.02         | 4.42         | 4.60         | 6.17         | 6.68         | 6.88       | 6.95       | 6.90'      | 7.04'      |
| Monetary Base                  | % yoy eop   | 42.9         | 33.6         | 24.4         | 34.2         | 31.0         | 30.7       | 30.0       | 30.2       | 30.0       |
| Lending rate on UAH credits ** | % pa, eop   | 20.1         | 19.5         | 17.9         | 17.2         | 18.1         | 17.8       | 18.0       | 17.9       | 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       |
| Exchange rate (official)       | EUR aop     | 5.24         | 5.33         | 5.71         | 6.05         | 6.00         | 6.23       | 6.23       | 6.54       | 6.73       |

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 series

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

\*\*\* Growth rate in dollar terms.

| <b>Key Economic Indicators</b> |           | <b>1995</b> | <b>1996</b> | <b>1997</b> | <b>1998</b> | <b>1999</b>      | <b>2000</b>       | <b>2001</b> | <b>2002</b> |
|--------------------------------|-----------|-------------|-------------|-------------|-------------|------------------|-------------------|-------------|-------------|
| Nominal GDP                    | UAH bn    | 54.5        | 81.5        | 93.4        | 102.6       | 130.4            | 170.1             | 204.2       | 220.9       |
| Nominal GDP                    | USD bn    | 37.0        | 44.6        | 50.2        | 41.9        | 31.6             | 31.2              | 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              | 13.2              | 14.2        | 7.0         |
| Agricultural production        | % yoy     | -3.6        | -9.5        | -1.9        | -9.6        | -6.9             | 9.8               | 10.2        | 1.2         |
| 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        | 15.7             | 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 <sup>o</sup> | 1.2 <sup>oo</sup> | 1.4         | 3.1         |
| Current account                | % GDP     | -3.1        | -2.7        | -2.7        | -3.1        | 2.9 <sup>o</sup> | 3.8 <sup>oo</sup> | 3.7         | 7.7         |
| 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             | 45.2              | 36.3        | 34.3        |
| External debt (total)          | % GDP eop | 26.3        | 20.5        | 19.4        | 38.4        | 49.9             | 33.0              | 26.0        | 24.6        |
| 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

<sup>o</sup> 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

<sup>oo</sup> 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:

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