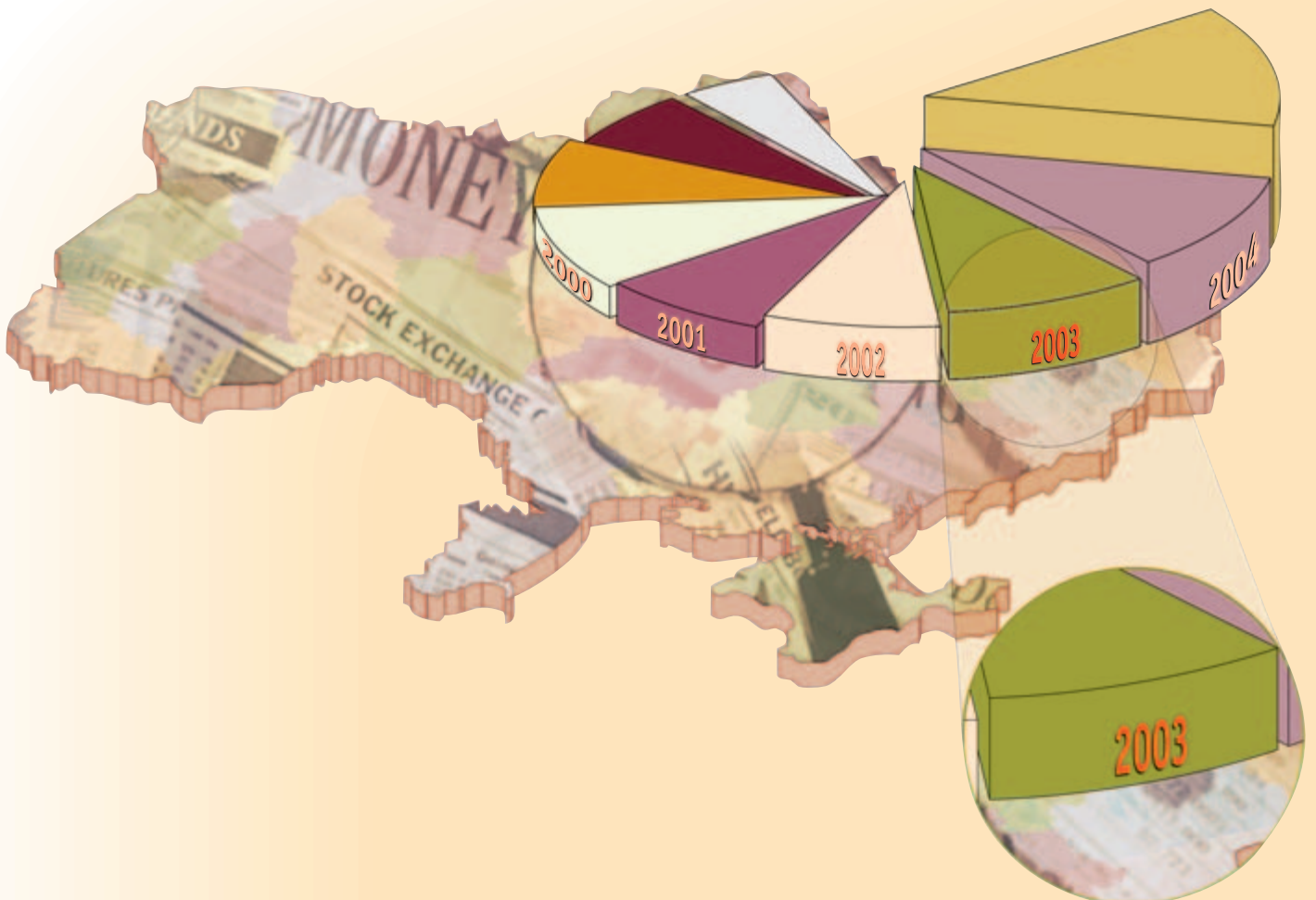


# Ukrainian Odyssey: Economy 2003

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**Ukrainian Odyssey:  
Economy 2003**

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## Overview

Following a decade of economic decline, Ukraine has gradually turned to a steady growth path. Macroeconomic stabilization and favorable external conditions contributed to rapid economic recovery in 2000-2001. After an impressive economic performance in 2000-2001, Ukraine's economic growth slowed in 2002 as external conditions deteriorated. Nevertheless, the Ukrainian economy demonstrated one of the highest growth rates in the region during the year. Strengthening domestic consumption, a gradually improving external environment and continuing investment expansion contributed to close to 5% GDP growth in 2002. The major sectors that drove economic growth during 2002 were industry, wholesale and retail trade and agriculture.

Relatively rapid expansion of capital investments and continuous growth of foreign direct investment inflow in 2002 provide evidence of positive development of the real sector. Although the overall level of FDI attracted into Ukraine's economy has been one of the lowest in the region, its sustained growth since the financial crisis of 1998 proves that the Ukrainian economy is becoming more attractive for foreign investment. On the other hand, an increase in foreign direct investment inflow was more than offset by massive portfolio outflows, driven mostly by political instability and some legislative deficiencies.

In 2002, the current account surplus increased significantly, driven by strong exports and a high level of transfers, and international reserves continued to accumulate. Constant interventions by the National Bank of Ukraine contributed to the stability of the national currency against the US dollar, and to a rapid growth of monetary aggregates that accommodated high money demand during the year. The growing working capital needs of the real sector were partly satisfied by a marked increase in commercial bank lending. At the same time, the cost of loans and their maturity structure were not conducive to wide use of loanable funds to finance long-term investment projects of enterprises.

Good harvest was the main reason for a substantial decline in inflation during the year. Consumer prices followed a deflationary path in 2002 that, in combination with a sizeable shortfall in privatization revenues, led to fiscal expenditure cuts and an increase in government borrowing in order to avoid substantial fiscal deficit. At the end of the year, Ukraine placed a new Eurobonds issue and resorted to additional borrowing from domestic creditors to satisfy its financing needs. As a result, the consolidated budget posted small surplus as of end-of-2002 and the stock of Ukraine's public debt has increased. Nevertheless, the country's debt to GDP ratio remained relatively modest at 34% of GDP in 2002.

Although the beginning of 2003 has brought about positive economic and political developments, as the external environment remained favorable, the gradually unfolding presidential election campaign contributes to a generally cautious investor attitude towards Ukraine. However, Ukraine's substantial progress in tax reform and the WTO accession process coupled with the generally optimistic macroeconomic climate sends positive signals to the international investment community. Among the recent achievements of Ukraine are the following:

- An impressive 7.5% GDP growth in the first half of 2003
- Real household incomes continued to grow, indicating an improvement in living standards
- Adoption of the new tax laws reflects the government strong intentions to proceed with structural reforms
- Sound external debt management led to successful Eurobonds placement in June 2003, which followed an increase in the country's international investment ratings
- The favorable external environment drove foreign trade surpluses, which allowed for the National Bank's international reserves to reach record high levels

- Improvement of the country's international image following cancellation of FATF sanctions and warming relations with the US government

Even though Ukraine's macroeconomic performance has been improving significantly over the last three years, a number of economic risks are still in place. Despite the fact that consumer inflation accelerated to almost 6% in the first half of 2003, monetary policy remains loose. Poor expectations for the 2003 agricultural output contribute to fears of further acceleration of consumer inflation.

Renewal of suspended adjustment lending from the international financial institutions remains uncertain as the government has yet to demonstrate its ability to cope with outstanding problems, such as reduction of VAT refund arrears and abolishment of tax privileges.

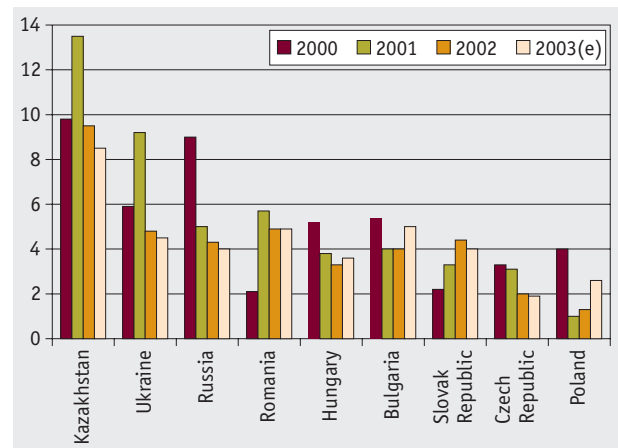
Subsequent sections of the report present the results of Ukraine's economic development for 2002 and discuss the future prospects for 2003. The evolution of the key economic indicators for 1997-2002 and projections for 2003-2004 are provided in Appendix.

## I. Real Economy

In 2002, GDP grew by 4.8%, which fell more than 1% short of original expectations. This represents a marked slowdown in economic growth compared to 2001 when GDP increased by an impressive 9.2% year-over-year (yoy). Nevertheless, 2002 was the third consecutive year of economic recovery after eight years of stagnation since independence. The peculiar feature of the GDP growth in 2002 was the relatively higher reliance on domestic rather than external demand. During the year, the Ukrainian economy demonstrated one of the highest growth rates in the region amid a global economic slowdown. As in previous years, manufacturing and trade made the biggest contributions to the value added in 2002. The economic recovery in transition countries and Ukraine's major trading partners, and strengthening domestic consumption were the driving forces of continuing output growth in the country.

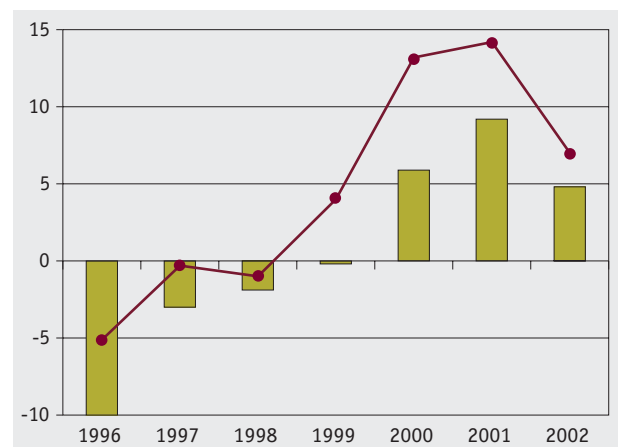
Industrial performance was quite modest in 2002 compared to the impressive rates of growth demonstrated in 2000-2001. In 2002, industrial production growth slowed to 7% yoy, as performance of exporting industries deteriorated due to the worsened external environment. The effects of the global economic slowdown were largely negative for raw materials and semi-produced goods markets. Therefore, market conditions for Ukraine's main exporting commodities such as metals and chemicals worsened, with corresponding negative implications for the overall economic development of the country, as the share of these industries in the total industrial output remained large. At the same time, industries oriented towards the domestic market, especially the food processing industry, have been strengthening their positions in recent years. A gradual increase in household income and improved financial stability fueled the rapid recovery of these industries. The fact that industrial growth has closely followed the GDP dynamic in recent years implies that broad-based industrial development is instrumental for further economic growth in Ukraine.

**Figure 1: Real GDP Growth in Ukraine and Selected Transition Economies, 2000–2003**



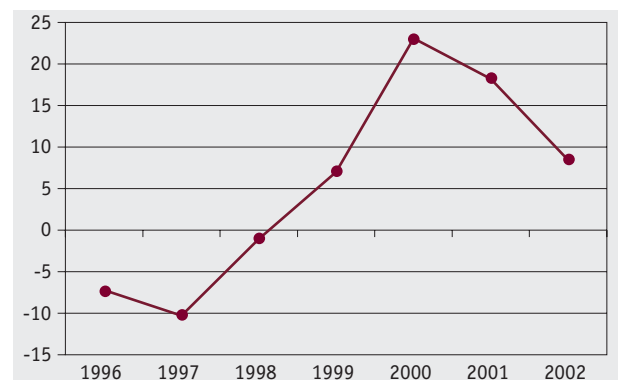
Source: World Economic Outlook, IMF

**Figure 2: Real GDP and Industry Growth in Ukraine**

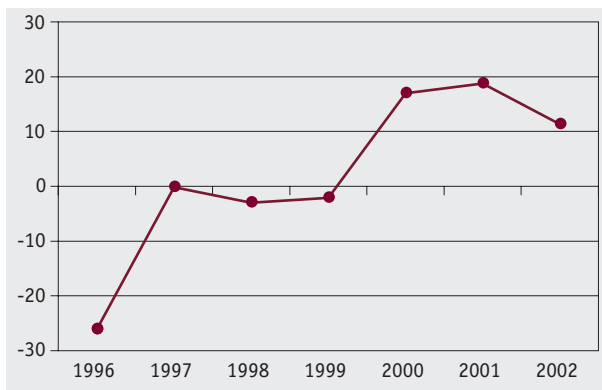


Source: State Statistics Committee

**Figure 3: Food Industry Growth, % yoy**



Source: State Statistics Committee

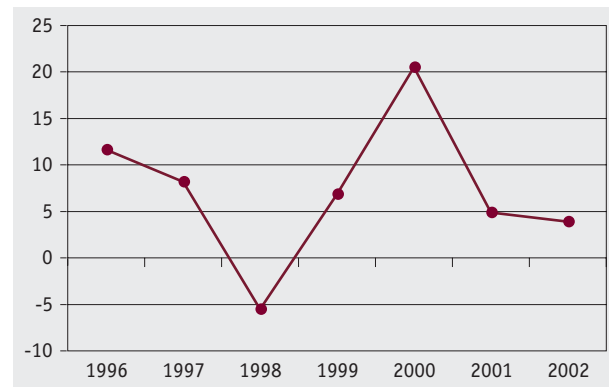
**Figure 4: Machine-Building Industry Growth, % yoy**

Source: State Statistics Committee

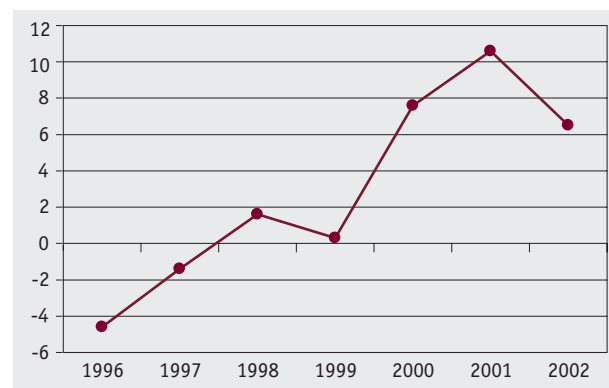
The largest contributors to overall industrial growth in 2002 were food processing, machine building, and the coke and petrochemical industry. Although the coke and petrochemical industry demonstrated the highest rates of growth over the last two years, its share in total industrial output constitutes about 5%. During 2001 and 2002, this industry was one of the most rapidly growing sectors in Ukraine, with production volumes increasing by 54% yoy and 26% yoy respectively. Growth in the food industry also outperformed the aggregate rate of industrial growth in 2002. Over the year, output in the food industry grew by 8.4% yoy. This represents a substantial deceleration compared to the rates of growth in previous years, which is largely explained by the less abundant agricultural harvest in 2002. It is worth mentioning that apart from strengthening domestic demand, the rapid recovery of food production took place because food processing has been one of the largest recipients of foreign direct investments. The introduction of up-to-date technologies, production promotion techniques, and efficient management also allowed Ukrainian producers of food products to expand their activity beyond the domestic market. Food processing is quite a diverse sector in Ukraine. During 2002, considerable development occurred in meat processing (up 30% yoy), fruit and vegetables processing (up 22.5% yoy), and beverages (up 16.2% yoy).

Machine building has been demonstrating high rates of growth over the last several years. Production in the sector recovered in 2000, and the industry has managed to sustain double-digit growth rates since then. In 2002,

machinery production increased by more than 11% compared to 2001 production levels. Although production expansion in the sector decelerated in 2002, there was a significant increase in production of transportation vehicles (+30% yoy), including 64.1% yoy production growth of locomotives and 23.3% yoy growth in the automobile industry. Rapid recovery in the sector is attributed to strengthened domestic demand and the inflow of investments (including foreign.) At the same time, Ukrainian machinery gradually gained positions on external (primarily CIS) markets, since the sector enjoys a low cost of skilled labor; wage levels in Ukraine still remain among the lowest in the CIS.

**Figure 5: Metals and Metal Processing Industry Growth, % yoy**

Source: State Statistics Committee

**Figure 6: Chemical Industry Growth, % yoy**

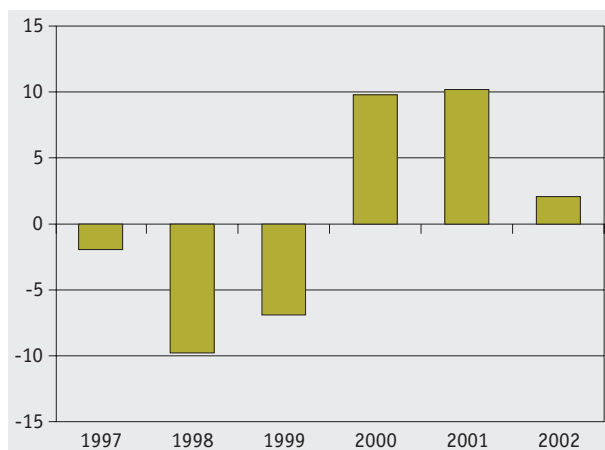
Source: State Statistics Committee

Growth in the metallurgic and metal processing industry decelerated in 2002, reflecting weak external demand. Ferrous metals and steel products remain the major export commodities of Ukraine, and the weightiest com-

ponent of the total industrial output of the country. Therefore, Ukraine's GDP growth is quite sensitive to movements on world metals market. Following an impressive pickup in metals output in 2000 (up 21% yoy), growth in this sector slowed to 5% yoy in 2001 and 4% yoy in 2002. Production deceleration in the sector could have been even more profound, but world prices for metals began to stabilize in the second half of 2002 and Ukrainian exporters managed to reorient their trade towards recovering Asian markets. Also, production expansion in machine building and gradually reviving activity in the construction sector fueled domestic demand for metals. However, domestic consumption does not exceed 20% of metallurgic output. Apart from external factors, further development of construction and machine building will also determine production patterns in the metallurgical industry. However, the sector needs substantial investment to improve energy efficiency in production in order to increase the competitiveness of its output on world markets. So far, metallurgical enterprises have enjoyed state support in terms of tax privileges, which also facilitated production growth. However, further expansion in metallurgy is limited because of a number of anti-dumping measures imposed by traditional trading partners, but the situation should improve upon Ukraine's accession to the WTO.

agricultural output increased by 2.1% yoy during the year, which is considerably lower than the impressive 9.8% and 10.2% growth rates observed in 2000 and 2001 respectively. The slowdown could be explained by statistical base effects (a relatively high benchmark level in 2001) rather than by a significant reduction in physical output volumes. The good harvest in 2000-2001 with the corresponding reduction in prices for feed crops on the domestic market contributed to the growth of animal production, which increased 5.6% compared to 2001. The livestock industry has been gradually increasing its production volumes over recent years, but overall profitability in the sector remained low. Poultry production reached the breakeven point in 2002 when its profit rate reached 8.8%. Overall crop production in 2002 dropped by 2% compared to 2001, largely due to the reduction of planting area by almost 3% during the year. After a sharp decline in 2001, sunflower output saw an impressive 45.3% growth due to an increase in the planting area and improved productivity. Production growth in the sector was a result of reforms implemented by the government that improved the ownership structure of enterprises operating in agriculture as well as currently existing tax incentives for agricultural producers (in particular, a special VAT regime and tax refunds for inputs.) The share of output produced by private agricultural enterprises has increased from 58% in 2001 to 60% in 2002.

**Figure 7: Agricultural Output Growth Dynamics**



Source: State Statistics Committee

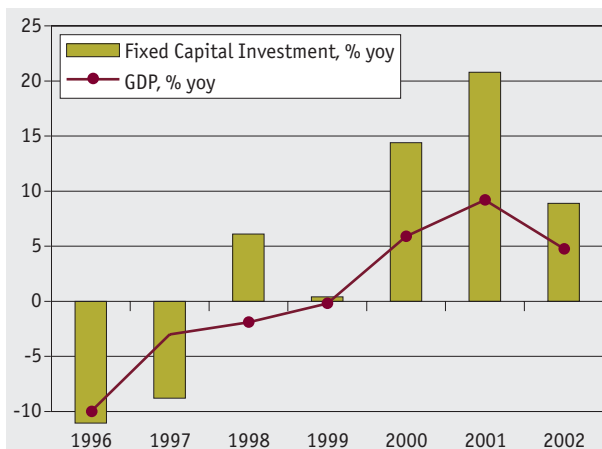
Growth in agriculture has been reported for the third consecutive year, although the pace of growth slowed significantly in 2002. Gross

The services sector demonstrated impressive development in 2002, and made a weighty contribution to overall GDP growth. However, the sector's share in GDP still remains at 45%, relatively low compared to other transition countries such as Poland and the Czech Republic. This indicates the rather high expansion potential for services and the construction sector based on the size of the Ukrainian market.

The wholesale and retail trade performance turned out to be quite modest in 2002 as compared to the previous year, when it was one of the major driving forces of economic growth. During the year, wholesale and retail trade grew by slightly more than 8% yoy compared to 43% yoy in 2001. The slowdown took place largely on account of the lower volumes of wholesale trade while retail sales have been on

the rise. Still, most of retail sales takes place at casual markets, street vendors and small retail outlets rather than western-style supermarkets as occurs in more advanced transition countries. The share of retail transactions performed through modern supermarkets has been slightly higher than 3% in Ukraine, compared to 30% in the Czech Republic. At the same time, the transportation sector significantly improved its overall performance in 2002. Value added growth in the sector reached 5.8% yoy compared to a modest 0.7% in 2001. Freight turnover increased by 3.3% yoy in 2002, including substantial increases in railway and automobile freight turnovers. Most of the companies operating in the sector are still state-owned, which hinders the attraction of private capital needed for renovation of worn-out equipment. Taking into account that the transportation sector makes up 15% of Ukraine's GDP, overcoming the negative tendencies in this sector will be instrumental for further economic development of the country.

**Figure 8. Fixed Capital Investment Growth, % yoy**



Source: State Statistics Committee

On the demand side, GDP growth in 2002 was largely driven by final consumption and exports, while the investment component was considerably lower. Household consumption increased by 5.6% yoy primarily due to rapid income growth. Gross accumulation of fixed assets has been following an increasing trend since 2000, generally repeating GDP growth dynamics. However, rates of fixed capital investment growth outperformed the rates of economic growth. In 2002, growth of fixed capital investment was 8.9% compared to 2001.

Capital investments in wholesale and retail trade almost doubled in 2002. Significant capital investments were made in communications (up 17% yoy) and agriculture (up 16.6% yoy). A positive development took place in energy and water distribution, where fixed capital investment also grew by almost 17% yoy, which can be attributed to the privatization of the six energy-distributing companies during the year with the participation of foreign investors. The processing industries managed to increase their fixed capital by 14% yoy in 2002. The effect of capital investment growth has been the rapid development of the above-mentioned industries. In 2002, substantial growth of capital investments occurred in housing construction. More than 12% of overall capital investments went into this sector. Strong demand and increasing purchasing power of the population suggest further development of housing construction and an increase of its attractiveness to investors. Positive trends were seen in investment dynamics in education and health care sectors as well.

## Future Prospects

The broad-based growth of the Ukrainian economy accelerated at the beginning of 2003 driven by strong external and domestic demand. In the first half of 2003, real GDP growth picked up by 7.5% yoy, which represents an almost twofold increase compared to the same figure a year ago. The major contributors to GDP growth were construction, processing industries, and utilities. After a decline during the past few years, construction is finally on the rise. Significant growth in office, trade, entertainment facilities and housing construction in most urban areas led to a significant leap (up 22% yoy) in the sector in 2003. In January-June 2003, growth of export-oriented metallurgy and chemicals was 12.1% yoy and 13.8% yoy respectively. Domestic-oriented industries also demonstrated high rates of growth during the first six months of 2003, driven by strengthening domestic demand. Over the period, growth in the food and wood processing industries picked up by 20% yoy and 22% yoy respectively. Higher utility requirements of rapidly growing energy-intensive industries like met-

allurgy contributed to the growth in utility generation, which posted an impressive 10.5% yoy growth during January-June. Growing demand for transport services encouraged further expansion in machine building, which reached a record high 28% yoy rate of growth. At the same time, value added in agriculture has shown negative growth in the first half of 2003 as compared to the same period of 2002. Unfavorable weather conditions threaten the agricultural harvest in 2003, thus contributing to fears of deteriorating macroeconomic indicators until the end of the year.

According to official forecasts, GDP growth should reach an expected 5-6% in 2003, which seems realistic assuming strong external demand for key export commodities remains in place until the end of 2003. International organizations are more conservative in their macroeconomic forecasts. The IMF expects GDP growth of 4.5%, while the EBRD forecast is 4%.

However, a lack of investments and diminishing public consumption will limit economic growth during the year. Heavy payments on external debt will not allow the government to expand investment into infrastructure sectors and to increase its consumption. So far, the rates of investment growth have been insufficient to sustain rapid economic growth in the long-run. The main source of investment is still the own financial resources of enterprises, which make up 66% of total investment volume. Commercial bank loans, which make up less than 5.3% of total capital investments, are concentrated on short-term borrowings. Therefore, the government should consider the development of long-term credit and the attraction of foreign investment as a very important task for further economic growth. Also, a substantial increase in foreign investment inflow is necessary to secure further acceleration of economic growth in Ukraine.

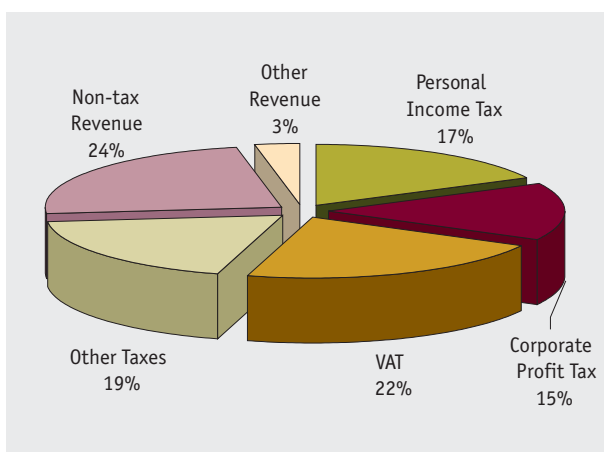
## II. Fiscal Policy

In 2002 the country continued to exercise the cautious fiscal policy it started following the financial crisis of 1998. The main achievement of 2002 fiscal policy was the rather good control of the fiscal budget by the government. The country ended the year with a fiscal surplus despite serious problems plaguing the public finance sector: difficulties with tax collection, failure of privatization efforts, problems with loans from international organizations, growing tax arrears, and widespread tax privileges and exemptions. The consolidated budget revenues reached \$11.6 billion, or 28% of GDP, while expenditures were slightly behind at \$11.3 billion, or 27.3% of GDP, generating a surplus of 0.7% of GDP.

### Fiscal Revenues

In 2002, 73% of the consolidated budget revenues came from tax payments. This number continues an upward trend in the share of tax receipts in the structure of fiscal revenues, and it shows an increasing reliance of the government on tax-related sources of the fiscal budget.

**Figure 9: Structure of Consolidated Budget Revenues in 2002, % of total**



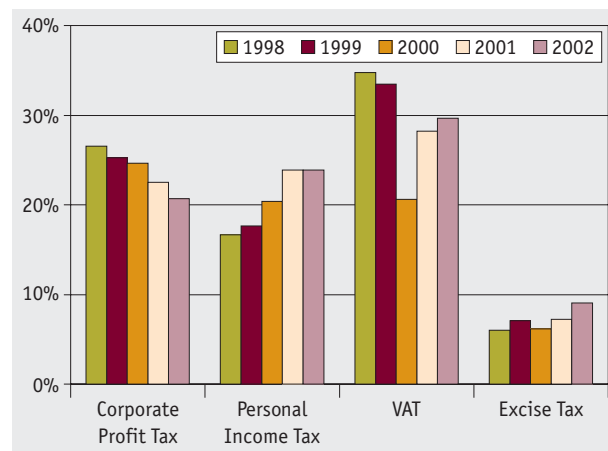
Source: State Treasury of Ukraine

The main reasons for the increase (up from 65% in 2000 and 68% in 2001) are found in the improved economic activities in the country, which resulted in increased industrial produc-

tion and trade (more VAT and excise taxes paid), and higher salaries (more personal income taxes paid). At the same time, the share of corporate profit tax shrank further, as companies often evaded payment of profit taxes they owed to the state, thus accumulating significant tax arrears.

Fiscal revenues in 2002 suffered from inadequate tax collection, mainly related to corporate profit taxes. In fact, over the year the volume of tax arrears to the budget more than doubled in size to reach \$2.8 billion. Nearly half of this amount came from VAT arrears, and about 30% was due to corporate profit tax arrears. The largest debtors continued to be state-run companies such as Naftogas Ukrainy (tax arrears equal to \$770 million) and Energoatom (tax arrears of \$118 million.)

**Figure 10: Major Tax Proceeds, % of total tax-related revenues of consolidated budget**



Source: State Treasury of Ukraine

At the same time, the parliament continued to grant tax exemptions and privileges, which resulted in big pressure on the fiscal budget. About 19% of the country's companies and institutions were granted such privileges. The total amount of tax exemptions and privileges reached \$10.6 billion and nearly equaled the consolidated budget revenues in size. Such practices significantly reduced the tax base, and in fact became a political rather than economic instrument.

On the other hand, in 2002 the government continued to accumulate debts on VAT refunds to exporters, with repayments of such debts being very slow. This issue soured relations with the IMF, which requires the government to repay VAT refunds as a pre-condition for receiving any further financial inflows from them.

Non-tax revenues accounted for 24% of the consolidated budget revenues, versus 25% the year before. These were mainly revenues for services rendered by state-funded entities, revenues from property and business activities of the state, and various administrative fees and charges. In 2002, privatization proceeds were moved from fiscal revenues into deficit financing.

However, low privatization inflows were also accountable for problems with the fiscal budget. The State Property Fund collected just above 10% of its ambitious \$1.1 billion annual target. The main reason for the shortfall was the failure to sell the telecommunications monopoly, Ukrtelekom, and the regional energy distribution companies (the "oblenergosts"). The transaction to sell the state's share in the leading mobile telecommunications provider, Ukrainian Mobile Communications, took place in 2002, but the budget did not receive this money by year-end due to legal disputes.

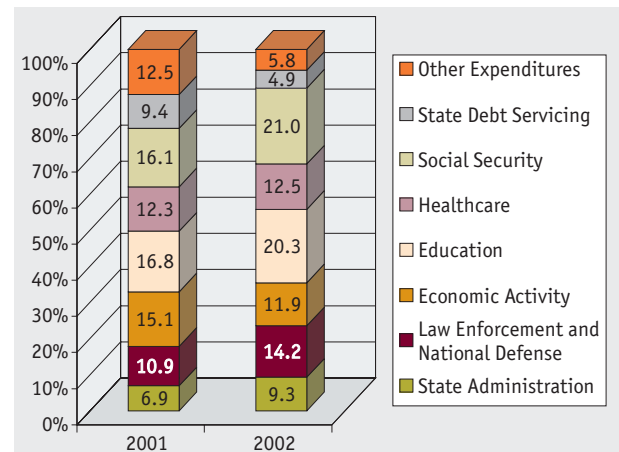
## Fiscal Expenditures

Fiscal expenditures in 2002 were again significantly below plan, coming in at about 85% of the planned consolidated budget expenditures.

The structure of fiscal expenditures is presented in Figure 11. A few positive trends should be noted here. The share of fiscal expenditures directed to social needs, such as education, health care, and social security, grew compared to 2001. Also, servicing of state debt was about half the share of 2001. Such expenditure items as the military, economic activities of the state, and general functioning of the state administration were financed by 80% of the target amount, or less, which also saved some resources for the government.

The authorities succeeded in financing nearly all "protected" items, such as social security and social care, education, and healthcare.

**Figure 11: Structure of Consolidated Budget Expenditures, % of total**



State Treasury of Ukraine

Throughout the year, fiscal revenues were coming in rather evenly. On the other hand, fiscal funds were used on a rather sporadic basis to cover arising needs. For example, as of July 1, fiscal expenditures of the consolidated budget were \$4.95 billion. In two months, they reached \$8.2 billion. Thus, about 30% of the year's expenditures were spent in July and August. Most of these funds were directed toward financing the harvesting campaign and state purchases of the abundant new crop. This episode once again demonstrates a lack of established procedures that governs the public finance sector.

Continuing its balanced fiscal policy, the government was trying to control the fiscal expenditures at the level of fiscal revenues. So, the government found itself unable to finance some of its planned expenditures. The problem was intensified by the refusal of the IMF and the World Bank to provide new loans that the government was relying on. Along with measures to improve the situation with fiscal revenues, the government succeeded in obtaining external financing of about \$400 million on rather favorable terms. This, together with financing the non-critical expenditures at lower-than-planned levels, allowed the government to end the year with a \$0.3 billion surplus of the consolidated budget.

## Future Prospects

The parliament approved the 2003 fiscal budget with a planned deficit of \$0.6 billion, which would amount to 1.2% of GDP. The 2003 budget was praised by the IMF and other international organizations as the most progressive and realistic one in Ukraine's recent history.

However, the biggest problem with the 2003 fiscal budget is that it was created using a minimum monthly wage number (which is the basis for calculation of most social payments) of UAH 165 (\$31), but according to the new law this number was increased to UAH 185 (\$35) as of January 1, 2003, and up to UAH 237 (\$44) as of July 1, 2003. Political discussions continued well into 2003 on whether to have the new minimum wage numbers imposed as of July 1. If the issue was left unresolved, the country's fiscal budget would be under extreme pressure since it would require the government to raise an additional \$1.3 billion to finance the minimum salary increase. Plus, a higher minimum wage requirement may force many companies to lay off their employees and lower the salaries of others to the minimum salary level to compensate, thereby destroying incentives for qualified workers.

However, the parliament passed the law to postpone the minimum salary increase from July 1 to December 1, 2003. Also, the parliament increased the 2003 fiscal budget by \$551 million (or by 5.9%) to finance the minimum salary increase, and to support agricultural producers that suffered from severe weather conditions in winter 2003.

The government is planning to finance the fiscal deficit mainly through privatization proceeds along with internal and external borrowings, while the bulk of the new borrowings would be directed to meet massive debt repayments. However, successful budget execution in the first half of 2003 makes the government optimistic. The privatization process also looks capable of providing the necessary funds, while the government takes a more aggressive position to meet the planned numbers.

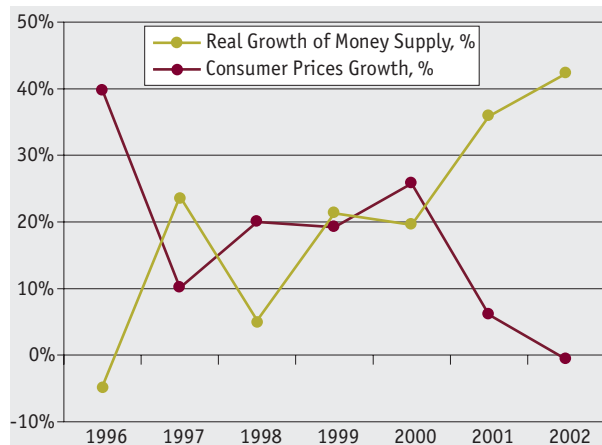
The parliament is actively discussing tax reforms, which have a good chance of being passed in 2003 and coming into force in 2004. If adopted, the new tax laws would significantly reduce corporate profit tax, value added tax and personal income tax, cancel most tax exemptions and privileges, thus creating a larger tax base and bringing more money out of the shadow economy.

### III. Monetary Policy

2002 was another year of expansionary monetary policy in Ukraine, which can be characterized by abundant money supply, falling interest rates, further liberalization of the financial markets, and relative stability of exchange rates, topped with a reduction in consumer price levels. The main feature of the monetary policy in 2002 was that the National Bank of Ukraine (NBU) was managing the money supply mainly to accommodate the growing needs of the real sector. The NBU saw the change of its governor as a result of the new Ukrainian government coming to power in November.

#### Money Supply

**Figure 12: Money Supply and Consumer Prices Dynamics**



Source: National Bank of Ukraine, State Statistics Committee.

The money supply grew by 42%, quite in line with the previous years' rates. Base money increased by 33.6% (37.4% in 2001), while cash in circulation was up by 35.7% (compared to 52% in 2001, 34% in 2000 and 1999). These numbers came as a result of the National Bank's continued policy of "cheap money" for the economy, combined with its vast positive balance of buying the foreign exchange at the inter-bank market. In total, using different monetary instruments, the NBU has directed about \$2.6 billion into the economy, including \$225 million through bank refinancing operations. The monetization of GDP reached 24.9% of GDP,

up from 19.2% in 2001, and 18.4% in 2000. Despite such significant growth in money supply indicators, it did not result in increasing price levels because of the high money demand from the growing economy.

The NBU significantly reduced the mandatory reserve requirements for commercial banks, thus allowing the banks more resources for their operations. Because of this instrument, commercial banks improved their liquidity by about \$560 million. As a result of the government monetary policies and revival of business activities, commercial bank lending to the real sector continued to grow considerably: it increased by 48.2% (45.6% in 2001). Such growth was assisted in part by higher amounts of deposits held in banks by both companies and individuals (increase of 28.8% and 76.5%, respectively). This can be explained by the intensified economic activities of companies, more money moving out of the shadow economy, and individuals regaining trust in the banking sector as a means to store their increasing savings.

#### Inflation

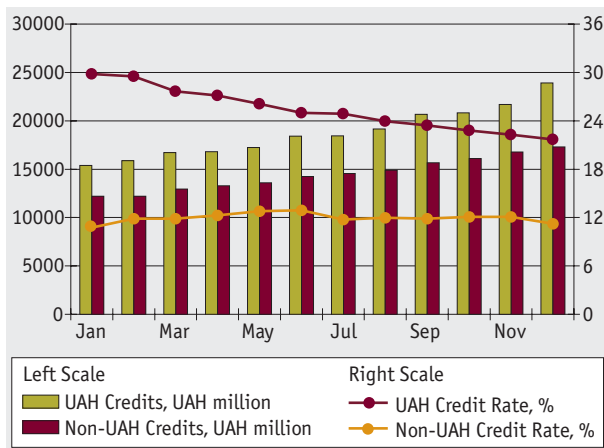
Ukraine experienced deflation for the first time in its contemporary history in 2002. Consumer prices were falling throughout most of the year, mainly fueled by decreasing food-stuff prices, which came as a result of abundant agricultural crops in both 2001 and 2002. The Consumer Price Index (CPI) saw a reduction of 0.6% yoy (compared to 6.1% growth in 2001). The country faced even more significant cuts in consumer prices early in the year, which were offset by an upward trend by year-end.

The Producer Price Index (PPI) increased by 5.7% yoy in 2002, compared to 0.9% yoy growth in 2001, and a 20.8% increase in 2000. Producer prices have grown mainly due to increasing production costs associated with rising energy prices. Producer prices started to increase in the second quarter and continued their rally through year-end.

## Interest Rates

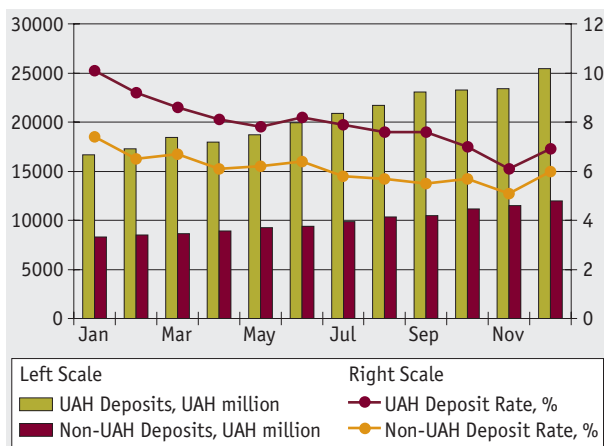
Interest rates continued to fall throughout 2002. The NBU discount rate was revised downward four times in 2002: from 12.5% at the beginning of the year down to 7.0% at year-end. However, this reduction is smaller in magnitude than the one in 2001: the rate dropped more than twofold then. Commercial bank lending rates in UAH were falling as well, from 27.4% down to 19.5% by year-end, while lending rates for foreign currencies were rather stable, fluctuating around the 11.9% year average. This allowed for a further increase in the amount of commercial bank loans, as noted before.

**Figure 13: Dynamics of Credit Rates and Crediting Volumes in 2002**



Source: National Bank of Ukraine

**Figure 14: Dynamics of Deposit Rates and Amount of Bank Deposits in 2002**



Source: National Bank of Ukraine

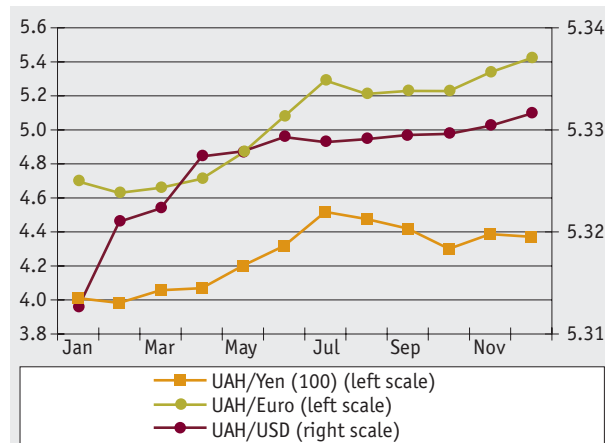
At the same time, commercial banks deposit rates continued to fall as well—from 9.5% at the beginning of the year down to 6.7% by year-end. Nevertheless, the amount of bank deposits grew by an average of 47% over 2002. Notably, deposits in the national currency saw much greater growth than those in foreign currencies, which shows that the hryvnia was regaining credibility with companies and individuals.

Interestingly, the "risk premium" between interest rates for the hryvnia and for foreign currencies was just a few percentage points for bank deposit rates (10.1% in UAH versus 7.4% in foreign currencies in January, and 6.9% versus 6.0%, respectively, in December), and two- to three-fold for bank credit rates (29.7% in UAH versus 10.8% in foreign currencies in January, and 21.8% versus 11.3%, respectively, in December.) There was a clear trend toward the convergence of interest rates for the hryvnia and foreign currencies, which shows an increasing trust in the stability of the national currency.

## Exchange Rate

The official USD/UAH exchange rate remained rather stable throughout the year. The hryvnia gradually slid against the dollar, from 5.3126 UAH/USD in January to 5.3316 UAH/USD in December (period average), or by a mere 0.36%. Such remarkable stability can be attributed to a nearly constant excess supply of US dollars on the country's foreign exchange market, which came mainly from grain and metal exporters. Another reason for UAH/USD exchange rate stability was a weakening US dollar, which was losing value against the major world currencies, especially the Euro, throughout the second half of 2002. In fact, the hryvnia depreciated significantly against the Euro: from 4.6965 UAH/Euro in January to 5.4224 UAH/Euro in December, or by 15.5%.

**Figure 15: Dynamics of Official Hryvnia Exchange Rates in 2002**



Source: National Bank of Ukraine

Excess supply of foreign exchange at the inter-bank market allowed the NBU to fill its gross international reserves significantly: they have grown from 3.1 billion in USD equivalent at the beginning of the year, to 4.4 billion in USD equivalent by year-end, or by about 43%. NBU net buying of foreign exchange totaled 1.7 billion in USD equivalent. The year-end level of gross international reserves was equivalent to 10.7 weeks of import coverage, versus 7.8 weeks in 2001.

The UAH/USD cash exchange rate experienced greater fluctuations throughout the year than the official exchange rate. It started at 5.17 UAH/USD in early January (below the official exchange rate of 5.31 UAH/USD for the period), rose and fell to reflect perceptions of US dollar strength and weakness, and ended the year at 5.32 UAH/USD, falling by 2.9% in total. One could argue that the cash UAH/USD exchange rate was a better indicator of US dollar position than the official UAH/USD exchange rate.

The cash hryvnia/euro exchange rate was falling steadily throughout the year, from 4.63 UAH/Euro in January to 5.38 UAH/Euro in December (a 16.2% decline, quite in line with the official exchange rate depreciation.) One should note that the regulation imposing a 5% band on fluctuations in the cash exchange rate around the official exchange rate remained in force in 2002, thereby impeding uncontrolled fluctuations of the cash exchange rates.

## Future Prospects

The NBU will continue its policy of liberalizing the financial sector, which will give more flexibility to banks and other agents, while ensuring stability and further development of the financial sector. The NBU expects that commercial bank lending will become more affordable for small businesses and individuals in coming years as the cost of loans will gradually fall. This will allow further development of the banking sector, and will expand consumer purchasing power for long-term buys (such as housing, cars, domestic appliances, etc.)

Monetary policy is expected to remain loose in 2003. The NBU is likely to keep its reserve requirements low while trying to encourage commercial banks' lending, unless significant acceleration of consumer inflation occurs. The growing needs of the gradually expanding real sector may prompt high growth of money supply in 2003. According to official forecasts, the money supply may grow by about 30% in 2003. In 2004, monetary aggregates growth could accelerate because the government may require significant financing for its social expenditures before presidential elections. Thus, the NBU may resort to monetary instruments to secure this financing.

Growth of consumer prices will accelerate to 6% eop in a base case scenario in 2003. However, it could reach as much as 8-9% in a pessimistic scenario due to expected poor crops, increased social payments, and higher utility prices. Producer prices should experience moderate growth at about 5-6% yoy.

The UAH/USD exchange rate should slide somewhat to end the year at about 5.4 UAH/USD, or about 1.3% depreciation. Even if the US dollar continues to slide against other major currencies on the world financial markets, the NBU is not likely to let the hryvnia appreciate against the dollar. The relative stability of the exchange rate should allow the NBU to further increase its gross international reserves. However, the NBU will try to ease the US dollar domination in the structure of its foreign reserves in favor of the euro and gold reserves.

## IV. Equity Markets

The Ukrainian equity market continued its growth in 2002, but was crippled by many serious problems. Reflecting the overall positive macroeconomic dynamics in the country, the equity market was also growing, and saw many new instruments. However, it was characterized by lower liquidity, fewer stocks traded, and no sizeable foreign investments that could fuel market growth. Starting a very negative trend, domestic investors often chose to gain control of their target companies through administrative, quasi-legal means, rather than through organized capital markets.

The organized equity market was dominated by the First Stock-Trading System (a.k.a. PFTS.) About 97% of all organized market transactions took place there, with the remaining share made at the seven official stock exchanges. The total volume of sales made on the PFTS was \$1.177 billion, which is a slight decline compared to \$1.18 billion in 2001.

The structure of PFTS sales is given in Table 1.

**Table 1: Structure of PFTS Sales in 2002**

| Equity                        | Sales volume, USD million | % of total PFTS | Change, % YOY |
|-------------------------------|---------------------------|-----------------|---------------|
| <b>Primary market</b>         |                           |                 |               |
| Corporate bonds               | 7.7                       | 0.65            | 231.3         |
| Options                       | 12.8                      | 1.09            | 538.6         |
| Shares (IPOs)                 | 7.7                       | 0.65            | - 4.8         |
| Shares (SPF auctions*)        | 1.3                       | 0.11            | - 93.2        |
| <b>Total Primary Market</b>   | <b>29.5</b>               | <b>2.50</b>     | <b>- 5.4</b>  |
| <b>Secondary market</b>       |                           |                 |               |
| Treasury bonds                | 888.6                     | 75.51           | - 3.0         |
| Shares                        | 117.9                     | 10.02           | - 37.0        |
| Corporate bonds               | 140.7                     | 11.95           | 571.5         |
| Promissory notes              | 0.2                       | 0.02            | - 98.7        |
| <b>Total Secondary Market</b> | <b>1,147.4</b>            | <b>97.50</b>    | <b>- 0.1</b>  |
| <b>Total PFTS</b>             | <b>1,176.9</b>            | <b>100.00</b>   | <b>-0.19</b>  |

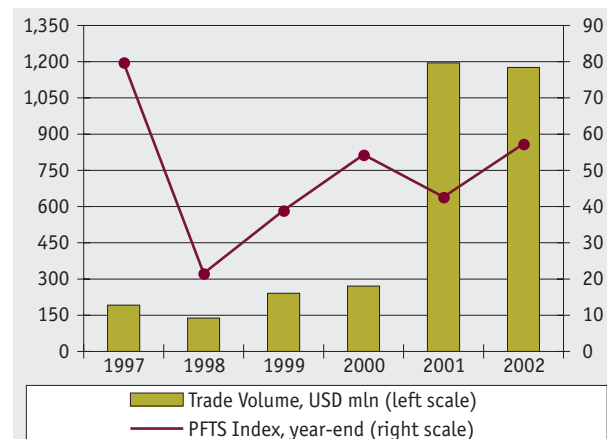
\* SPF auctions-auctions held by the State Property Fund where shares of the about-to-be-privatized companies are offered.

Source: PFTS

In 2002, most PFTS transactions (97.5%) were made on the secondary market. Government securities still held the dominant position in PFTS sales, although they saw a slight decline in trading volume against the previous year. Trading in corporate bonds soared in 2002 (by nearly seven times in the secondary market) to become a rather popular instrument of corporate financing for some companies, and an attractive investment opportunity for others.

The PFTS index has grown by 34.4% in 2002 to reach 57.34 points by year-end. The main drivers of PFTS index growth were the stocks of a few energy companies: Tsentr-Energo, Dnipro-Energo, Zahid-Energo and Kyiv-Energo, local oil extraction monopoly UkrNafta, and a few others.

**Figure 16: PFTS Trade Volume and Index Dynamics**



Source: PFTS

Stock market capitalization increased nearly three-fold to reach \$4.4 billion, but mostly due to newly-issued stock of the telecommunications monopoly, "Ukrtelekom".

A few new stock market instruments were introduced in 2002. The derivatives market grew, with futures contracts (mainly on electricity) as well as options contracts (on interest rates) becoming more popular as hedging instruments for banks and corporations.

The main downside of the local equity market in 2002 was that most transactions were still

made outside the organized market. According to official statistics, the total volume of equities transactions reached \$20.4 billion, or 48.9% of GDP, out of which only about \$1.2 billion, or 6%, were registered on the organized market. This way, market agents were trying to avoid income taxes on equity sales (currently 30%), even though these transactions enjoyed value-added tax exemption.

## Future Prospects

In 2003, the Ukrainian equity market is expected to see relative stability with moderate growth. Macroeconomic growth, decreasing interest rates and improved market mechanisms should contribute to equity market

growth. On the other hand, the market desperately needs improved regulations that will prevent widespread non-market practices and make equities trading less risky and more civilized. The "Law on Joint-Stock Companies (Corporations)" that is being drafted in the parliament aims to fill many gaps in corporate governance legislation and allows for easier stock issues and trading. The corporate bond market will continue its rapid growth and become a valid alternative to bank financing for many companies. Privatization of Ukrtelekom and regional energy-distribution companies ("oblenergos"), along with privatization of some other promising state-owned companies barred from sale before, should fuel stock market activity in the country.

## V. International Trade and Capital

Favorable conditions on world markets for traditional export commodities helped improve Ukraine's external position in the second half of 2002, when the current account reached a record high. Ukrainian foreign trade has become slightly more diversified in both geographical and commodities breakdowns, but the major part of Ukrainian exports was still low value added items, while energy resources dominated among imports. Worn-out production capacities and an urgent need for investment led to a rising share of high-tech goods in Ukrainian imports in recent years. At the same time, net foreign direct investment into the country remained low in 2002, due to the slow pace of reforms and the still risky business environment in the country.

### Balance of Payments

The current account balance improved in 2002, reaching an impressive surplus of \$3.2 billion, which represents a more than twofold increase compared to 2001. The robust current account performance is attributed to a substantially larger merchandise trade surplus and service balance. Net current transfers saw 32% yoy growth reaching \$1.92 billion, which also contributed to the positive current account balance in 2002. At the same time, financial account dynamics in 2002 reflected the deterioration of the investment climate in the country. The financial account decreased from a \$432 million surplus in 2001 to a \$1.26 billion deficit in 2002 due to large portfolio investment outflow. Also, constantly negative errors and omissions article reflects capital outflow from the country.

### Foreign Trade

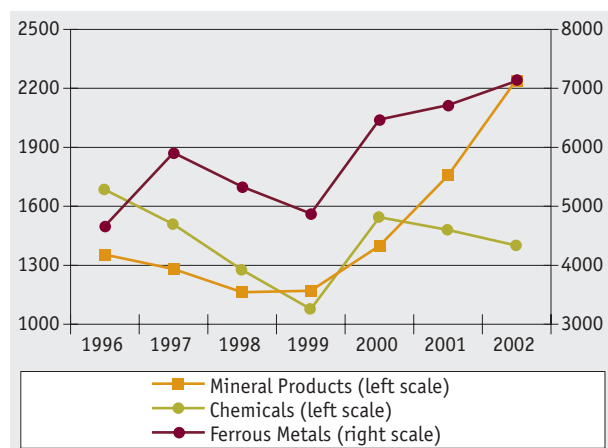
In 2002, Ukrainian foreign trade of goods and services turnover was \$40.5 billion, representing 10.3% yoy growth compared to 2001. In 2002, exports of goods and services rose to \$22.0 billion, out of which \$18 billion were goods. Imports grew to \$19 billion, including almost \$17 billion of goods. During the year, the

foreign trade balance posted a \$3.5 billion surplus compared to a \$2.9 billion surplus in 2001. A twofold increase in the merchandise trade balance over the year contributed the most to an increase in the foreign trade surplus. At the same time, the services trade surplus increased by only 5% yoy, as imports growth significantly outweighed exports expansion. Balance of trade with the rest of the world (non-CIS countries) increased by 16.3% yoy-to \$5.96 billion. At the same time, trade with CIS countries followed a well-established declining trend, primarily due to falling exports to this region. The balance of trade with CIS countries posted a \$2.5 billion deficit as export decreased by 0.3% yoy and imports grew by 5.5% yoy. Still, Ukraine remained a net exporter of ferrous metals, chemicals and food products, and a net importer of energy resources and machines and equipment.

Total merchandise exports growth in 2002 is explained by the real depreciation of the hryvnia, strengthened external demand for metals, and the abundant grain harvest in 2002. The goods structure of Ukraine's foreign trade changed during the year. On the positive side, there was a gradual (albeit slow) increase in the share of high-value added goods of total exports. In particular, mechanical machines and transport equipment became the third largest export group in 2002, after ferrous metals and mineral products. On the negative side, relatively high shares of raw materials or goods with a low degree of processing still indicate the high vulnerability of Ukrainian trade to price fluctuations of raw materials on the world markets. In 2002, the major changes in the composition of exports are attributed to a marked increase in agricultural and mineral products exports. In particular, grain exports share of the total rose from 0.8% in 2000 to 5.6% in 2002 due to the abundant harvest and certain improvements in legislative support of export-import operations on the grain market. At the same time, the shares of the country's traditional exports commodities — metals and chemicals — gradually declined, thus reflecting a positive trend towards the diversification of Ukrainian

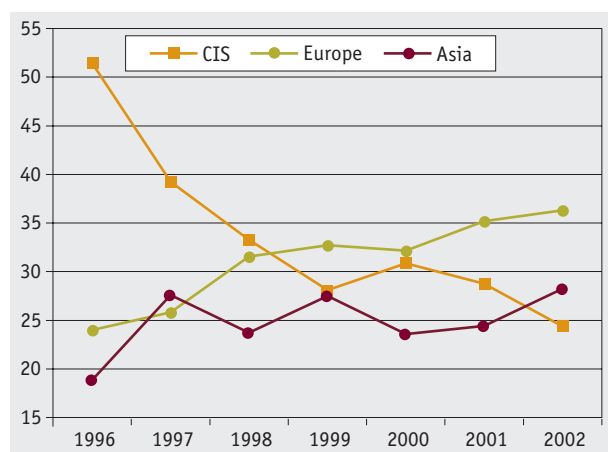
exports. Although ferrous metals exports were up 7.8% yoy to \$5.4 billion in 2002, their share in the total merchandise exports fell from 41.3% in 2001 to 39.7% in 2002. The chemical products share has been declining over the last two years, and in 2002 accounted for 7.8% of the total goods exports. In contrast, the share of refined oil in Ukrainian exports increased from 7.3% to 9.2% over 2002 following double-digit growth rates in the oil-refining industry during the year. The largest share of services exports is transport services (85.6% of the total), mainly on account of gas transit from Russia to Europe through Ukrainian territory. Gas transit will continue dominating in Ukrainian services trade, taking into account the underutilized capacity of the Ukrainian gas transportation system.

Figure 17: Dynamics of Goods Exports, \$ million



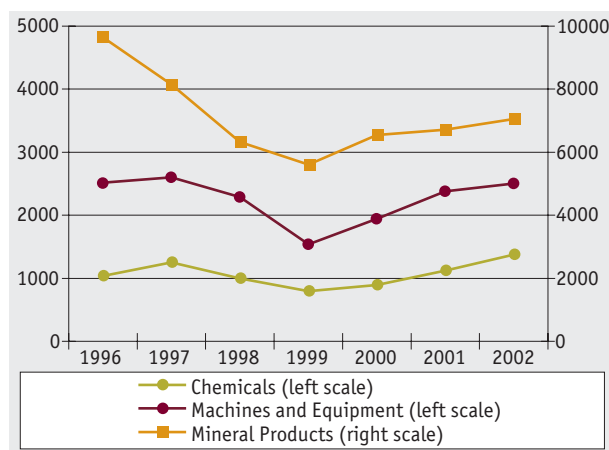
Source: State Statistics Committee

Figure 18: Geographical Breakdown of Goods Exports, % of total



Source: State Statistics Committee

Figure 19: Dynamics of Goods Imports, \$ million



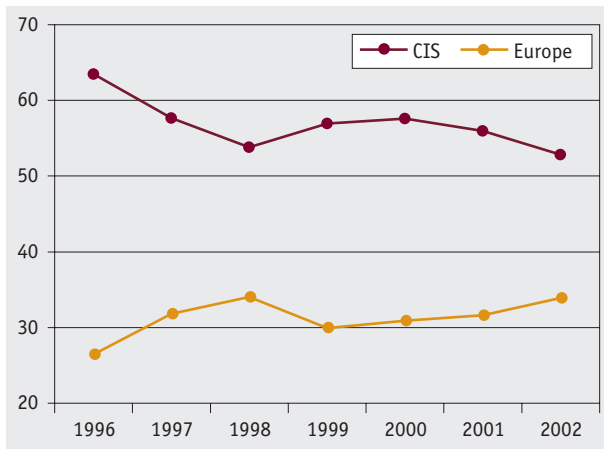
Source: State Statistics Committee

The major changes in geographical breakdown of exports in 2002 are attributed to the opening of new markets for Ukrainian metals and chemicals in Southeast Asia. The relatively quick economic recovery in Asian countries and the trade sanctions imposed on Ukrainian metals by traditional importers of these commodities (like the US and the EU) allowed Ukraine to increase its exports to this region. Over 2002, the share of Asian countries in Ukrainian exports rose by 4.3 percentage points to 28.2% of total exports. Also, trade with the EU has been increasing over recent years, but the process of integration was impeded by a number of trade barriers to Ukrainian exports from this region. In 2002, Ukrainian exports to the EU accounted for 36% of the total, having expanded mainly on account of higher grain and petroleum exports during the year. Despite a sustained declining trend in exports to the CIS, Russia remained the largest importer of Ukrainian products in 2002, accounting for 18% of total Ukrainian exports. However, a number of mutual trade sanctions imposed by Russia and Ukraine in 2002 caused a decline in Russia's share of total exports by 5pps or about \$0.9 billion during the year. Among the other major export destinations were Turkey with 6.9% and Italy with 4.6% of total exports.

Despite rapid growth of real household incomes, merchandise imports growth decelerated to 7.6% yoy in 2002. On the one hand, among the rapidly growing import items in 2002 were consumer goods such as home appli-

ances, vehicles and foodstuffs. On the other, the composition of goods imports is rigidly tied to energy resources from Russia and Turkmenistan, which account for 42% of total merchandise imports. The share of investment goods (machines, equipment, etc.) in total imports demonstrated only modest rates of growth relative to the potential investment demand of the country given its obsolete production capacities and the scope of production in import substituting industries. In 2002, imports of machines and equipment increased by only 3% yoy compared to 26% yoy growth in 2001, although this category still accounts for about 15% of total goods imports. The major share in imports of services belongs to consultancy services, which account for 49% of the total. This indicates a still underdeveloped services sector in the country due to a skills mismatch of Ukrainian labor resources and the source of capital outflow.

Figure 20: Geographical Breakdown of Goods Imports, % of total



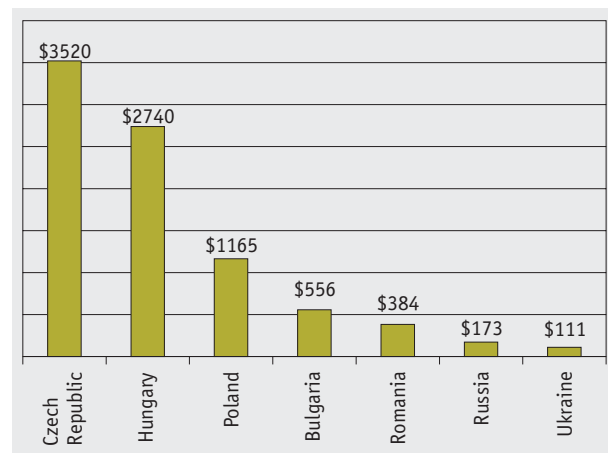
Source: State Statistics Committee

The geographical orientation of the country's imports has been changing quite slowly, primarily due to the high dependency of the Ukrainian economy on foreign energy resources. The major suppliers of mineral products to Ukraine remained Russia and Turkmenistan. Russian exports to Ukraine grew to 37.2% of all imported goods. The share of Turkmenistan in Ukrainian imports made up 11.1%, followed by Germany with 9.8%. Imports from CIS countries gradually declined, while the share of European goods in the total is on the rise. In 2002, the volume of merchan-

dise imports originating in European countries reached the pre-crisis 1998 level of 34%. Asian goods continued to gradually penetrate the Ukrainian market in 2002, reflecting rapid economic recovery in the region. Over the year, imports from Asian countries grew by 21% yoy compared to 16.5% yoy growth during the previous year.

## Foreign Direct Investment

Figure 21: Net FDI per Capita in 2002



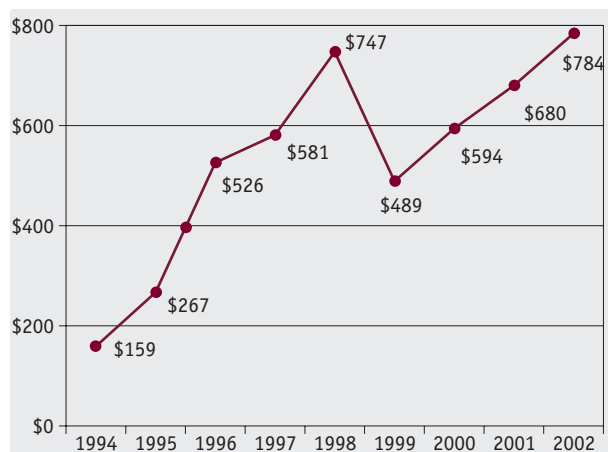
Source: WIIW Research Report # 293 (February 2003), World Bank

An essential condition for sustained economic growth in Ukraine is a substantial increase in foreign direct investment (FDI) inflow. In 2002, Ukraine received the largest volume of net FDI since its independence. Over the year, foreign investors contributed \$784 million of net FDI. Foreign investment inflow has been steadily rising over the last 3 years after the drastic decline in 1999 caused by the financial crisis of 1998 and political uncertainty due to the presidential elections in 1999.

Despite the fact that in 2001 JP Morgan considered Ukraine one of the most attractive countries for foreign investors (57.1% return on bonds in 2001), the average rate of FDI growth lags far behind Russia and other countries of Eastern and Central Europe. Since independence, Ukraine only managed to attract a total of \$5.3 billion in foreign direct investment. Since 1991, the highest levels of FDI per capita in Ukraine reached only \$111 in 2002. This is extremely low compared to the Czech

Republic and Hungary, whose FDI per capita is more than 40 and 20 times Ukrainian FDI, respectively.

**Figure 22: Dynamics of Net FDI Flows to Ukraine, \$ million**



Source: State Statistics Committee

Besides political instability, shortcomings in privatization represent another concern for foreign investors. Many steps are being taken to simplify the privatization process and make it more transparent. However, the government failed to fulfill its privatization plan for 2002. The initial plan for \$1 billion privatization proceeds was lowered to \$400 million by the middle of the year due to the postponement of privatization of energy distribution and telecommunication companies. But actual privatization receipts for 2002 were considerably lower. The overall proceeds from privatization to the state budget in 2002 constituted just under \$110 million.

## Regional Structure of FDI

Foreign investment went into 8,690 Ukrainian enterprises. Three fourths of all FDI has been invested in the city of Kyiv and the seven most developed regions (out of 25 regions in Ukraine.)

Traditionally, the food processing industry and internal wholesale and retail trade have been the most attractive to foreign investors. These sectors usually give investors a quick return on investment and lower risk compared to other industries. FDI in food processing and

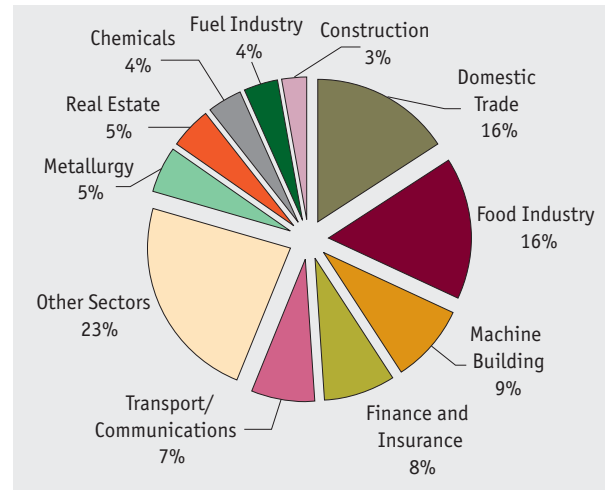
internal wholesalers and retailers exceeded 32% of the total FDI in Ukraine. Nevertheless, machine building is also attractive for investors due to the high liquidity of its products.

**Table 2: Regional Distribution of FDI Flows**

| Region / City                   | Jan. 1, 2003, \$ million | % to overall FDI |
|---------------------------------|--------------------------|------------------|
| City of Kyiv                    | \$1,849                  | 34.6%            |
| Kyiv Region                     | \$419                    | 7.9%             |
| Donetsk Region                  | \$389                    | 7.3%             |
| Zaporizhya Region               | \$362                    | 6.8%             |
| Dnipropetrovsk Region           | \$359                    | 6.7%             |
| Odesa Region                    | \$289                    | 5.4%             |
| Lviv Region                     | \$220                    | 4.1%             |
| Republic of Crimea              | \$195                    | 3.7%             |
| <b>Total for Listed Regions</b> | <b>\$4,082</b>           | <b>76.5%</b>     |
| <b>Other Regions</b>            | <b>\$1,257</b>           | <b>23.5%</b>     |
| <b>Total FDI</b>                | <b>\$5,339</b>           | <b>100.0%</b>    |

Source: State Statistics Committee

**Figure 23: Net FDI by Sector, \$ million**



Source: State Statistics Committee

After the financial crisis of 1998, FDI started flowing into the banking sector. Today, the banking sector, along with insurance companies, holds the fourth position in FDI volume. Revival of the Ukrainian economy and the privatization process resulted in an increase in the number of foreign companies operating in Ukraine and, in turn, the development of the banking sector.

## Major Foreign Investors

Overall, over 110 countries have invested in the Ukrainian economy. The largest volume of FDI has come from the US, the Netherlands, Cyprus, the United Kingdom, Virgin Islands, Russia, and Germany. These 6 countries contributed approximately 60% of the total FDI in Ukraine.

The US remains the main foreign investor in Ukraine. As of January 1, 2003, the US share of FDI constituted \$898 million or 16.8%. More than 17% of the investments went to domestic wholesale and retail trade. However, investors were mostly interested in the food processing industry, construction and metallurgy in 2002. The volume of FDI from the US in construction grew by 72% in 2002, while FDI declined in the financial sector (by 14.5%). The share of the construction business of total US FDI reached approximately 6%. FDI in the food processing industry, the second largest recipient of American investments, also grew by 12% during the last year. Some US multinational companies, such as Coca-Cola, Procter & Gamble, McDonald's, Phillip Morris, Gillette, and others, have propelled the US to the top of the list of foreign investors in Ukraine with their proactive expansion and investment strategy.

FDI from Cyprus almost doubled over the last two years, which indicates the gradual return of flight capital to Ukraine. As of January 1, 2003, Cyprus had invested \$602.6 million in the Ukrainian economy. The high volume of FDI from Cyprus can be explained by the dozens of Ukrainian offshore companies registered in Cyprus. In 2001, FDI in the domestic wholesale and retail sector increased three-fold, and in 2002 the volume grew by another 34%. In 2002, Cyprus doubled its investment into metallurgy and metal processing, services and real estate.

For the second consecutive year, the United Kingdom demonstrated the highest growth in investment. FDI from the UK grew by 23.2% yoy in 2002. Significant increases in FDI from the UK occurred in the transport and communication industries (where British investments almost tripled during the year), machine building, metallurgy, construction and real estate.

Dutch investors, who were very active in Ukraine in 2000, ranking second in the list at that time, appeared only fourth among the largest foreign investors in 2001 and 2002. FDI volume from the Netherlands reached only \$400 million in 2002 (compared to \$367 million in 2000.) During the last year, Dutch companies invested their capital mostly in wholesale and retail trade, real estate, transport and communications.

**Table 3: Major Foreign Investors in Ukraine**

|                       | FDI as of<br>January 1,<br>2003,<br>\$ million | Increase<br>in 2001,<br>% | Share of<br>Total FDI,<br>% |
|-----------------------|--|---------------------------|-----------------------------|
| <b>USA</b>            | \$898.0  | 15.5%                     | 16.8%                       |
| <b>Cyprus</b>         | \$602.6  | 22.2%                     | 11.3%                       |
| <b>United Kingdom</b> | \$510.5  | 23.2%                     | 9.6%                        |
| <b>Netherlands</b>    | \$398.8  | 6.6%                      | 7.5%                        |
| <b>Virgin Islands</b> | \$337.0  | 22.5%                     | 6.3%                        |
| <b>Russia</b>         | \$322.6  | 2.2%                      | 6.0%                        |

Source: State Statistics Committee

In the mid-90s, Russia was one of the largest investors in Ukraine. But the picture has changed since Russian investors redirected their capital to their own domestic market. In 2002, Russian FDI in Ukraine grew by only 2.2% yoy against 3% yoy growth in 2001. Currently, Russian investors are targeting nuclear fuel, coke, and oil-refining industries, which received half of the overall Russian FDI in Ukraine. Health care and social security, the financial sector, and the transport industry have also attracted significant investment from Russia.

## Future Prospects

The foreign trade balance is expected to remain in surplus in 2003-2004, but it will likely narrow, as major factors responsible for strong export growth will begin to wane while import demand will get stronger. According to forecasts, in 2003 the current account surplus may shrink to \$2.5 billion, due to the expectation that exports prospects will be less favorable, while imports growth will accelerate. Real appreciation of the hryvnia against the currencies of Ukraine's major trading partners and strengthening import

demand for both investment and consumer goods, which will only partly be mitigated by development of import substituting industries, are among the likely reasons for a shrinking foreign trade surplus in forthcoming years.

In 2003, export growth may slow down partly as a result of lower volumes of grain exports in the anticipation of a less abundant harvest than in previous years. In addition, there are still a number of structural vulnerabilities in Ukraine's foreign trade. Although Ukraine's reliance on metals exports is currently yielding substantial benefits as world demand for metals remains strong, it also contributes to the vulnerability of the country's external position. Markets for these commodities are highly volatile and protected, and thus sales of ferrous metals can hardly serve as a reliable source of sustained foreign exchange inflow. However, further growth of metals exports to newly opened markets in South East Asia are expected to partly compensate for shortfalls in sales to neighboring Russia, which still keeps its market restricted for Ukrainian goods and also remains economically vulnerable to oil price fluctuations. On the positive side, the rapid economic recovery of other CIS partners is likely to encourage exports growth, especially of such high-value added products as machinery and equipment.

Major risks still lie in Ukraine's dependency on energy imports and its inability to diversify its exports base due to extremely low foreign investment inflow. However, data for the first quarter of 2003, when the foreign trade balance posted 26% yoy growth to \$411 million despite an oil price increase, supports the view that an upsurge in Ukraine's energy imports can not easily erode the benefits of growing exports in a favorable external environment for export commodities.

Expectations for foreign direct investment inflow remain not very promising due to the escalation of political risks in anticipation of 2004 presidential elections, and a slow pace of structural reforms. Nevertheless, the government is taking serious steps to attract investors to Ukraine. A number of legal acts have been adopted to attract investors to medium and small businesses, as well as a special act that envisages measures to improve the investment climate in Ukraine. The State Program of Investment Activities Development for 2002-2010 was

adopted. Also, the government is taking steps to improve the tax system, adopt a new tax code, and reform export-import regulations. Adopted in 2001, the land code became an important reform landmark and legalized private ownership of land. Early in July 2003, President Kuchma initiated creation of a specialized agency on FDI issues that should promote the attraction of foreign investments into the Ukrainian economy.

In early 2003, positive macroeconomic developments stimulated an acceleration of foreign direct investment (FDI) inflow. In the first quarter of 2003, net FDI amounted to \$222 million, which is two times higher than over the same period of 2002. Overall, in 2003-2004 the government expects FDI inflow at about \$800 million each year. So far, foreign capital inflows to Ukraine have been insignificant in terms of Ukraine's needs and economic potential. Ukraine needs a considerable acceleration of investment inflow in order to sustain high rates of economic growth in the future. According to estimates, Ukraine needs at least \$40 billion in foreign direct investment (FDI) over the next decade if it wants to maintain a significant level of sustainable growth.

Liberalization of business activities with corresponding improvements in the legal framework and public governance are the three most important policy actions that Ukraine can undertake to increase capital inflows. If reforms in only these three sectors were to be undertaken, the capital inflow to Ukraine would increase significantly. The willingness of Ukrainian authorities to join the WTO encourages the government to implement reform-minded policies, thus contributing to Ukraine's chance to get more FDI in forthcoming years. Despite a marked acceleration of the WTO accession process in early 2003 and optimism of Ukrainian authorities, it is doubtful that Ukraine will become a WTO member before the presidential elections in 2004. The process of concluding bilateral agreements with member-countries of the WTO has only minor effects on the terms of external trade. At the same time, market economy status, which Ukraine expects to get from the USA and the EU, would definitely help Ukraine settle ongoing trade disputes more easily, and improve conditions for the country's export commodities on the international markets.

## VI. Public Debt and International Lending

During 2002, Ukraine's public debt situation remained stable. Total public and publicly guaranteed (PPG) debt increased only marginally (up 0.3%) to \$14.1 billion equivalent. The increase is attributed mainly to the additional placement of sovereign Eurobonds at the international debt market in November-December 2002. Nevertheless, the public debt burden of Ukraine has declined since 2000 due to rapid GDP growth, relatively modest fiscal deficits, and debt restructuring. In 2002, the total public debt to GDP ratio dropped to an estimated 34% from 37% reported for 2001. The peak of Ukraine's debt burden was registered in 1999 at about 50% of GDP, and significant reduction was achieved afterwards due to successful Paris Club debt restructuring and lower cost of borrowing (on average, interest rates declined to an estimated 8% in 2002, from 10% in 2001.)

The current level of Ukraine's public debt is moderate according to international standards. However, suspended international lending programs along with political instability contribute to the risks of debt servicing problems as perceived by international credit rating agencies. The government's failure to meet IMF and EBRD loan requirements during 2002 was the reason for their blocking the disbursement of the last tranche under the IMF EFF program that expired in September 2002, and the postponement of the World Bank's financing within the PAL-2 program. Over 2002, Ukraine's international credit ratings have been subject to a number of revisions in response to worrying political developments and ambiguous relations with international financial organizations. However, following the election of the new government at the end of 2002, successful placement of new Eurobonds on the international debt market and positive macroeconomic developments early in 2003, major rating agencies confirmed Ukraine's sovereign ratings at B with a stable outlook. Among other B-rated countries (Paraguay, Venezuela, Romania, Russia), Ukraine's macroeconomic indicators look much better, but the political risk component still deteriorates the overall assessment of the economy.

The assessment of the country's creditworthiness in coming years will crucially depend on the ability of the government to accelerate the pace of structural reforms. Starting in 2003, Ukraine entered the period of peak payments on its debt obligations. In 2003, the Ukrainian government has to repay about \$2.1 billion equivalent in direct public debt repayment and service, more than 75% of which are external debt payments. Since the NBU kept accumulating its international reserves (having reached a high \$6.2 billion or about 15 weeks of imports as of June) in the first half of 2003, the key to meeting public debt obligations lies in fiscal performance and re-accessing multilateral financing. Despite robust inflow of foreign exchange into the country, an additional \$1.5 billion of external and domestic borrowings are necessary to perform all debt repayments due this year.

### Domestic Debt

During 2002, domestic debt increased by 1.8% yoy to \$4.0 billion (equivalent). To a great extent, the increase is attributed to the additional issue of T-bills that the government made at the end of the year as it faced a severe fiscal revenue shortfall. The structure of internal debt remained virtually unchanged over the year, as the government's debt to the NBU still accounted for about 50% of total domestic debt. Having restructured its debt to the NBU in 2000 into government bonds with longer maturities (up to 124 months), the Ministry of Finance kept postponing its debt payments to the NBU in 2002. During the year, debt to the NBU remained unchanged at about \$2 billion. Another \$2 billion is held by commercial banks, the State Pension Fund and the State Deposit Guarantee Fund, most of which is also kept in the NBU portfolio because the central bank accepts government papers as collateral in its refinancing. This particular feature increases the attractiveness of government securities for local commercial banks. In 2002, the Ministry of Finance attracted about \$525 million (equivalent) from the internal market, while redemption volume amounted to \$600

million equivalent. The average annual rate of return on government paper sold during the year dropped to 10.8% from 13% in 2001. Anticipating fiscal imbalances and growing uncertainty with financing from international financial institutions, the government asked Parliament in November to approve an increase in the domestic borrowing ceiling by about \$450 million equivalent. Having obtained Parliament's approval, the Ministry of Finance managed to sell only about \$240 million equivalent worth of government securities, yielding a 9% annual return during December 2002. The bonds are to be redeemed in March and June 2008, which is the longest maturity on the local market.

In 2003, domestic debt payments will make up about \$470 million equivalent. Facing hard external financing constraints, the government will have to attract more funds from domestic creditors. The expected volumes of borrowing are planned at about \$325 million equivalent so the stock of domestic debt may decline by about 3% by the end of 2003. Given the excessive liquidity of the banking system, this level of borrowing seems achievable, but the effect on the volumes of private sector lending would be negative since funds attracted to the budget are unlikely to be allocated in a productive way but rather spent on recurrent expenditures. In the first half of 2003, the Ministry of Finance borrowed \$120 million from domestic creditors, while redemption volumes reached \$220 million equivalent.

## Foreign Debt

Total official external debt went up by 0.7% (or \$ 73 million) to \$10.2 billion as of December 31, 2002. Throughout the year, Ukraine's foreign debt was kept at reasonable levels—below 30% of GDP (estimated at 24% of 2002 GDP.) An additional Eurobond placement made in November–December 2002 made direct external debt increase by 1.3% yoy. At the same time, publicly guaranteed external debt dropped by about 5% yoy after Ukraine's debt to the IMF shrunk by 25% yoy to \$1.87 billion. The major holders of Ukraine's foreign debt at the end of 2002 remained the World Bank, IMF, and Russia; their joint share in Ukraine's

external obligations constituted about 60% (see Table 4).

**Table 4: Stock of Official External Debt in 2002**  
(In millions of U.S. dollars; end-of-period)

|  | US\$ millions |
|--|---------------|
| <b>Multilateral</b>                      | 4,529         |
| <b>IMF</b>                               | 1,865         |
| <b>WB</b>                                | 2,232         |
| <b>EBRD</b>                              | 122           |
| <b>EU</b>                                | 300           |
| <b>Bilateral</b>                         | 3,065         |
| <b>Russia, Direct Government Credits</b> | 1,779         |
| <b>Turkmenistan</b>                      | 282           |
| <b>Germany</b>                           | 417           |
| <b>USA</b>                               | 273           |
| <b>Japan</b>                             | 159           |
| <b>Italy</b>                             | 95            |
| <b>Private</b>                           | 2,597         |
| <b>Eurobonds denominated in US\$</b>     | 1,456         |
| <b>Eurobonds denominated in Euros</b>    | 1,068         |
| <b>Foreign commercial banks</b>          | 73            |
| <b>Total Foreign Debt</b>                | <b>10,191</b> |

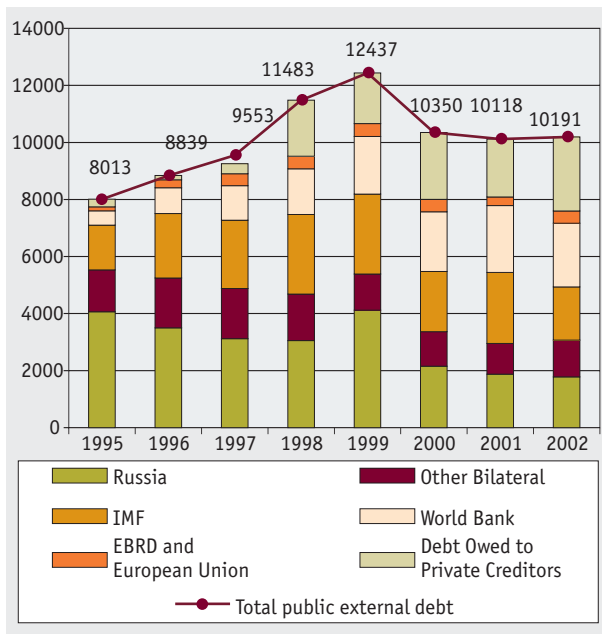
Sources: Ministry of Finance, IMF, World Bank

External debt dynamics over the last eight years show that Ukraine's stock of external debt has been declining since the 1998 financial crisis, reaching about \$10.1 billion at the beginning of 2002 (see Fig. 24). At the same time, the structure of Ukraine's external debt gradually changed as the share of debt owed to official creditors declined, while the share of private debt is on a rise. In 2002, the relative amounts of Ukraine's obligations to the IMF and the World Bank shrunk from 27% and 24% of the total external debt in 2000 to 18% and 23% in 2002, respectively. Also, settlement of gas supply-related debt to Russia contributed to the reduction of the stock of external debt. Nevertheless, Ukraine can hardly rely more on private creditors than on multilateral and bilateral official lenders due to its low international investment ratings.

During 2002, Ukraine's external obligations were rather high compared to previous years. Total external debt repayment and service

amounted to \$1.42 billion, more than half of which was redeemed by the NBU. Foreign debt service obligations were performed through repayments from the budget, Black Fleet debt swap and repayments, and also through the additional issue of Eurobonds last year. Also, sustained growth of the NBU reserves during the year supported by strong export performance contributed to timely repayment and servicing of public external debt.

**Figure 24: Official External Debt, 1995-2002**  
(\$ million, end-of-period)



Sources: Ministry of Finance, IMF, World Bank

Ukraine's debt service will increase through 2005, when external payments reach a peak of \$1.8 billion. This amount is rather high compared to the current level of the NBU's liquid international reserves. In 2003, Ukraine has to pay \$1.65 billion on its external obligations. To serve this debt, the government expects to obtain funds from multilateral lenders, from new Eurobond placements, from the current account surplus expected in 2003-2004, and from privatization revenues. Overall, the government plans external borrowings at \$1.22 billion in 2003 to perform all due debt payments during the year, while the rest is to be paid from expected privatization receipts of \$390 million (equivalent) by year-end. Still, the government is counting on the disbursement of \$250 million of adjustment lending from the World Bank, which has already been

earmarked in the 2003 budget. Facing uncertainty over the crops harvest due to unfavorable weather conditions, the government may resort to additional borrowing from private creditors to finance necessary volumes of grain imports. The dynamics of the NBU's international reserves in 2003, with a level that has already exceeded the benchmark of 12 weeks of imports in June, gives rise to the hope that international reserves can serve as a reliable source of foreign exchange for debt service. So far, the government managed to secure enough budget revenue to meet all debt repayments in the first half of 2003, including the first peak payment on Eurobonds (about \$350 million equivalent) due in March.

### Foreign Debt Owed to Private Creditors

The size of external debt owed to private creditors increased in 2002 after the placement of new Eurobonds on the external debt market. Overall, Ukraine owed its Eurobond holders \$2.6 billion equivalent at the end of 2002, out of which about 60% is denominated in US dollars, while the rest is denominated in Euros. During the last two months of 2002, Ukraine placed \$220 million worth of Eurobonds at a 10.8% yield and \$120 million at a 9.75% yield. The spread over comparable US treasuries was 891bps (basis points), indicating their relative attractiveness to foreign investors.

State-owned Naftogaz Ukrainy and Russian Gazprom eventually agreed on the mechanism of restructuring of Ukraine's natural gas debt accumulated in 1998-2000. The governments of Ukraine and Russia signed corresponding debt restructuring agreements in October 2001, but companies failed to settle the mechanism of restructuring during 2002. In April 2003, they agreed that \$1.4 billion of debt would be restructured into Eurobonds issued by Naftogaz, which should be later transferred to Gazprom. Payments on Naftogaz Eurobonds are state guaranteed. Also, Gazprom will be exempt from paying \$180 million of foreign currency component of the gas transit fee charged by Naftogaz until 2010. In addition, Naftogaz Ukrainy has to issue \$155

million worth of Eurobonds yielding 12-months LIBOR+1% to compensate for service payments accrued over the period from May 2000 to May 2002. Payments on Naftogaz Ukrainy Eurobonds will be made on a semi-annual basis.

The government's timely payments on Eurobonds and positive macroeconomic performance are a pledge of successful new borrowings from the external market at a reasonable price. Also, the resumption of cooperation with the IMF and the unlocking of the PAL-2 facility of the World Bank are likely to ease the terms of new borrowings, as investors perceive good relations with international financial organizations as an indicator of the country's creditworthiness. In June 2003, the government successfully placed \$800 million worth of Eurobonds at a record low rate of 7.7% with a maturity of 10 years. The lower-than-expected yield came as a result of strong investor demand, which can be partly attributed to higher investor interest in transition economies due to the economic slowdown in the EU and the USA. Facing uncertainty over the harvest, the government may resort to additional borrowing from private creditors to finance necessary volumes of grain imports.

## IMF Program

In 2002, Ukraine obtained no financing from the International Monetary Fund (IMF) due to the country's failure to cope with arrears on VAT refunds to exporters—the requirement the IMF set for loan disbursement. Since September 2001, when Ukraine received the \$375 million tranche under the Extended Fund Facility (EFF) program, the IMF suspended its financing to Ukraine. In September 2002, the EFF program to Ukraine expired. The total volume of financing envisaged by the EFF program amounted to \$2.6 billion, of which Ukraine has managed to receive only \$1.5 billion. Although it was expected that a final large tranche could have been disbursed in August 2002 before the expiration of the EFF program on September 3, 2002, the IMF decided not to disburse any funds due to further disagreements on policy reforms.

The major barrier to resumption of financing under the EFF program was the government's failure to eliminate arrears on VAT reimbursements to exporters. Among other issues the IMF considered inadequately addressed were: the inability to abolish excessive tax privileges and exemptions, and the possibility that this would lead to poor implementation of Ukraine's fiscal budget for 2002. In early 2002, the IMF technical mission to Kiev concluded that Ukraine fulfilled almost all of the conditions set by the IMF in 2001 within the EFF program, but insisted the country borrow on the internal market to finance the VAT refund. However, the government rejected the IMF's recommendations preferring to use its own methods, which turned out to be quite ineffective.

Robust economic growth and the gradual accumulation of international reserves by the NBU made the Ukrainian government overly optimistic about its external financing needs in 2002. This led the government to seek a precautionary stand-by agreement with the IMF upon expiration of EFF program. Under a precautionary stand-by, disbursements are not scheduled in advance but are made in case of urgent necessity. However, even in case of a financing need, a precautionary stand-by envisages meeting certain program conditions set by the IMF. Among the advantages of precautionary stand-by are the resumption of World Bank lending programs, the possibility of IMF financing with less demanding conditions, more flexibility in domestic policy conduct, and more evaluation of the country's economic performance by investors.

Having finished a number of discussions with Ukraine over June 18–July 1, 2003, the IMF mission issued a concluding statement giving little hope of the resumption of cooperation under a precautionary stand-by arrangement in the near future. Actions that remain to be carried out by the government before the IMF Executive Board makes a positive decision on its financing resumption include a substantial net reduction in the stock of VAT refund arrears and reduction in the amount of tax exemptions. Although the Ukrainian government suggested exchanging VAT refund arrears for special government securities, the

Parliament failed to adopt the corresponding bill before its summer holiday. Also, the abolishment of tax privileges has not been approved by the Parliament. Therefore, resumption of cooperation with the IMF in late August is still at risk. The lack of an IMF program has a negative effect on structural adjustment lending by other multinational and bilateral agencies, in particular the World Bank and the European Union.

## World Bank Program

During 2002, the lending activities of the World Bank were limited mostly due to the suspension of the IMF EFF Program. In 2002, the World Bank disbursed only \$44 million for ongoing projects, while the government repaid about \$200 million in interest and principal payments due in 2002. At the same time, Ukraine expected to receive \$250 million—the second tranche under the Programmatic Adjustment Loan (PAL) program in 2002, but this financing has not yet been released. In March 2002, the World Bank approved a \$30 million loan to Ukraine within the framework of a private sector development project, with a total budget of \$82 million. The project is aimed at improving the business climate and strengthening the private sector, restructuring privatized and new private enterprises and training managers involved in corporate restructuring. Other large development projects for which preparation or implementation started in 2002 include rural land titling and cadastre development project, treasury system project, and social investment fund project.

The World Bank's board of directors approved the 3-year Programmatic Adjustment Loan facility worth \$750 million in September 2001. Within the framework of the PAL program, the loan should be disbursed in three tranches of \$250 million each over 2001–2003. The first tranche was disbursed in September 2001 and December 2001 in support of the government's Medium-Term Economic Development and Reform Program. In general, the PAL program is aimed at determining and helping to remove critical institutional bottlenecks that presently hamper economic reforms, weaken property

rights, favor soft-budget constraints, and lower the effectiveness of public services provision. Although the WB was satisfied with the macroeconomic developments taking place in Ukraine recently and with the adoption of the new tax laws, it also expects Ukrainian authorities to proceed with energy sector reform, the state-run Savings Bank (Oschadbank) restructuring, and reduction of VAT refund arrears to exporters before deciding whether to approve PAL-2 disbursement. Judging by current government efforts to implement reforms, the World Bank's board of directors' approval of the PAL-2 \$250 million second tranche disbursement might come in September 2003 at best. The IMF's decision on whether to resume cooperation with Ukraine will be instrumental to the World Bank's decision on PAL-2. It should be mentioned that Ukraine's budget for 2003 has already earmarked \$250 million to be received from the World Bank, and without this loan Ukrainian authorities will have to make additional borrowings to meet all its external obligations in 2003.

According to the World Bank's Country Assistance Strategy (CAS) to Ukraine for 2004–2007, which is currently under preparation by the World Bank's staff, the priority areas of cooperation with Ukraine include economic growth promotion, improvement of public governance, modernization of health care and education services, poverty reduction and ensuring environmental sustainability. In 2003, the World Bank plans to provide lending for the Rural Finance Project (RFP), which envisages \$200 million in total. The two new projects have been launched in 2003 in Ukraine. One project concerns Ukraine's development of the Internet (planned disbursement is up to \$5 million), while the other deals with modernization of the State Tax Administration of Ukraine (total sum of the project amounts to \$100 million.) Also, the World Bank approved a \$60 million loan to help Ukraine fight the spread of tuberculosis and HIV/AIDS. The Municipal Development Loan Fund envisaging \$150 million of disbursements is currently under preparation. Within its framework, several infrastructure development projects in large regional centers of Ukraine are to be implemented.

## EBRD Program

The European Bank for Reconstruction and Development (EBRD) began its active support of the market transformation process in Ukraine in 1992. Since 2000, the EBRD strategy for Ukraine has been focused on financial sector strengthening and supporting needs of small and medium businesses, structural reform of public infrastructure, and services aimed at improving energy efficiency and quality of services rendered by public agencies. As of end-of-2002, there were 56 projects launched by the EBRD in Ukraine, amounting to a total of about EUR 1 billion (including undrawn commitments.) Of this amount, 70% was assigned to the private sector and 30% to the public sector. In addition, there are technical assistance activities that EBRD finances in Ukraine, the total value of which adds up to less than EUR 55 million.

Among the largest projects assigned to the public sector are the EBRD's Nuclear Safety Account and the Chernobyl Shelter Fund initiatives, including the project financing the completion of two compensating nuclear power units. Several rounds of negotiations with the EBRD on conditions for a loan to complete construction of two nuclear units at Khmelnytsky (K2) and Rivne (R4) nuclear power plants produced no marked results in 2002. Completion of construction of these nuclear units has to compensate for the closure of Chernobyl NPP in terms of nuclear power generating capacity. In late 2001, the Ukrainian government withdrew the K2R4 project prior to the EBRD board's final approval of the \$250 million disbursement to look for ways to reduce the cost of loan. It was envisaged that the K2R4 loan would be set out in the framework of a credit line worth \$1.48 billion. Co-creditors of the line are Euroatom, an EU agency on energy, and a few large credit-export agencies. Among conditions set up by the EBRD for the loan disbursement were improvement of payment discipline in the energy sector, privatization of energy distributing companies (oblenergosp) and an increase in electricity tariffs for households to a level that would make the K2R4 project implementation self-supporting (an estimated increase expected from the government was 30%). The Ukrainian government found such an increase

unacceptable, and negotiations were suspended. At the same time, the Russian government revealed its readiness to support the project at a substantially lower cost of about \$450-\$500 million. According to a bilateral agreement signed in late 2001, Russia is to lend \$250 million for six years (with 3 years of grace period) for K2R4 construction. Obviously, Russia will partake in the financing of the K2R4 project together with the EBRD. However, the final decision on the terms of the K2R4 project financing has not yet been made.

## Bilateral Debt

In 2002, Ukraine signed the remaining bilateral agreements with member-countries of the Paris Club in line with the general agreement on Paris Club debt restructuring settled in July 2001. In late 2001, Ukraine managed to sign a bilateral debt restructuring agreement only with Germany, the largest creditor of the country within the Paris Club. Bilateral agreements with the US, Italy and France were signed in June-July 2002. Japan was the last Paris Club member with which Ukraine signed a debt-restructuring agreement. Bilateral agreements defined interest rates for each of the member-countries of the Paris Club. According to the general agreement, the \$580 million debt due to Paris Club members has to be repaid in 12 years with a three-year grace period. The amount of debt to be rescheduled includes the principal amount and interest arrears that Ukraine had to pay from December 19, 2000 to September 3, 2002.

Following the successful restructuring of the Paris Club debt in 2001, the government reached an agreement with the government of Turkmenistan on the repayment of about \$280 million debt for gas supplied by Turkmenistan in 1994-1995. The debt repayments were suspended in January 2000. According to the bilateral agreement, 50% of the outstanding amount will be paid in cash and 50% in kind, particularly by the participation of Turkmenistan in investment projects in metallurgy, machine building and agriculture. Cash repayments are to follow similar conditions to those agreed with the Paris Club (12-year maturity, including a 3-year grace period.)

## VII. Economic Goals and Reforms for the Future

The priorities of the government's activity for the next two years are to maintain steady economic growth in order to improve the standards of living for Ukrainian citizens and to retain the country's external and internal stability. Macroeconomic stability achieved in recent years provides the basis for sustainable economic growth and further implementation of structural reforms. The major tasks of the government in 2003 are: (1) to successfully deal with large foreign debt service payments in 2003 by pursuing tight fiscal policy and following a prudent foreign debt management strategy; (2) to accelerate implementation of structural reforms in order to improve the investment environment; and (3) to prevent the political unrest impairing the country's international image and negatively affecting business activity.

Resumption of suspended lending programs with international financial organizations in 2003 and tight fiscal policy are important elements of a successful foreign debt management strategy. Foreign debt obligations have to be met without negative effects on macroeconomic stability and the country's international image. The government fully recognizes what measures should be implemented to pursue this task.

To sustain the current rates of economic growth, the government has to significantly improve the investment climate in the country. Foreign direct investment is a universal and key source of long-term development for the economy. Among the major difficulties discouraging foreign investments in Ukraine as well as other transition economies are excessive government regulation of business activity, ambiguity of the legal environment, corruption, a high tax burden, problems in establishing clear property rights conditions, lack of physical infrastructure, and volatility of the political environment. A study conducted by the International Private Capital Task Force (IPCTF) developed a range of recommendations for attracting foreign capital to Ukraine, including the creation of a favorable investment climate, improvement of Ukraine's image on world financial markets,

and development of a system that could attract foreign entrepreneurs and renew foreign investors' confidence in Ukraine. The task force specified the following key "policy actions" that affect the business climate in Ukraine and generate foreign investment inflow:

1. Liberalize and deregulate business activities
2. Provide a stable and predictable legal environment
3. Enhance governance and reform public administration
4. Liberalize foreign trade and international capital movements
5. Facilitate financing of businesses by the financial sector
6. Reduce corruption level
7. Minimize political risks
8. Expand country promotion and improve image
9. Rationalize investment incentives

In line with the main principles of the IPCTF Economic Policy Framework, the government program identifies tax and energy sector reform, foreign trade liberalization, development of the financial sector and a transparent privatization process as key structural challenges for the government for the next two years. Most of those challenges will be instrumental in reviving investment activity in the country and improving Ukraine's attractiveness for foreign investors, since lack of investment resources will be the limiting factor of future economic development. The government acknowledges that a stable tax environment is key to the creation of fair "rules of the game" (competition) for all business entities. In particular, this concerns elimination of tax exemptions and privileges and reduction in tax rates. The adoption of the new tax code by the parlia-

ment in 2003 envisaging broad-based reduction in tax rates and enhancement of tax and customs administration accountability signals the strong reform intentions of the government. To improve the investment climate in the country, it is important to increase the transparency of state agencies' activities, to eliminate ad-hoc public management practices by making government policy more predictable and comprehensive. Also, it is widely recognized that acceleration of the privatization process and the introduction of fair and transparent tender procedures will encourage investment activity in the country. Among steps facilitating further foreign trade liberalization, the government is currently taking measures required for Ukraine's successful accession to the World Trade Organization (WTO) in 2004. The process of WTO accession is a powerful external incentive for the government to implement structural reforms.

The government program also calls for strengthening of the State Commission on Financial Services, and further improvement of the appropriate legislation. Namely, the government has committed to preparing and pass-

ing to the parliament a draft law on joint stock companies (corporations). The new law is expected to improve norms and regulations that cover corporate governance, with the main emphasis on protection of shareholder rights and information disclosure. Development of the banking system is another priority identified in the program. The government will be working together with the National Bank to make the national banking sector more competitive, to make lending more affordable for companies and individuals and less risky for banks, and to improve the structure of bank capital.

The government realizes the damage to the economy from undue practices in the privatization process, when companies were often acquired through administrative and political means. Thus, the government program highlights this problem, and resolves to dispose of the loopholes in the legislation that allowed it, and to ensure a transparent and uncorrupted privatization process. Also, the program calls for better pre-privatization support of state-owned companies to improve their investment attractiveness while taking into consideration the social aspects of privatization.

# Appendix

## Key Economic Statistical Information\*

|                                   | 1996  | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003<br>(Proj.) | 2004<br>(Proj.) |
|-----------------------------------|-------|------|------|------|------|------|------|-----------------|-----------------|
| <b>GDP</b>                        |       |      |      |      |      |      |      |                 |                 |
| Real GDP (% YoY)                  | -10.0 | -3.1 | -1.9 | -0.4 | 6.0  | 9.2  | 4.8  | 5.0             | 5.1             |
| GDP (UAH bn)                      | 81    | 93   | 104  | 127  | 175  | 205  | 221  | 246             | 275             |
| GDP/Capita (US\$)                 | 870   | 856  | 828  | 612  | 555  | 720  | 859  | 958             | 1061            |
| Gross Investment (% of GDP)       | 22.7  | 21.4 | 20.8 | 17.4 | 19.7 | 21.8 | 18.9 | 20.4            | 20.5            |
| Gross National Savings (% of GDP) | 20.0  | 19.0 | 18.0 | 22.0 | 20.0 | 20.0 | 22.0 | 25.1            | 25.0            |
| Industrial Growth Rate, %         | -5.1  | -0.3 | -1.0 | 4.0  | 13.2 | 14.2 | 7.0  | 8.0             | 9.0             |
| <b>Public Finances</b>            |       |      |      |      |      |      |      |                 |                 |
| Fiscal Balance (% of GDP)         | -4.9  | -6.6 | -2.2 | -1.5 | 0.6  | -0.3 | 0.7  | -0.4            | -0.1            |
| Revenues (% of GDP)               | 37.1  | 30.1 | 28.2 | 25.2 | 28.9 | 26.9 | 27.6 | 26.8            | 26.0            |
| Expenditures (% of GDP)           | 41.9  | 36.8 | 30.4 | 26.7 | 28.3 | 27.2 | 27.3 | 27.2            | 26.1            |
| <b>Monetary Statistics</b>        |       |      |      |      |      |      |      |                 |                 |
| Consumer Prices (%YoY)            | 40.0  | 10.1 | 20.0 | 19.2 | 25.8 | 6.1  | -0.6 | 6.0             | 5.4             |
| Monetary Base (%YoY)              | 38.0  | 44.6 | 22.2 | 39.0 | 40.0 | 37.4 | 33.6 | 21.4            | 20.9            |
| Money Supply-M3 (%YoY)            | 35.1  | 33.9 | 25.2 | 40.5 | 45.4 | 42.0 | 41.7 | 28.0            | 28.6            |
| Exchange Rate (UAH/\$)            | 1.8   | 1.9  | 2.5  | 4.1  | 5.4  | 5.4  | 5.3  | 5.4             | 5.5             |
| Exchange Rate (UAH/Euro)          | -     | -    | -    | 4.4  | 5.0  | 4.8  | 5.0  | 5.4             | 5.5             |
| <b>Balance of Payments</b>        |       |      |      |      |      |      |      |                 |                 |
| Goods Exports (US\$bn)            | 15.5  | 15.4 | 13.7 | 12.5 | 15.5 | 17.1 | 18.7 | -               | -               |
| Goods & NFSE (US\$bn)             | 20.3  | 20.4 | 17.6 | 16.3 | 19.3 | 21.1 | 23.4 | 24.5            | 25.6            |
| Goods Imports (US\$bn)            | 19.8  | 19.6 | 16.3 | 13.0 | 14.9 | 16.9 | 18.0 |                 |                 |
| Goods & NFSI (US\$bn)             | 21.5  | 21.9 | 18.8 | 15.2 | 18.1 | 20.5 | 21.5 | 23.1            | 24.6            |
| Trade Balance (US\$bn)            | -4.3  | -4.2 | -2.6 | -0.5 | 0.5  | 0.2  | 0.7  | -               | -               |
| Current Acc. Balance (US\$bn)     | -1.2  | -1.3 | -1.3 | 0.9  | 1.2  | 1.4  | 3.2  | 2.6             | 2.0             |
| Direct Investments (US\$bn)       | 0.5   | 0.6  | 0.7  | 0.4  | 0.6  | 0.8  | 0.7  | 0.8             | 0.8             |
| Gross Reserves (US\$bn)           | 1.9   | 2.3  | 0.8  | 1.1  | 1.6  | 1.7  | 4.4  | 5.3             | 6.1             |
| Gross Reserves (weeks of imports) | 5     | 6    | 2    | 4    | 4    | 8    | 11   | 12              | 13              |
| <b>Public Debt</b>                |       |      |      |      |      |      |      |                 |                 |
| External Debt (US\$bn)            | 8.8   | 9.6  | 11.5 | 12.4 | 10.4 | 10.1 | 10.2 | 10.1            | -               |
| External Debt Service (US\$bn)    | 1.2   | 1.2  | 1.8  | 2.0  | 1.7  | 1.8  | 1.4  | 1.5             | -               |
| Domestic Debt (US\$bn)            | 1.3   | 4.6  | 3.7  | 2.9  | 3.8  | 3.8  | 4.0  | 4.2             | -               |

\* Projections for 2003 and 2004 are presented based on a consensus forecast developed by major forecasting agencies in Ukraine and the forecasting department of the Ministry of Economy of Ukraine.