

## Macroeconomic Situation

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### Summary

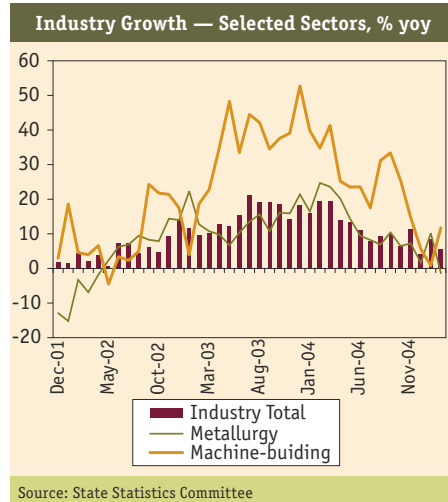
- In February, real GDP growth slowed to 4.5% yoy, bringing the cumulative figure to 5.5% yoy in the first two months of 2005.
- On March 25th, Parliament adopted amendments to the 2005 State Budget envisaging a 1.86% of GDP deficit. Taking into account very ambitious increases in pensions and the minimum wage as well as optimistic revenue growth, the new deficit target may be hard to achieve.
- Inflationary pressures continue to grow; the consumer price index increased 13.3% yoy in February.
- The banking system seemed to fully recover from the liquidity crisis that took place at the end of 2004. Commercial banks managed to restore their deposit base as deposits growth sped up to 42% yoy in February.
- On the path to foreign currency market liberalization, the NBU abandoned its regulation requiring the mandatory sale of 50% of exports proceeds starting April 1, 2005.
- Good export performance allowed the NBU to replenish its gross international reserves to \$10.94 billion by the end of February.

### Economic Growth

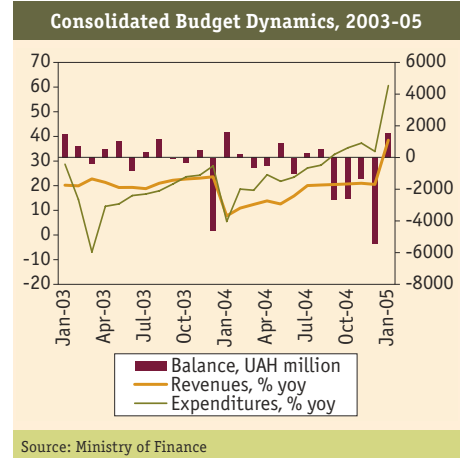


In February, Ukraine's GDP growth continued to decelerate but remained quite strong and broad-based. Over the month, real GDP grew by 4.5% yoy compared to 6.5% yoy in January. Cumulative real GDP growth reached 5.5% yoy in the first two months of the year. One possible explanation for the growth slowdown is that the economy experienced a kind of "political shock" during and after the 'Orange Revolution' and is currently adjusting to operate in new conditions. In addition, lower growth rates for specific sectors of the economy are attributed to high base effects. For instance, construction has been stagnating since the beginning of the year following a construction boom last year. In January-February, value added in construction shrunk 1.7% yoy, which may well be a consequence of the bank liquidity crisis in December 2004. If this was the reason for the dismal performance in construction then the situation should improve in March, when banks renewed their credit ac-

tivity to pre-crisis levels. In January-February, the major contributors to GDP growth were industry (7.3% yoy), agriculture (4.7% yoy), and transport (7.2% yoy). In contrast to previous year, wholesale and retail trade performance worsened as added value increased by a mere 1.8% yoy.



Industrial performance remains robust, though it continues to decelerate. In February, industrial output expanded 5.6% yoy, down from 8.4% yoy a month before. Deceleration can be explained by the significant decline in metals output as increasing input costs reduced the profit margins of metallurgical enterprises. In February, metallurgy experienced negative growth (-1.4% yoy) for the first time since April 2002. However, this decline may also be a temporary phenomenon taking into account the still strong external demand for metals products. Since the beginning of the year, output of oil-refineries declined by almost 4% yoy. Most likely, this was caused by uncertainties concerning taxation of cross-border trade of crude oil in the beginning of the year. At the same time, food processing continued to demonstrate impressive rates of growth in 2005 thanks to the good harvest in 2004. In January-February, food processing output grew 17.4% yoy, encouraged by robust payable domestic demand. Other growth areas included chemicals (up 13.6% yoy) and the paper industry (22.3% yoy). One positive sign is that growth in machine-building recovered to 6.9% yoy in January-February after less than 1% yoy growth in January. Much lower rates of growth in the sector could be explained by last year's base effect, as machine-building output demonstrated



35% yoy growth over January-February 2004. Overall, the growth outlook for 2005 is positive. Assuming a favorable external environment in 2005, most analysts believe that Ukraine's economic growth may reach 7%. The amended 2005 State Budget assumes a more optimistic rate of 8.2% GDP growth for the whole year. This higher rate of growth is expected to be achieved in part by the formalizing a good part of the informal economy in the second half of the year.

### Fiscal Policy

On March 25th, Parliament adopted amendments to the 2005 State Budget developed by the new government. A few days later, President Yushenko approved these amendments. The amended budget includes additional increases in both revenues and expenditures, which poses a challenge for the execution of new budget parameters (see table below). In particular, the government's assumption of budget revenues growth by over 50% yoy is quite optimistic. Last year, budget revenues increased by less than 30% yoy supported by rapid GDP growth at 12.1% yoy. In order to get extra revenues, the amended Budget Law envisages a number of changes in taxation levels and profit deductions from state-owned enterprises. Additional revenue is also expected from the formalizing the shadow economy. On a positive note, the government abolished a number of tax privileges for specific enterprises and industries, as well as free economic zones. Furthermore, excise taxes and fees for oil and gas extraction were raised. Also, the government is requiring state-owned enterprises to transfer twice as much of their profits as last year to the budget, and small businesses working under fixed-tax schemes

Amended 2005 State Budget Parameters					
Law on State Budget for 2005:	Initial parameters		Revised parameters		
	UAH billion	% of GDP	UAH billion	% of GDP	% yoy growth
Revenues	86.361	21.1	106.135	24.3	+50.9
Expenditures	95.231	23.3	114.081	26.2	+41.7
Balance	-8.870	-2.2	-7.045	-1.86	-22.1
Consumer inflation, %	8.7		9.8		
Annual GDP growth, %	6.5		8.2		
Nominal GDP, UAH billion	409.9		436.0		

Source: Ministry of Finance, The Bleyzer Foundation's calculations

must pay payroll taxes, which they were exempt from previously. The new government decided to further increase pensions (up 22% yoy) to an average UAH 383 retroactively from January 2005, and to raise the minimum wage to UAH 332 by the end of 2005 (an average 10% increase every quarter). Overall, the government needs over UAH 10 billion to finance the above mentioned increases in social benefits and the additional UAH 10 billion of social expenditures pledged by the President during the election campaign (particularly benefits for childbirth, social benefits to invalids etc).

Taking into account the very ambitious increases in social security payments (including pension and minimum wage increases), the targeted deficit of 1.86% of GDP will be difficult to achieve. Although the revised budget gap target is low, the actual figure may be higher because the economy may find it difficult to adjust to significant changes in the business environment immediately implied by the Budget Law. Thus, the risk of a high budget deficit is substantial, which could have negative effects on the country's economic development.

Targeted budget gap financing for 2005 should be financed through increases in both domestic and external borrowings and privatization revenue. In January-February, privatization receipts were only UAH 122.4 million (\$23.1 million), a large part of which are privatization revenues from deals concluded last year. In 2005, the government plans to receive UAH 6.99 billion (over \$1.3 billion) but the list of state enterprises subject to privatization has not been made public yet. This is why it is difficult to assess whether the target is realistic. Keeping in mind the as yet unresolved Kryvorizhstal dispute, the total targeted privatization receipts figure seems quite ambitious. At the same time, if Ukraine succeeds in its country promotion campaign and provide for an efficient and transparent privatization process, then arrival of foreign investors willing to enter the Ukrainian market may help to outpace the target. A new borrowings ceiling is set at UAH 6.24 billion and UAH 3.23 billion from domestic and external markets, respectively.

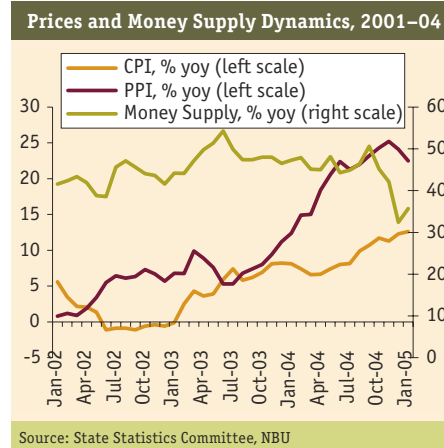
In January-February, fiscal performance was successful. The state budget posted a healthy surplus of UAH 1 billion (\$194 million), which is equivalent to 2% of period GDP. Deflated state budget revenues grew by 37% yoy to UAH 11.9 billion (\$2.23 billion), while expenditures increased by 6.4% yoy to UAH 10.8 billion (\$2.04 billion). The Minister of Finance reported that the state budget revenues targeted for January-March were exceeded by about 10% due to higher than expected tax and customs collections. However, this positive outcome may be reversed after the amendments to the budget will come into force.

In January-February, the stock of public debt grew by 1.2% year-to-date (ytd) to \$16.3 billion. Over the period, external public debt fell to \$12 billion due to a reduction of the country's obligations to the IMF, while domestic debt picked up by almost 7% ytd to \$4.3 billion.

In total, the Ukrainian government has to pay UAH 9.4 billion (\$1.77 billion) of public debt in 2005.

### Monetary Policy

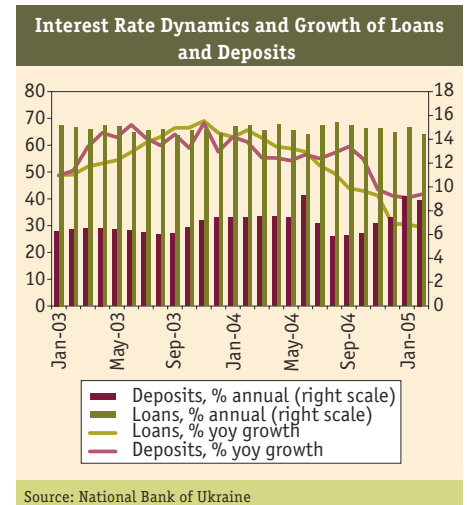
Until recently, the NBU has been targeting the stability of the nominal exchange rate and this policy was successful, but increasing inflationary pressures became the major concern in 2005, prompting a change of monetary policy priorities. So far, the NBU has not revealed strong intentions to tighten its monetary stance and has continued buying excess foreign exchange from the interbank market. However, the situation could change in April when the 2005 Budget amendments come into force, implying massive payouts of increased social benefits.



Consumer prices continued to grow in February, reaching 13.3% yoy, indicating spillover of producers' inflation into the retail market. Over the month, food prices grew by 17.3% yoy primarily on account of 54% and 26% yoy growth in meat and milk prices, respectively. Non-foods and service prices accelerated as well. In February, the non-food price index picked up to 5.4% yoy, while service tariffs growth increased to 6.8% yoy thanks to transportation tariffs growth. At the same time, the producer price index (PPI) kept decelerating, reaching 22.2% yoy in February. Taking into account inflationary budget amendments, consumer inflation may well exceed 12% for the full year, considerably higher than the 9.8% CPI growth assumed in the amended budget. Inflationary pressures on the retail market may be cushioned by lower customs tariffs and non-tariff barriers to imported goods recently introduced by the government. However, the effect on prices of foodstuffs (which account for over 65% of the current consumer basket) is likely to be minimal, at least in the short run, because imported goods are only a small fraction of the consumer food basket.

By the end of February, the banking system had seemed to fully recover from the liquidity crisis in December 2004. In February, money supply (M3) growth further accelerated to 36.4% yoy. Faster deposits growth (42% yoy) contributed the most to

money supply acceleration. Growth of disposable income and the commercial banks' campaign to attract household incomes supported the expansion of banks' deposit base to pre-crisis levels. Lending to the real sector also recovered, but at a much slower pace, as commercial banks became more scrupulous about their risk management strategies. In February, credit growth continued to slow down to 29% yoy from 30.5% yoy a month before. The average cost of loans declined in February to 14.4% per annum, about 60 basis points lower than in January. Deposit rates declined as well to 8.9% annually after commercial banks restored their liquidity positions.



Robust inflow of foreign exchange into the country allowed the NBU to replenish its gross international reserves, which went up 41% yoy and reached \$10.94 billion by the end of February. During the month, the NBU continued to intervene on the forex market and its net purchases were \$893 million. As a result, appreciation pressures on the hryvnia have been partially alleviated. In February, the official hryvnia rate went down only slightly to 5.299 UAH/USD. At the same time, the hryvnia/euro rate picked up by 1% to 6.98 UAH/EUR, reflecting euro strengthening against the dollar. A nominal appreciation of the hryvnia is expected by the NBU during the year, and it should help to contain the strong inflationary pressures from the fiscal deficit.

### International Trade and Capital

At the beginning of 2005, Ukraine's traditional export commodities still remained in great demand on the external markets. Despite some deceleration, merchandise exports growth remained robust, expanding 17% yoy to \$2.5 billion. At the same time, goods imports increased by a considerably lower 4.2% yoy to reach \$1.8 billion. The sharp slowdown of imports growth may be only a temporary phenomenon, which may be attributed to temporary uncertainties regarding taxation of cross-border crude oil trade at the beginning of the year and structural changes in customs procedures introduced by the new government. As a result, the merchandise trade surplus increased by 73% yoy to

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reach \$681 million. By product breakdown, metals exports remained among the largest contributors to the overall growth of goods exports. These items' trading volume expanded by more than 60% yoy in January, while their share in total exports increased to over 45%. For comparison, the share of metallurgical products in total goods exports was considerably lower last year — at 36%. Therefore, Ukraine's export base is poorly diversified and vulnerable to international prices on metals. At the same time, export of machines and equipment declined by 6% yoy in January, which is not comforting. However, it could be partially explained by the high comparison base, since machines exports grew 90% yoy during January 2004. On the imports side, machines and transport equipment imports increased to 14.8% yoy, indicating strong investment demand in the country. Oil and gas imports (the weightiest items in total goods exports) were on the decline, thus explaining total goods imports deceleration. In January, imports of energy resources dropped by 7% yoy due to a more than 24% decline of crude oil imports.



Europe accounted for 38% of total merchandise exports in January, while Asia and CIS countries accounted for 28% and 22%, respectively. At the same time, almost 50% of all goods imported to Ukraine came from CIS countries, whereas the European countries share constituted 31%.

### International Programs

An IMF mission that visited Ukraine at the end of February concluded that Ukrainian authorities have to follow more prudent fiscal policy in order to prevent in-

flation from exceeding 10% in 2005. In particular, the IMF representatives were concerned with the high expected fiscal deficit and the current high inflation in the country. According to the IMF, substantial increases of budget expenditures and ambitious fiscal revenue targets may result in a fiscal deficit on the order of 6% of GDP. Also, the IMF recommended that the NBU allow more flexibility in the hryvnia exchange rate. The exact terms of further cooperation between the IMF and the Ukrainian government are being discussed by the IMF mission currently in Kyiv. As we reported earlier, the last Precautionary Stand-By Program, under which Ukraine could have used funds amounting to \$607 million (or 30% of Ukraine's quota) in case of urgent need, expired in March 2005.

The situation with the Second Programmatic Adjustment Loan (PAL-2) Program is as follows. The World Bank management in Ukraine expressed its readiness to extend the remaining \$175 million under PAL-2 within the next few weeks after the remaining loan conditions related to the restructuring of the energy sector debts is resolved. The government expects to settle this issue soon. Meanwhile, the World Bank promised to extend a EUR 100 million loan for developing municipal infrastructure in Ukraine in January 2006. The latter project envisages financing development of infrastructure in the area of sewage, water supply, waste processing, municipal management, and municipal finances in several Ukrainian cities. Negotiations on specific projects will be carried out in autumn of this year.

### Other Developments and Reforms Affecting the Investment Climate

On the international front, Ukraine continues to reap the laurels of the Orange Revolution. Ukraine's key officials are currently implementing an extensive program of official visits abroad. On April 4th, President Yuschenko headed to the US to make his first official visit to this country. While visiting Washington D.C., he had a meeting with President Bush, addressed a joint session of the US Congress and made several public speeches at universities. Solid relationships with the US government can facilitate Ukraine's integration in the world economy. In particular, the US can formally grant functioning market economy status to Ukraine; this will expedite its admission to the WTO.

WTO membership will enhance Ukraine's global trade opportunities and attract direct foreign investment. Also, the US Congress is expected to introduce legislation to remove Ukraine from Jackson-Vanik trade restrictions with the US.

On the European front, Ukraine hopes to obtain functioning market economy status by mid-June. According to Foreign Minister, this may occur during the Ukraine-EU cooperation council scheduled to take place on June 13th in Luxemburg. By the end of 2005, Ukraine plans to complete negotiations on the creation of a free trade zone with the EU and liberalization of the visa regime. Upon successful implementation of the reform agenda specified in the action plan by 2007, Ukraine may conclude a new agreement with the European Union with a view to achieve the country's membership in the EU in 2010-2014.

On its way to foreign currency market liberalization, the NBU abandoned its regulation requiring the mandatory sale of 50% of exports proceeds beginning April 1st. This major restriction on forex market operations has been in effect since the financial crisis of 1998 when the NBU was short of international reserves. Currently, the elimination of the surrender requirement may have limited effect on the exchange rate because it may not be a binding constraint for most exporters (demand for local currency is quite high and by estimates exporters sell about 80% of their export proceeds).

The new government proposed a number of reductions of import duties and introduced changes in customs procedures to streamline customs clearance of goods coming into Ukraine. The Parliament of Ukraine adopted a draft law envisaging reduction of import duties for imported home appliances, textiles, footwear and certain groups of food products in the first reading. However, the second reading of the draft has been postponed. There is a strong lobby in the Parliament opposed to major reductions of import duties as it may hurt domestic producers. In addition, the government launched an extensive anti-smuggling campaign to legalize so called "grey imports" of goods, which should mean higher customs duties into the state budget. Early in April, fiscal authorities reported that the change has yielded its first results. In March, the State Customs Committee collected 42% more customs duties than was targeted for the period, while import volumes did not increase significantly.