



Quarterly overview 4/2003 (3 quarter 2003)

Center for social and economic
research CASE Ukraine

Ukrainian Economic Outlook

tendecies * estimates * forecasts



“Ukrainian Economic Outlook: Tendencies, Estimates and Forecasts” is a quarterly overview of Ukrainian economy that has been launched in the first quarter of 2000. It was conducted as a joint Harvard/CASE Ukraine project till December 2001 when CASE Ukraine proceeded with development of the publication independently.

Publication presents an overview of current macroeconomic tendencies taking place in the economy of Ukraine. It is also provided quarterly forecasts of GDP, value added, exchange rates, inflation, monetary aggregates, and other indicators.

Outlook was designed as a publication that provides independent analysis of current economic situation and possible scenarios of the development of the economy. The information suggested in the Outlook will be interesting for government officials, policy makers, CEOs of large enterprises, analytical departments of banks, consulting firms, investors and those just interested in macroeconomic tendencies.

The forecast of macroeconomic indicators is conducted on the basis of the macroeconomic model of Ukraine developed by Harvard/CASE Ukraine team in 1995-98. Since that time the model was upgraded several times according to economic situation in Ukraine.

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Overview

For the first three quarters of 2003 GDP grew by 6.5% (y-o-y). Although in agriculture there was registered significant decline (-16.7% (y-o-y), January-September 2003), expansion of domestic demand and favorable external conditions maintained positive growth tendency. GDP was busted by outstanding growth in construction: 25.7% (y-o-y) for the nine months of current year. Industrial output grew by 15.2% for the period.

The exchange rate of hryvnia continued to be stable in the third quarter of 2003. As in the number of previous periods, supply of foreign currency exceeded its demand. Monetary reserves by the end of third quarter increased by USD 2.28 billion to USD 6.68 billion.

Traditional for this period deflation was observed in the third quarter, but its rate was lower than in the corresponding period of the previous year. During July-September consumer prices in Ukraine fell by 1.2% (1.5% in the third quarter of 2002). Annual CPI growth rates increased from 5.9% in June to 7.4% in July and then went down to 6.2% in September.

After a half-year soft monetary policy, in Q3 2003 NBU implemented tighter policy aimed at preventing rapid growth of money supply (limitations on using cash to form required reserves, and deposits certificates issuing). As a result, money supply growth rates decreased from 51.8% (quarter average, y-o-y) in Q2 2003 to 49.0% in the third quarter. Money supply growth was mainly caused by rapid growth of monetary base: in July and August monetary base grew by 4.0% and 4.4% correspondingly, although in September it decreased by 0.5% (as a whole, in the third quarter monetary base increased by 8%).

In the third quarter of 2003 total amount of credits has increased by 17.7% to UAH 60.5 billion. Annual growth rate reached 66.4% in September (+57.4% in June).

Since the beginning of the year total credits increased by 47%.

Deposits grew by 12.0% in the third quarter of 2003 (14.5% in the corresponding period of 2002). During the quarter the annual growth rates remained at high level of +60 - +64%. In the first part of the quarter annual growth rates fell from +67.6% in June to +60.0% in August, but in September they partly restored to +64.0%.

During January-September 2003 the revenues of consolidated budget were collected over the plan for this period. On November 27 Verchovna Rada approved the state budget for 2004. In the state budget revenues amounted to UAH 60.7 billion (21.4% of GDP), and expenditures – UAH 64.2 billion (22.6% of GDP).

In January-September of year 2003 the export of goods and services from Ukraine totaled USD 19,412.1 million, which is 24.1% more compared with the corresponding period of 2002. At the same time Ukraine imported USD 16,934.5 million of goods and services, an increase of 30.6% compared with the corresponding period of 2002. Thus, growth of import volumes exceeded growth of export ones in the first three quarters of 2003. This resulted in reduction of the positive trade balance surplus to USD 2,477.6 million (USD 2,578 million in the same period of 2002).

As of October 1 the stock of the foreign direct investment in Ukraine amounted to USD 6,212.9 million. The net increase in the stock of FDI in Ukraine in the third quarter of 2003 equaled USD 175.4 million. In January-September the inflow of the FDI in Ukraine totaled USD 954.09 million (680.9 million in January-September of 2002), of which 41.28 million came from the CIS and Baltic countries and the remaining USD 912.8 million from the rest of the world. The outflow of FDI from Ukraine equaled USD 346.28 million (247.7 million in January-September of 2002).

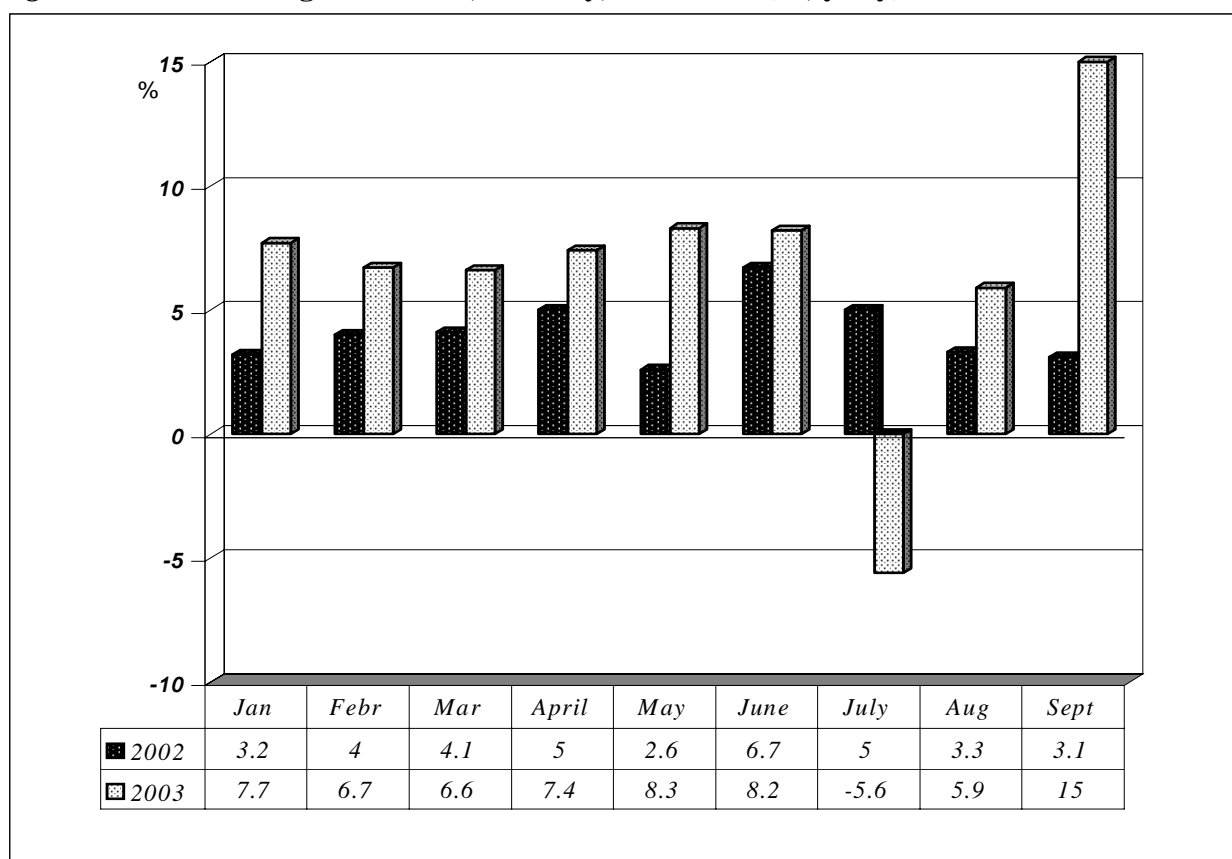
Overview of Economic Situation for the Third Quarter of 2003

1. Gross Domestic Product and Value Added

- Remarkable growth rate of GDP endured in Q3 2003 despite poor performance in agriculture
- Outstanding growth of construction
- Growth rate of expenditures exceeds growth rate of income

The growth rate of Ukrainian GDP continues to be very high. According to the preliminary data the growth rate of GDP during January-September 2003 was about 6.5%. However, there were sharp fluctuations in monthly growth rates: an abrupt decline in July, caused by poor agricultural performance, was fully compensated by considerable output increase in August and September (Figure 1).

Figure 1.1. Real GDP growth rates, monthly, 2002-2003 (% , y-o-y)



Source: The State Committee of Statistics of Ukraine

The GDP increase was apparently stimulated by the growth in households' expenditures. For the period of January-September of 2003 household's expenditures increased by 19.8% (y-o-y), while nominal income grew only by 12.4%. This tendency of exceeding growth of

expenditure over income was firstly observed in 2002 (households' income rose by 76.4%, household's expenditure rose by 92.3%)¹. This phenomenon can be

¹ Interestingly, due to deflation registered in 2002, real increase in income and expenditures was even higher than nominal one.

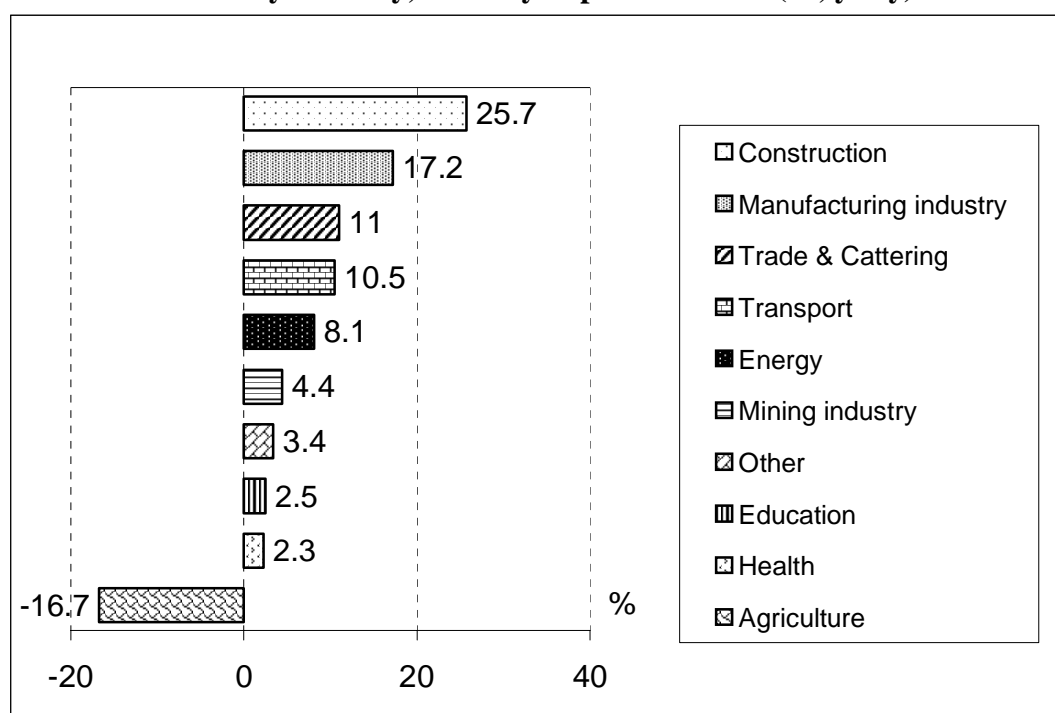
explained by positive expectancies of Ukrainians about the future development of Ukrainian economy (and, hence, their future incomes). Also the tendency has another possible explanation: boosting growth of households' shadow income.

Favorable external market conditions also positively affected rapid growth of Ukrainian economy. More detailed analysis

of the factor can be read at **Foreign Trade** section.

During January-September 2003 the highest growth in value added was registered in construction (+25.7%) and manufacturing industry (+17.2%). As it was expected, due to poor harvest there was observed drastic decline in agriculture (-16.7%).

Figure 1.2. Value added by industry, January-September 2003 (% , y-o-y)



Source: The State Committee of Statistics of Ukraine

Construction sector in 2003 shows an outstanding growth rates. It should be noted that for the first three quarters of 2002 there was registered a decline in the sector (Figure 1.3)². Therefore, partly such high growth rates should be attributed to negative numbers in 2002 (as a result of mathematical manipulations). On the other hand, the growth in construction is explained by a number of large projects such as: construction of power generating units at Rivne and Khmelnytskyi nuclear power plants, Kyiv-Odessa highway,

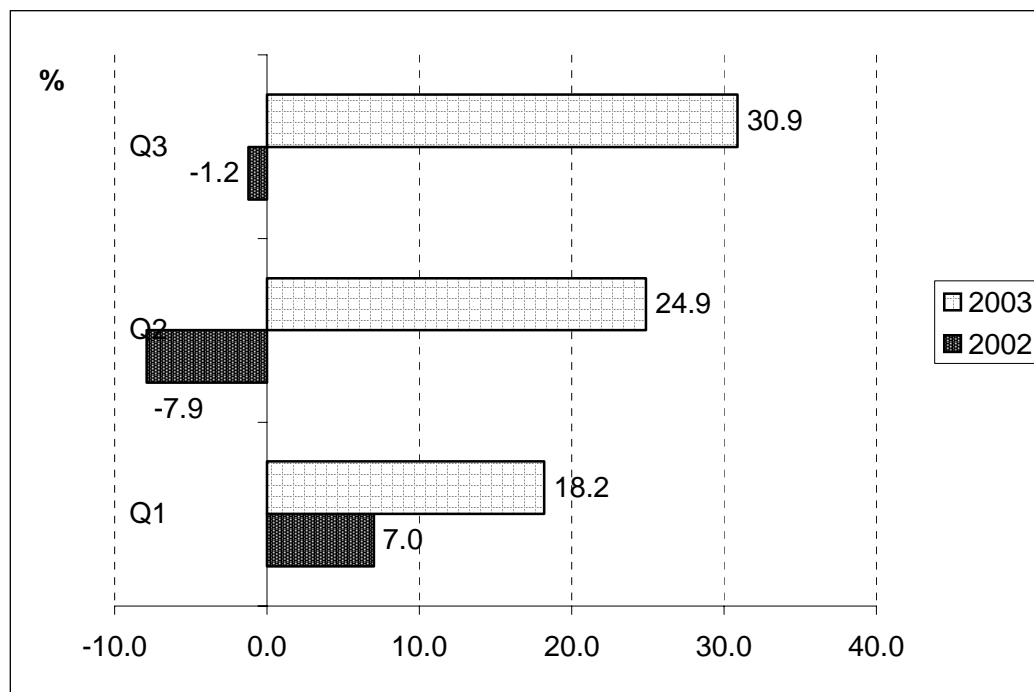
Zhulyn-Nadvirna oil pipeline, the second factory by Eurocar, etc. Furthermore, significant increase in housebuilding was registered for this period. The largest Ukrainian housebuilding company "Kyivmiskbud" increased its scope of work by 21.8% in Q3 2003. Significant growth in housebuilding can be accounted for extremely high demand on accommodations. The latter was apparently stimulated by the rapid development of the market for mortgages. Moreover, investment of available funds in real estate property is still the best opportunity for most economic agents to protect their money and to make them work in the long-run.

² The number for Q3 2003 is CASE Ukraine estimate based on preliminary data of State Committee of Statistics of Ukraine.

According to the preliminary results of quarterly survey in banking sector conducted by CASE Ukraine, construction

is considered by banks as the most perspective sector for crediting for the next three months.

Figure 1.3. Real growth rate in construction, quarterly, 2002-2003 (% , y-o-y)



Source: The State Committee of Statistics of Ukraine, CASE Ukraine estimations

Industrial output

During the nine months of 2003 industrial output grew by 15.2% compared with the corresponding period of 2002. The industrial growth was mainly supported by the development of three sectors of economy: machinery construction, food industry, and metallurgy. Machine building made the major impact on the total industrial output growth. The growth rate of the sector was about 33% (y-o-y) during the first three quarters of the current year (the

share in the overall industrial output is about 13.6%) and it is attributed mostly to external market conditions. Considerable growth in food industry (22.8%, y-o-y, January-September 2003), on the contrary, is stimulated by increasing domestic demand (the share in total industrial output is 17.1%). Metallurgy showed more modest growth rates than the two above sectors (only 12.7% for the corresponding period), although its share in industrial output is the largest – 24.7%).

Table 1.1 The growth of industrial output, 2003

	Jan	Febr	Mar	April	May	June	July	Aug	Sept
The growth of industrial output %	11.6	9.7	10.1	13.0	12.3	15.4	21.1	19.1	19.2

Source: The State Committee of Statistics of Ukraine, Ministry of Economy and European Integration

Table 1.2. Value added by sectors, 2001-2003 (% , y-o-y)

	Value added	Industry	Agriculture	Construction	Market services*	Non-market services**
2001	8.9	14.2	10.4	9.0	10.0	3.8
2002	4.4	7.0	1.9	0.1	3.5	1.5
2002 Q1	4.1	2.4	9.2	0.7	9.0	0.6
Q2	4.5	7.6	12.1	-7.9	2.6	0.4
Q3	4.1	6.5	2.1	-1.2	2.1	1.5
Q4	4.8	9.1	5.8	2.7	2.7	1.5
2003 Q1	7.7	10.4	4.4	18.1	8.4	2.2
Q2	9.0	12.6	-13.0	24.9	13.1	3.8
Q3***	4.0	20.0	-21.0	30.9	10.5	1.3

* - includes Transport & Communication and Trade & Catering

** - includes Public healthcare service and Education

***- CASE Ukraine estimations on the basis of the express-information from The State Committee of Statistics of Ukraine

Source: The State Committee of Statistics of Ukraine

Table 1.3. Aggregate demand in constant prices, 2001-2003 (% , y-o-y)

	GDP	Domestic demand	Consumption		Investment	Export	Import
			Private	Gov-t.			
2001	9.1	9.5	9.1	9.6	8.3	2.9	2.2
2002	4.9	1.2	6.5	2.4	5.5	2.8	2.0
2002 Q1	4.1	2.0	7.6	3.0	1.4	3.2	-0.2
Q2	4.7	4.4	8.1	2.4	7.8	3.3	2.7
Q3	4.3	1.9	7.1	2.5	6.4	2.8	3.0
Q4	6.1	-2.3	6.9	2.4	6.7	2.2	2.5
2003 Q1	7.9	10.1	11.0	10.1	15.0	9.8	13.6
Q2	9.3	14.5	15.7	14.5	20.6	8.9	17.9
Q3***	4.0	7.4	12.8	13.1	11.9	8.9	10.8

***- CASE Ukraine estimations on the basis of the express-information from The State Committee of Statistics of Ukraine

Source: The State Committee of Statistics of Ukraine

2. Foreign Exchange Market

- Hryvnia's nominal exchange rate stability
- Continuing growth of NBU foreign reserves
- Smooth REER dynamics after significant depreciation

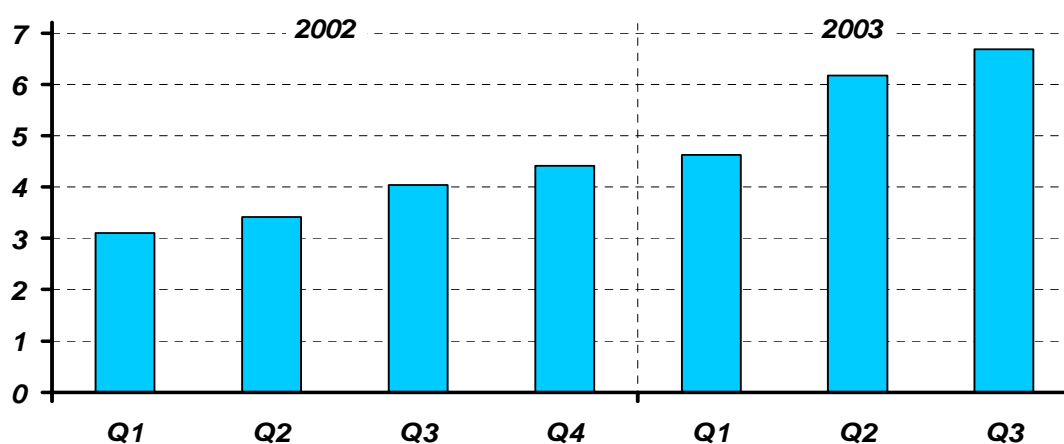
Under the circumstances of significant prevalence of foreign currency supply, NBU continued maintaining nominal stability of UAH/USD exchange rate by buying out the surplus of currency, although allowing very slight fluctuations. In the third quarter 2003 official UAH/USD nominal exchange rate has appreciated by 0.02% and amounted to UAH 5.3315 per US dollar at the end of the period. Since the beginning of the year hryvnia has already appreciated by 0.02% (in 2002 hryvnia depreciated by 0.68%).

During Q3 2003, similarly to a number of previous periods, supply of foreign currency exceeded its demand. However, the quantity demanded and supplied on the inter-bank foreign exchange market varied greatly. In the first two months of the third quarter foreign currency surplus was quite significant, but by the end of the period demand and supply were almost equalized.

Demand and supply trends on foreign exchange market were mainly affected by foreign trade patterns and fluctuations on the inter-bank resource market:

- During Q3 2003 trade balance was deteriorating (from +USD 11.5 million in July to – USD 28.3 million in September, see **Foreign Trade**). It has a negative impact on foreign currency inflows to the market. The most significant effect of the changes in foreign trade patterns could have been observed in September, when amount of NBU interventions dropped to the lowest level since the beginning of 2003 - to USD 37.7 million.
- Variability of interest rates on the inter-bank resource market (see **Monetary Policy**) could also affect supply of foreign currency this quarter. In August, when inter-bank interest rates climbed out, positive difference between currency supply and demand significantly increased also. As a result, total National bank interventions amounted to USD 537.6 million – the highest level since the beginning of the year.

Figure 2.1. NBU international reserves, USD billion, end of the period³



Source: NBU

³ Given amount of reserves for Q3 2003 is preliminary.

Policy of retaining stable nominal exchange rate (such slow appreciation could be counted as stability) has both advantages and disadvantages. On the one hand, it obviously contributed to successful repayment of foreign debt due in September (Euro 130.9 million and USD 180.5 million). This, in turn, increased credibility of Ukraine and allowed placing Ukrainian government bonds of USD 200 million on external markets. Moreover, despite large foreign debt payments such policy allowed NBU substantially enlarge its international reserves. During July-September 2003 they increased by 10.1% to approximately USD 6.7 billion (by preliminary calculations it equals almost 16 weeks of import). Since the beginning of the year reserves grew by 51.2% (see **Figure 2.1**). Furthermore, the policy, together with real GDP growth, creates positive expectations of economic agents for future economic situation of Ukraine.

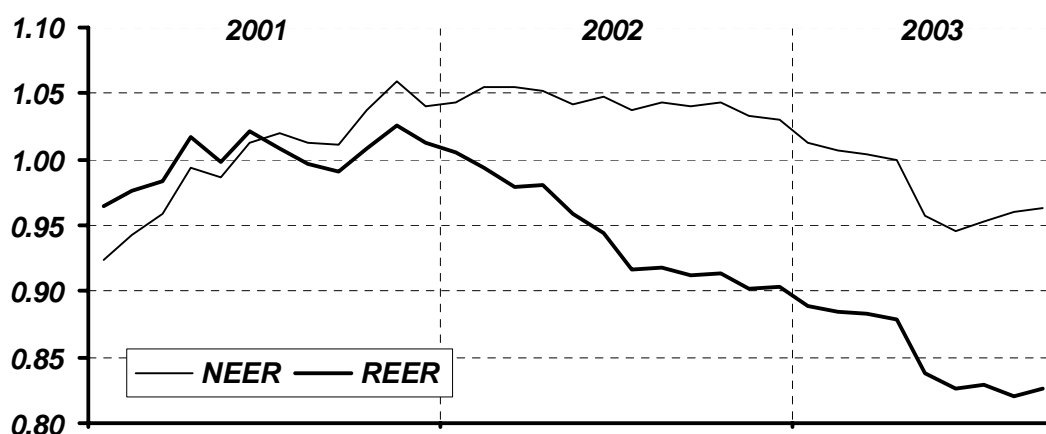
On the other hand, in spite of sharp decline in September, total amount of NBU interventions in the third quarter equaled

USD 904.4 million, which is 45.3% and 22.8% higher than in the first and the second quarters correspondingly. Such massive interventions of the National bank on the foreign exchange market stimulated increase of money supply. For the time being, however, NBU manages to control inflation having considerable budget surplus (see **Budget**) and GDP growth (see **GDP and Value added**).

According to the tendencies, which formed on the international markets, nominal exchange rate of the hryvnia to the Euro was quite volatile: during July-August Ukrainian currency appreciated by 5.3% and during September - depreciated by 5.4%. As a result, in the third quarter hryvnia has appreciated to the Euro by 0.2%.

After significant appreciation of the Russian ruble (RUR) to the US Dollar in the first half of this year (by 4.5%), in the third quarter nominal exchange rate has depreciated by 0.9% (official CBR exchange rate). As a result, during Q3 2003 hryvnia appreciated to ruble by 0.9% too.

Figure 2.2. Hryvnia's REER and NEER, 2001 - 2003 (2001 = 1)⁴



Source: CASE Ukraine calculations

⁴ When NEER or REER decreases, it means that hryvnia depreciates.

For the last two years stable depreciation tendency of hryvnia's real effective exchange rate (REER) was observed. In 2002 it depreciated approximately by 10.8% and since the beginning of this year it has already depreciated by 8.5%. Very low domestic inflation rate (and even deflation in 2002) is the main reason of such REER behavior. At the same time, hryvnia's nominal effective exchange rate (NEER) was less volatile (see **Figure 2.2**).

Depreciation of REER is, obviously, in favor of Ukrainian producers since increases their products competitiveness.

In Q3 2003 hryvnia's REER remained almost unchanged, appreciating only by 0.1% (preliminary calculations). Such stability can be explained by almost unchanged consumer prices in Ukraine (see **Prices**) and its major trade partners, and absence of significant fluctuations of hryvnia's nominal exchange rate.

Table 2.1. Hryvnia's nominal exchange rate (UAH per 100 foreign exchange units)

Period	USD/UAH		EUR/UAH		RUR/UAH	
	Period average	End of period	Period average	End of period	Period average	End of period
2000	544.01	543.45	502.88	505.68	19.40	19.30
2001	537.08	529.85	481.36	466.96	18.40	17.60
2002	532.68	533.24	503.86	553.29	16.99	16.78
2002Q1	531.89	532.20	466.11	464.29	17.28	17.10
2002Q2	532.83	532.88	488.24	523.50	17.03	16.95
2002Q3	532.91	532.95	524.35	521.17	16.88	16.85
2002Q4	533.06	533.24	532.97	553.29	16.77	16.78
2003Q1	533.37	533.45	572.15	572.39	16.85	17.00
2003Q2	533.34	533.28	605.12	609.65	17.27	17.58
2003Q3	533.18	533.15	599.80	608.48	17.52	17.42

Source: NBU

3. Monetary Policy

- Implemented monetary policy is directed at prevention of rapid money supply growth
- Interest rates stable dynamics
- Fast growth of crediting real economy is continued

After a half-year of the soft monetary policy, in Q3 2003 NBU implemented tighter policy aimed at preventing rapid growth of money supply (limitations on using cash to form required reserves, and deposits certificates issuing). As a result, money supply growth rates decreased from 51.8% (quarter average, y-o-y) in Q2 2003 to 49.0% in the third quarter. Obviously, the main goal of the policy is to reduce risk of speeding up inflation especially taking into account expected price increase in the fourth quarter of 2003 and at the beginning of 2004 (see **Prices**).

The money supply growth in Q3 2003 was mainly caused by rapid growth of monetary base: in July and August monetary base grew by 4.0% and 4.4% correspondingly, although in September it decreased by 0.5% (as a whole, in the third quarter monetary base increased by 8%). Lower M3 growth in the first two months (2.3% and 2.7% correspondingly) was altered by 4.2% increase in September. Likewise, money multiplier decreased from 2.24 in June to 2.17 in August and climbed to 2.28 in September.

Monetary base fluctuations in the third quarter (increase in the first two months of the quarter and decline in September), were mainly caused by:

- **NBU operations on foreign exchange market:** during July and August NBU bought out USD 329.1 and 537.6 million correspondingly, although in September volume of these operations dropped to USD 37.7 million (see **Foreign Exchange Market**);
- **Open market operations:** in the first two months of the quarter government

sold bonds amounting to UAH 110.8 million, but, at the same time, it made UAH 609.1 million repayments on previous bonds. Therefore, net commercial banks' receipts (main buyers of government bonds) were almost UAH 500 million. However, in September this difference dropped to UAH 58.7 million.

- At the same time, National bank used **sterilizing operations** to regulate immediate value of commercial banks liquidity: at the beginning of July NBU issued deposit certificates of UAH 250 million.

During the quarter NBU actively refinanced commercial banks (by UAH 3.5 billion) to prevent significant interest rate fluctuations on the inter-bank resource market. In spite of significant amount of these operations, their influence on monetary base is quite restricted, because most of them are short-term and their amount is quite volatile.

Another important factor of MS rapid growth this year is money multiplier. In 2003 its level is significantly higher than in the previous one: 2.21 on average over three quarters of 2003 vs. 1.94 in 2002 (see **Figure 3.1**). The main causes of this are considerable growth of credits and deposits, (while cash in circulation growth is slowing down).

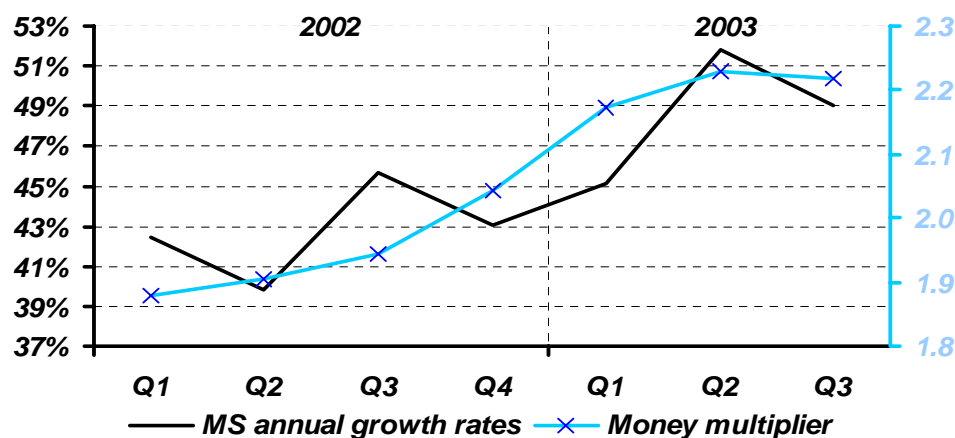
In Q3 2003 the multiplier continued to fluctuate around 2.2 and reached 2.28 in September. Temporary monetary multiplier decline in July-August was caused by NBU's prohibition since the beginning of July to include in required reserves cash in foreign currency and since the beginning of August, in national currency. Another reason was issuing the NBU deposit certificates at the beginning of July (see above).

As a result, in the third quarter 2003 money supply (M3) in Ukraine increased by 9.5% (12.8% in the third quarter of 2002) to UAH 86.5 billion. Therefore, annual growth rates of M3 (y-o-y) felled during the

quarter: from +54.3% in June to +49.8% in

September.

Figure 3.1. Money supply, annual growth rates (%), and money multiplier, 2002-2003



Source: NBU and CASE Ukraine calculations

In the third quarter of 2003 the growth rates of currency in circulation were also lower than in Q3 2002: +5.1% and +10.3% correspondingly. Annual growth rate of M0 decreased to +30.6% in September after +37.1% in June. The share of M0 in money supply also decreased from 37.2% in June to 35.7% in September. This situation is, obviously, explained by stable development of money markets and increasing trust in the national currency and banking system.

Real GDP growth remained the major reason of high demand for money (see **GDP and Value Added**). Moreover, through positive effect on money multiplier it allowed NBU to suppress significant pressure on prices caused by high money supply growth. It also stimulated growth of credits.

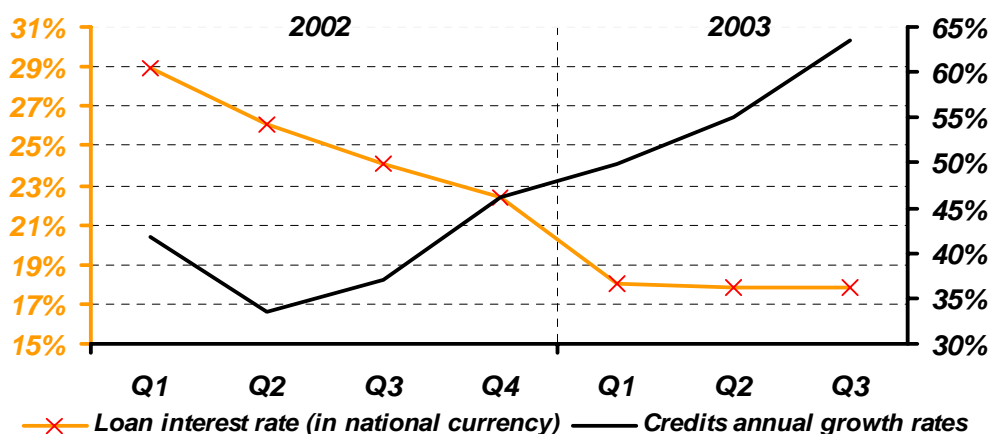
In the third quarter of 2003 total amount of credits has increased by 17.7% to UAH 60.5 billion. Annual growth rate reached 66.4% in September (+57.4% in June) (see **Figure 3.2**). Since the beginning of the year total credits increased by 47%. Acceleration of growth of credits compared with previous year is, obviously, explained by increase in the amount of deposits and significant real GDP growth. Another important reason is NBU's measures, aimed

at increasing commercial banks ability to credit both legal entities and private sector. These measures were, mainly, implemented in the first half of the year. They included reduction of required reserve rates for standard credit operations, simplification of borrowers' financial state estimation procedure and expanding private sector borrowing opportunities. These measures, however, put the banking system at risk, because already ratio of capitalization of the banks is low. At the same time such regulations may lead to increased amount of "bad" credits, and, in a few years, to the financial crisis similar to Asian in 1997.

Deposits grew by 12.0% in the third quarter of 2003. During the quarter the annual growth rates remained at high level of +60 - +64%. In the first part of the quarter annual growth rates fell from +67.6% in June to +60.0% in August, but in September they partly restored to +64.0%.

Structure of deposits was almost unchanged: the share of private deposits remained at approximately 50%. This structure is not very good, because deposits of legal entities are quite volatile and cannot be a stable source of long-run credits.

Figure 3.2. Credits (annual growth rates, %) and interest rate on credits in national currency (%)



Source: NBU

After significant decline in 2002, interest rates for credits and deposits in 2003 remained almost unchanged, although monthly rates fluctuated. At the end of the third quarter interest rate for loans (in national currency) did not change from the level at the end of the second quarter 17.2%; however, during this quarter it reached 18.2%.

Deposit interest rate (in national currency) was unchanged at the end of the quarter compared with last month of the second quarter - 6.7%. But during the quarter it reached 6.3% in July and 6.8% in August.

Quite volatile situation remained on the inter-bank resource market. After interest rates stability in July (6.3% on average) at the end of August they increased to 10.5 - 15.0% (8.4% on average this month). Obviously, this was mainly caused by NBU measures toward using cash to form required reserves (see above), which led to resources deficit on the market. To prevent further interest rates increase, NBU refinanced commercial banks by UAH 1.3 billion in the second half of August. In

September amount of NBU refinancing operations also remained at significant level and inter-bank interest rates dropped to 6.6 - 7.8% (7.2% on average).

In the third quarter the government issued bonds of UAH 170.9 million. This is less than in the previous quarter (UAH 387.5 million) and in the corresponding quarter of 2002 (UAH 779.6 million). Weighted average returns on government bonds increased from 9.9% in the second quarter to 10.5% in third quarter. At the same time weighted average period on which resources were attracted decreased to 475.8 days from 567.7 in the previous quarter. The reduction obviously indicates on the existence of inflation expectations, and difficulties placing the government bonds.

In the third quarter of 2003 National bank of Ukraine did not changed values of its instruments of monetary policy: discount rate was 7% and overnight central bank discount rate (lombard rate) was 8%. The rate of required reserves also remained unchanged.

Table 3.1. Reserve money components (million hryvnias)

Period	Reserve money	Net foreign assets	Net domestic assets	Net claims on government	Net claims on banks	Other net items
2001 Q1	17 471.30	260.78	17 210.52	17 838.10	1 525.31	-2 152.89
Q2	19 459.80	2 357.96	17 101.84	17 565.90	1 569.96	-2 034.02
Q3	20 807.00	4 783.87	16 023.13	16 550.20	1 513.32	-2 040.39
Q4	25 033.70	6 871.21	18 162.49	18 389.70	1 570.25	-1 797.46
2002 Q1	25 343.30	7 200.28	18 143.02	18 257.30	1 473.71	-1 587.99
Q2	26 924.50	8 258.32	18 666.18	18 348.70	1 458.46	-1 140.98
Q3	29 455.40	12 196.60	17 258.80	18 094.30	1 444.36	-2 279.86
Q4	30 990.30	13 852.60	17 137.70	18 273.30	1 755.75	-2 891.35
2003 Q1	31 468.40	17 118.10	14 350.30	17 508.60	1 673.45	-4 831.75
Q2	35 163.00	23 234.30	11 928.70	12 277.90	2 052.00	-2 401.20

Source: NBU

4. Prices

- Seasonal deflation in the third quarter of 2003
- Risk of inflation acceleration due to food prices rise at the end of 2003 - at the beginning of 2004

Traditional for this period deflation was observed in the third quarter, but its rate was lower than in the corresponding period of the previous year. During July-September consumer prices in Ukraine fell by 1.2% (by 1.5% in the third quarter of 2002). Annual CPI growth rates increased from 5.9% in June to 7.4% in July and then went down to 6.2% in September.

There are risks of inflation acceleration at the end of the year - beginning of the next one. Because of poor harvest this year, it is expected that prices on a number of foods will rise in Q4 2003 - Q1 2004.

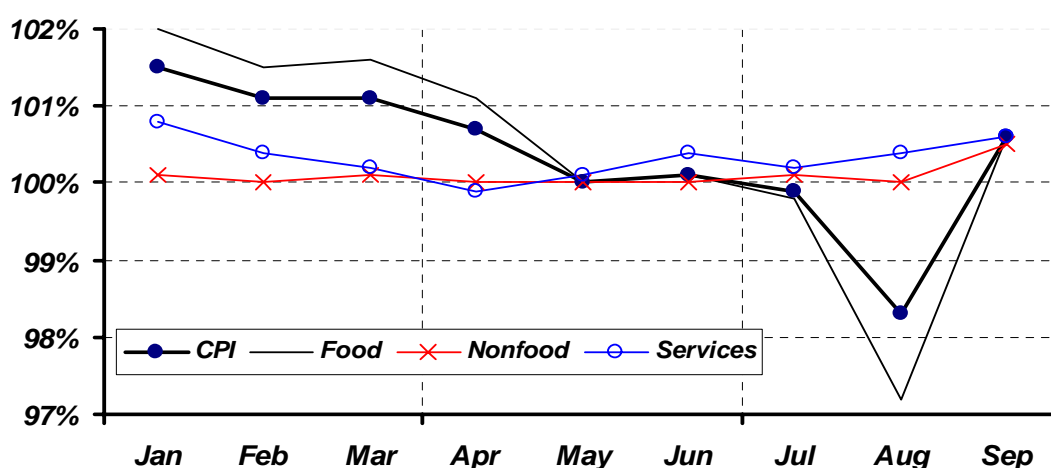
Another factor that can cause inflation at the end of the year is expected significant budget expenditures (see **Budget and Fiscal Policy**), which, we think, will be made in a form of social payments and

repayments of wage arrears to the employees of budgetary organisations.

Up to now, NBU and government managed to control inflation mainly due to budget surplus, stable hryvnia's nominal exchange rate and considerable real GDP growth. However, deterioration of trade balance and significant price increase on foods at the end of the year may have negative effect on inflation. Hence, price dynamics in the nearest future will depend on the exact actions the government will make to regulate food prices and whether these measures will be in accordance to market mechanisms.

These were mainly food prices that determined CPI fluctuations in 2003 (see **Figure 4.1**). Like in Q3 2002, when foods became cheaper by 3.2% (q-o-q), in July-September 2003 they fell by 2.4% (q-o-q). However, unlike last year, when food prices decreased by 6.1% during Q1 - Q3, in the corresponding period of 2003 they have grown by 3.9%. Greater growth rates of food CPI are mainly caused by poor agricultural performance this year.

Figure 4.1. CPI and its structure, 2003 (m-o-m)



Source: The State Committee of Statistics of Ukraine

Nonfood price index in Q3 2003 was slightly higher than in the same period last year: 100.6% and 100.3% correspondingly.

Since the beginning of the year nonfood prices have increased by 0.8% (+1.2% in the corresponding period of 2002).

In September 2003 nonfood prices increased by 0.5% - the highest level since June 2002. Sharp price increase on petroleum by 10.7% is primarily responsible for the nonfood price index leap that month in agriculture, which was caused by seasonal increase of the demand on petroleum.

In the third quarter of 2003 prices on services had normal dynamics without any significant fluctuations. They grew by 1.2%, which is slightly smaller than in the corresponding period of 2002 (+1.8%). Since the beginning of the year services became 3.0% more expensive (+2.1% during the same period last year).

Producer price index (PPI) in Q3 2003 equaled 102.9%, which significantly higher than in the third quarters in 2001 and 2002 (100.1%, 100.9% correspondingly). Since the beginning of the year producer prices have surged by 7.0% (+5.4% in the same period last year). The largest price increase was registered in mining (+3.3%) and manufacturing (+3.2%) industries while the slightest - in energy industry (+0.4%).

This rapid growth of prices on producer's goods may lead to faster consumer prices growth next year and deteriorate inflation expectations today.

Table 4.1. Prices and nominal USD/UAH exchange rate (at the end of period), indices, 2000-2003

Period	CPI		PPI		USD/UAH exchange rate	
	q-o-q	y-o-y	q-o-q	y-o-y	q-o-q	y-o-y
2000		125.8		120.6		104.0
2001		106.1		100.9		97.5
2002		99.4		105.8		100.6
2002Q1	98.9	102.2	99.5	99.5	100.4	98.2
2002Q2	99.3	98.9	105.0	104.0	100.1	99.1
2002Q3	98.5	98.9	100.9	104.9	100.0	100.0
2002Q4	102.8	99.4	100.4	105.8	100.1	100.6
2003Q1	103.7	104.3	103.3	109.9	100.0	100.2
2003Q2	100.8	105.9	100.6	105.3	100.0	100.1
2003Q3	98.8	106.2	102.9	107.4	100.0	100.0

Source: The State Committee of Statistics of Ukraine

5. Budget and Fiscal Policy

- Revenues of consolidated budget are collected over 100% of the plan
- Verhovna Rada of Ukraine approved the project of the state budget 2004
- On October 1 the budget profit totaled UAH 3.97 billion.

During January-September 2003 the revenues of consolidated budget were collected over the plan for this period. Since the beginning of the year consolidated budget revenues totaled UAH 53.22 billion or 30.1% of GDP (this ratio was 25.9% in the corresponding period of 2002). Till the end of the current year it is planned to receive UAH 73.83 billion.

During the first three quarters of 2003 the rate of execution of consolidated budget expenditures was only 60.6%. Expenditures totaled UAH 49.25 billion or 27.9% of GDP (this ratio was 25.9% in 2002). On October 1 the budget profit was UAH 3.97 billion.

On November 27 Verhovna Rada approved the state budget for 2004. The state budget revenues amounted to UAH 60.7 billion (21.4% of GDP), and expenditures to UAH 64.2 billion (22.6% of GDP). The peculiarities of the budget-2004 are changes in the tax system. Starting 2004 the rate of the enterprise profit tax will be reduced from 30% to 25% and the progressive scale of personal income tax (10-40%) will be replaced by one flat tax rate of 13%.

The introduction of new rules of taxation of personal income produced sharp debate about the consequences of the changes. Similar tax reforms were conducted in many countries. The main reason for the reform was to make tax evasion less tempting. Such experiments were conducted in USA in 1986, in Sweden in 1990/91, and in Russia in 2000. The outcomes of the reduction in tax rates varied from country to country: in USA and in Russia there were observed significant positive effects of the reforms on the economy and on the budget revenues, while in Sweden the tax rate changes were followed by recession. Such dispersion of tax reform outcomes makes the analysis of possible consequences of the reduction of personal income tax rate in Ukraine more difficult. Initial conditions in Ukraine are more similar to those in Russia (however, still not identical); so, we have some premises to expect that the reform will have positive consequences.

Russia. In 2000 progressive tax rate scale was replaced by 13% flat tax rate. As a result, in 2001 the revenues from the personal income tax increased by more than 45% nominally (+23% real change). The growth of household's income (as a result of economic growth), tax avoidance in year 2000 in favor of the tax payments in year 2001, and some other factors were defined as the sources of the budget revenues' growth. However, the main reason of the increase was the growth of the tax base (as a consequence of tax evasion reduction). According to the results suggested by Russian researcher Sinelnikov-Muryliev, the tax base increased due to changes in the tax rate by 39.7%, due to household's income growth by 41.5% and due to inflation by 18.8%. So in Russia the reduction of the scale of tax evasion (as a consequence of personal income tax rate changes) was one of the strongest factors for budget revenues increase.

In Ukraine in 2003 the revenues from the personal income tax are expected to be on the level of UAH 12.75 billion. For 2004 the Ministry of Finance has estimated the revenues from this tax about UAH 12.5 billion, while SEFR (Support for Economic and Fiscal Reform Project) has estimated these revenues on the level of UAH 10.7 billion. Own forecast of CASE Ukraine is close to the SEFR's results – UAH 10.9 billion. This estimate is based on the pessimistic scenario. The scenario considers a modest increase in household's income and quite insignificant effect on tax evasion. Despite the fact that the evidence from Russian tax reform indicates that in the CIS countries a significant increase in the tax base as a consequence of tax rate reduction, it is necessary to consider pessimistic outcome in order to prevent excessive budget deficit.

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Table 5.1. State budget revenues structure for year 2003 and 2004 (% of GDP)

	State budget revenues for year 2003 with amendments	State budget revenues for year 2004 approved by Verchovna Rada of Ukraine	Comments
VAT	5.5	6.5	<i>Tax rate remains the same – 20%</i>
Enterprise profit tax	4.7	4.3	<i>Tax rate decreases from 30% to 25%. As a result, revenues from the tax are expected to remain approximately on the same level as in year 2003.</i>
Own revenues of budget organizations	2.6	1.8	<i>Expected decrease in revenues from budget organizations' services</i>
Revenues from property and entrepreneurship	2.4	2.0	X
Excise	1.9	2.3	<i>Preservation of the taxation of gasoline; increase of the tax rate on alcohol and tobacco products; introduction of ad-valorem taxation of tobacco products;</i>
Import duties	1.0	1.4	<i>Expected increase in the imported quantities of goods and services</i>
Other	3.0	2.5	X
Total*	21.4	20.8	X

* without inter-budgetary transfers

Source: Budget committee of Verchovna Rada of Ukraine; CASE Ukraine estimations

The structure of budget revenues underwent some changes during the last three years. The share of personal income tax in total revenues has been permanently increasing during the last three years. This tendency directly indicates the increase of the population's income (officially declared). The share of VAT in tax revenues (19.2%) in 2003 is significantly smaller than in 2002

(22.8%) and slightly smaller than in 2001 (19.4%). The share of enterprise profit tax in the structure of budget revenues in the current year (15.8%) is larger than in both year 2002 (14.6%) and year 2001 (15.7%). These structural changes are direct consequences of positive economic development in Ukraine.

Table 5.2. Consolidated budget, revenues

	October 1, year 2001			October 1, year 2002			October 1, year 2003		
	UAH million	% GDP	Structure, %	UAH million	% GDP	Structure, %	UAH million	% GDP	Structure, %
Total	39153.6	26.2		43544.2	27.6		53214.8	30.1	
<i>Tax revenues</i>	26767.3	17.9	68.4	32350.2	20.5	74.3	38716.3	21.9	72.8
VAT	7599.7	5.1	19.4	9912.8	6.3	22.8	10189.4	5.8	19.2
Enterprise profit tax	6143.4	4.1	15.7	6374.8	4.0	14.6	8386.7	4.8	15.8
Personal income tax	6171.3	4.1	15.8	7631.1	4.8	17.5	9438.7	5.4	17.7
Excise	1992.9	1.3	5.1	2956.6	1.9	6.8	3746.6	2.1	7.0
Taxes on international trade	1421.3	1.0	3.6	1683.3	1.1	3.9	2629.3	1.5	4.9
Other	3438.7	2.3	8.8	3791.6	2.4	8.7	4325.6	2.5	8.1
<i>Non-tax revenues</i>	11018.0	7.4	28.2	9896.8	6.3	22.7	12659.2	7.2	23.8
Own revenues of budget organizations	4036.1	2.7	10.3	5001.0	3.2	11.5	5554.4	3.2	10.4
Other	6981.9	4.7	17.8	4895.7	3.1	11.25	7104.8	4.0	13.4
Budget deficit financing	-766.8	-0.5	-2.0	-1861.5	-1.2	-4.3	-2405.9	-1.4	-4.5
Internal financing	-828.8	-0.6	-2.1	816.7	0.5	1.9	-1987.1	-1.1	-3.7
External financing	62.0	0.0	0.2	-2678.2	-1.7	-6.2	-418.7	-0.2	-0.8
Privatization	2125.0	1.4	5.4	520.32	0.3	1.2	1737.1	1.0	3.3

Source: Budget committee of Verhovna Rada of Ukraine, CASE Ukraine estimations

As it was mentioned above, expenditures of the consolidated budget are lower than officially planned. However, available resources (budget profit of UAH 3.97 billion) and future revenues (expected amount in Q4 2003 is about UAH 22.00 billion) gives an option to execute budget completely. Analyzing the structure of budget expenditures one can clearly determine priorities in government actions. Government support of coal mining industry is considered as the most important activity (item executed by 72.4%). Approaching to presidential elections stimulates on-time social payments (64-68% execution rate). Agriculture appeared to be the most underfinanced sector at the current moment (42.6% of the plan).

Interesting changes could be observed in budget expenditure structure. The expenditures on state administration, law

enforcement and social protection decreased and that allowed to increase the share of all other items of expenditure part (Table 5.2).

The current budget profit was motivated by the necessity of foreign debt repayment. Although the main external debt payments were executed in March and September of the current year, till the end of the year it is planned to repay about UAH 1.3 billion of external debt, UAH 0.8 billion of internal debt and UAH 1.37 billion of debt servicing payments⁵.

⁵ According to the plan of budget deficit financing presented by Budget committee of Verhovna Rada of Ukraine

Table 5.3. Structure and rate of execution of consolidated budget expenditures, 2002-2003

Main budget accounts	October 1, year 2002		October 1, year 2003	
	Budget expenditure structure	% of execution	Budget expenditure structure	% of execution
State administration	14.7	54.9	13.4	60.6
Defense	5.9	53.9	6.2	56.8
Law enforcement	8.3	59.8	7.9	64.6
National economy	11.9	48.6	14.7	53.0
Agriculture	2.1	49.2	2.5	42.6
Coal-mining industry and other solid fuel-mining industries	3.8	58.6	3.9	72.4
Preservation of the environment	1.0	45.6	1.1	56.8
Housing and communal services	2.2	65.2	2.3	68.4
Public health service	12.8	64.2	13.3	68.0
Intellectual and physical development	2.3	59.4	2.6	63.9
Education	20.0	66.4	20.7	67.7
Social protection	20.8	65.7	17.9	68.1
Total		55.0		60.6

Source: Budget committee of Verhovna Rada of Ukraine, CASE Ukraine estimations

According to the Budget committee of Verhovna Rada of Ukraine in 2004 the debt payments will be on the level of UAH 9.517 billion (41.2% of the sum are internal payments; 58.8% - external payments). The expenses on the debt servicing will equal UAH 3.53 billion (on 12.5% higher than in year 2003). 73.4% of the sum will be spent on external debt servicing, correspondingly, 26.6% - internal debt servicing.

The volume of the borrowings will increase in 2004 by 20.2% in comparison with the planned borrowings on 2003 and will be about UAH 10.922 billion. Remarkable point is that in the plan for the 2004 external borrowings constitute only 58.8% of the sums while for year 2003 they are expected to be on the level of 79% of the total borrowings.

On October 1, 2003 revenues from privatization totaled to UAH 1,737.1 million. It constitutes 80.7% of the planned amount. Obviously, this item of the budget account will be fully executed till the end of the current year.⁶ In 2004 receipts from

privatization are expected to be UAH 2.14 billion.

It is clear that taking into account significant economic growth government should put every possible effort to lower the debt burden. And large volumes of new borrowings in 2004 are based more on political reasons than on economic. The budget for 2004 is based on pessimistic scenario (4.8% of GDP growth); however, current tendencies do not give any grounds for pessimism. It seems that current Ukrainian government does not want to take any miserable risk of budget underfulfilment in the year of elections. On the other hand, expenditures (especially, social one) must be on a high level. Therefore, new budget contains large amount of new borrowings for the next year. The only good feature of the future borrowings is the orientation on domestic creditors (at least payments for debt servicing will go to Ukrainian agents). However, in the year of presidential election Ukrainian creditors hardly will be eager to invest into uncertainty.

⁶ In 2002 receipts from privatization were only 19% of the planned amount.

6. Foreign Trade

- Reduction of positive foreign trade balance compared with the corresponding period of 2002
- Subscription of the Common Economic Area agreement by the President of Ukraine
- Completion of the eleventh round of negotiations between Ukraine and WTO

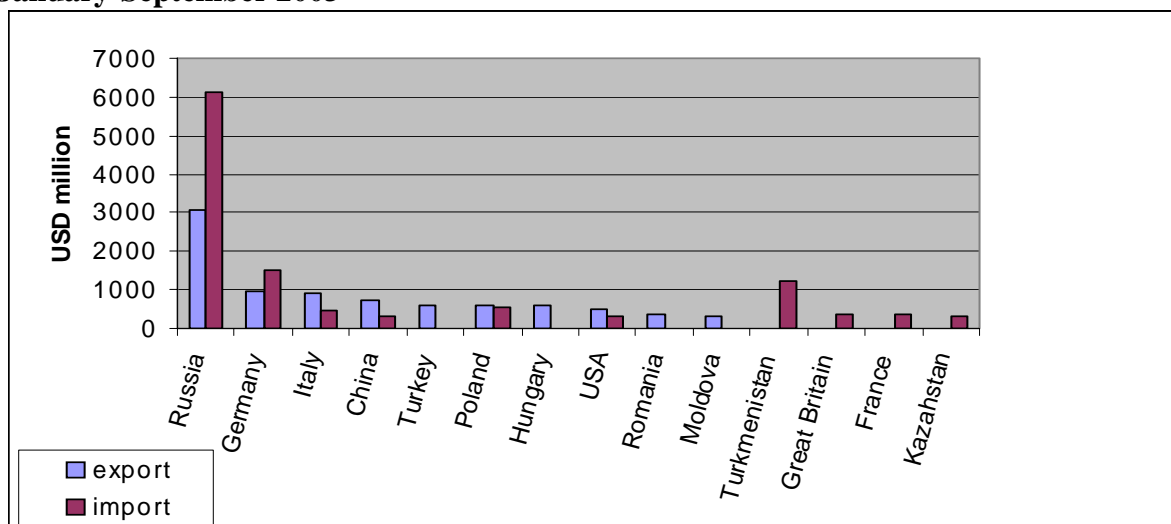
In January-September of 2003 the export of goods and services from Ukraine totaled USD 19,412.1 million, which is 24.1% more compared with the corresponding period of 2002. At the same time Ukraine imported USD 16,934.5 million of goods and services, an increase of 30.6% compared with the corresponding period of 2002. Thus, growth of import volumes exceeded growth of export ones in the first three quarters of 2003. This resulted in reduction of the positive trade balance surplus to USD 2,477.6 million (USD 2,578 million in the same period of 2002). In January-September 2003 USD 5,957 million of the Ukrainian export came to CIS countries (USD 4,770.3 million in January-September 2002) while CIS countries supplied USD 8,376 million of imported goods (USD 6,649.5 million in the same

period of 2002). This preserved the long-lasting tendency of the negative balance of the Ukrainian trade with the CIS countries. At the same time, the EU countries imported USD 3,656 million of Ukrainian goods and services (increase of 21% compared with January-September of 2002). The import of goods and services produced in EU countries to Ukraine totalled USD 4,641.1 million. This increased the negative balance of trade of Ukraine with the EU countries to USD 487.1 million compared with USD 41.7 in the corresponding period of 2002.

The leading exporting oblasts of Ukraine were Donetsk oblast providing 21.6% of the total Ukrainian export volumes; Dnipropetrovsk oblast (16%); city of Kyiv (11%). Kyiv imported 20.1% of total Ukrainian imports, Dnipropetrovsk oblast – 7.5%, Donetsk – 6%.

84.2% of the total Ukrainian exports and 94.2% of the total Ukrainian imports in the first three quarters of 2003 are export and import of goods (81.6% and 93.2% correspondingly in the same period of 2002). The positive balance of trade in goods in January-September of 2003 amounted to USD 375.4 million. In this period Ukraine traded in goods with 198 countries (see **Figure 6.1.**)

Figure 6.1. Trade flows of goods between Ukraine and its major trading partners, January-September 2003



Source: The State Committee of Statistics of Ukraine

The most successful exporting industries in January-September of 2003 were oil seeds and fruits industry (330% of export growth compared with the corresponding period of 2002), sugar industry (99%), mineral fuel, crude oil and petroleum products industry (80%), organic chemicals industry (60%), fertilizers industry (60%), ferrous metal products industry (80%), electric machines industry (70%), space aircraft industry (200%). Export of grain crops has fallen dramatically in January-September of 2003. It constituted only 46.3% of the export volumes in the same period of 2002. This is due to the poor harvest of grain in Ukraine and subsequent governmental measures restricting the grain export.

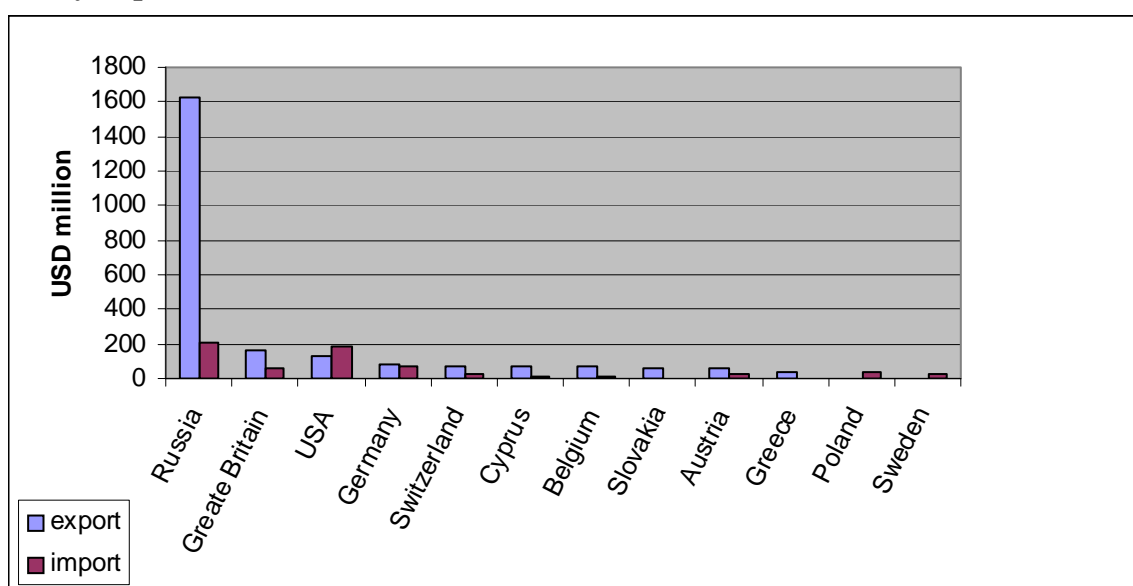
At the same time, Ukraine has significantly increased the import of the following goods groups: sugar and sugar products (increase of 440% compared with January-September of 2002), organic chemicals (50%), textile clothes (50%), ferrous metals (60%), road vehicles (except railroad vehicles) (80%). Import of grain crops has increased by 620%, which is partly due to the imposition of zero import tariffs rate on grain crops till

November 1 by the Ukrainian parliament. Import of natural gas has decreased by 10.5%, ships, vessels and boats - by 24.6%, chemical fiber threads – by 3.2%.

As a result of these changes the share of mineral fuel, crude oil and petroleum products in the total export volumes of Ukraine has increased from 9.1% (in the first three quarters of 2003) to 12.7% (in the first three quarters of 2003), organic chemicals from 1.3% to 1.6%, fertilizers from 2.2% to 2.7%. The share of grain crops has decreased from 7.1% to 4.8%, textile clothes from 2.5% to 2.1%. The share of grain crops in the total import volumes has risen from 0.2% to 1%, sugar and sugar products from 0.5% to 1.9%, ferrous metals from 1.8% to 2.2%.

The export of services from Ukraine to other countries equaled USD 3,083.1 million while import amounted USD 980.9 million, which resulted in the positive trade balance in services of USD 2,102.2 million. In January-September of 2003 Ukraine traded in services with 201 countries of the world (see **Figure 2**).

Figure 6.2. Trade flows of services between Ukraine and its major trading partners, January-September 2003



Source: The State Committee of Statistics of Ukraine

In January-September of 2003 Ukrainian exporters succeeded in providing abroad services classified as aerial transportation (38% increase compared with the corresponding period of 2002), railroad transportation (21.8%), insurance services (240%), tourism services (14.7%), legal and book-keeping services (50%). Communication services and construction services sectors have experienced decrease in export volumes (-5.1% and -24.9% correspondingly).

At the same time, Ukrainian residents increased consumption of foreign railroad transport services (33.7% of increase), insurance services (32.6%), computer services (35.9%), and licensing services (130%). The import of communication services and various business, professional and technical services has fallen by 24.3% and 17.3% respectively.

September 19 the leaders of four CIS countries - Ukraine, Russia, Belarus and Kazakhstan - have signed the Common Economic Area (CEA) agreement. The agreement establishes that the member states commence formation of the CEA, that is an economic area which unites customs territories of the member states and within which a coherent foreign trade, tax and monetary policy is conducted. The agreement also states that the participating countries independently determine the degree of their integration in the CEA. However, the economic benefits of the CEA creation for Ukraine are doubtful. Unification of customs union and economic policy will lead to a loss of economic sovereignty of Ukraine, since the CEA agreement gives Russia the power to pursue policy measures without other CEA members' consent. According to the treaty, a supranational governing body is established, which is given the right to take decisions which are obligatory for all CEA participating countries. The voting power of member states is distributed in accordance with the potential of their economies. Preliminary calculations show that

whatever criterion is chosen, Russia will have over 80% of the votes in this body. Free trade zone without exemptions between Ukraine, Russia, Belarus and Kazakhstan may be beneficial for the Ukrainian economy in the short-run. But this scheme is unlikely to be realized. The Russia's governmental officials have declared that Russia's internal and external energy resource prices will not be equalized for all CEA participating members. In order Ukraine to join the CEA, the agreement has to be ratified by the Ukrainian parliament.

On November 13 the Ukrainian and Moldavian governments have signed free trade zone agreement, which may be a precondition for intensification of trade between these two countries. In January-September of 2003 the trade flows between Ukraine and Moldova amounted to USD 400 million.

The prospective of European Union expansion is becoming a matter of increasing concern for the Ukrainian government and businesses. Accession of 10 new member states to the European Union is likely to hinder the sustainable growth of trade volumes between Ukraine and the new EU member states. The core of the problem is that despite increase in the common European market the quotas established for the Ukrainian production will not be adequately changed. Thus, export of the Ukrainian products to the acceding countries will become the subject to restrictions established within the EU. For example, the export of the Ukrainian metallurgy industry products to Poland is 1.5 times higher than the quota of the EU. Besides, Baltic countries (Estonia, Latvia and Lithuania) will denounce treaties on free trade zones on the date of accession, which is a requirement of the EU. In January-June of 2003 the Ukrainian export to these countries totalled USD 348.5 million, while import amounted USD 88.7 million.

In this context the rapid accession of Ukraine to the WTO may be viewed as a

mean to reduce the negative impact of the EU expansion. The WTO rules prohibit all non-tariff protectionist measures (including quotas) and require the application of the most-favoured nation regime to all WTO members. Thus, Ukrainian producers will

be able to accede to the EU goods and service markets on the terms common to all other WTO members.

WTO accession process

October 27-28 2003 the 11th round of negotiations between Ukraine and the WTO Working Party took place in Geneva, Switzerland.

As of November 1st the WTO Working Party on Ukraine's accession consists of 34 members, 12 of which have joined it in the third quarter. By the end of October Ukraine has completed bilateral market access negotiations on goods and services with 15 members of the WTO working group. These are Bulgaria, Canada, Cuba, Czech Republic, European communities and member states, Georgia, Hungary, India, Republic of Korea, Latvia, Mexico, New Zealand, Slovak Republic, Slovenia, and Uruguay.

The Working Party of the WTO on the Ukraine's accession has initiated the preparation of the Report, including draft Decision and Protocol of Accession, thus acknowledging that most of the debated issues are about to be resolved.

One of the successes of the 11th round is a preliminary approval of the Ukraine's proposal concerning subsidizing of agriculture, which was the subject of plurilateral negotiations. It was agreed that Ukraine would spend at maximum USD 1.38 billion of state support to agriculture in the first post-accession year. However, this limit will be reduced by 13% each year in 10 subsequent years.

The next round of negotiations between Ukraine and the WTO Working Party is scheduled for the first quarter of year 2004.

7. Foreign Direct Investment

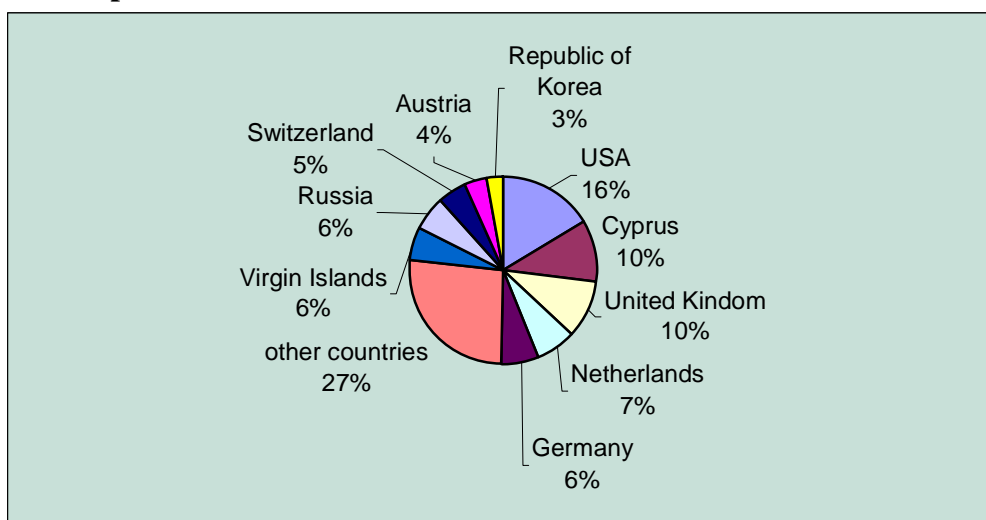
- Net increase in the FDI stock by USD 175.4 million in the third quarter and USD 608.7 million as a result of three quarters.

As of October 1 the stock of the foreign direct investment in Ukraine amounted to USD 6.212.9 million. The net increase in the stock of FDI in Ukraine in the third quarter of 2003 equaled USD 175.4 million. In January-September the inflow of the FDI in Ukraine totaled USD 954.09 million (680.9 million in January-September of

2002), of which 41.28 million came from the CIS and Baltic countries and the remaining USD 912.8 million from the rest of the world. The outflow of FDI from Ukraine equaled USD 346.28 million (247.7 million in January-September of 2002). About 59% of the investment volumes were supplied in the form of money and 33% in the form of assets.

The FDI came from 114 countries. However, the share of the FDI volumes in Ukraine from 10 major investor countries is about 73.6% (see **Figure 7.1.**).

Figure 7.1. Share of the major investor countries in the foreign direct investment stock in Ukraine, as of September 2003



Source: The State Committee for Statistics of Ukraine.

About 9,160 Ukrainian enterprises were recipients of the foreign direct investment as of September 2003. About 15.2% of the total FDI volumes in Ukraine were invested in the enterprises of food industry, 14.6% in the wholesale trade, 9.3% in machinery industry, 7.8% in transportation and communications, and 7.1% in financial services.

The most attractive regions for foreign investors were the city of Kyiv which received USD 2,012.5 million of foreign direct investment (which equals 32.4% of the total FDI volumes), Dnipropetrovsk oblast – USD 484.8 million (7.8%), Kyiv

oblast – USD 462.5 (7.4%), Zaporizhzhia oblast – USD 420 million (6.8%), Donetsk oblast – USD 408.8 million (6.6%), Odessa oblast – USD 361.2 million (5.8%), Lviv oblast – USD 282.8 million (4.5%).

The stock of the FDI from Ukraine to the rest of the world by the end of September 2003 reached USD 159.2 million (a reduction of USD 0.5mln since the end of the second quarter of 2003). Among the investment priorities of the Ukrainian residents were transportation and communications (35% of the total investment volumes), real estate activities



and services to legal entities (40%), financial activities (4.9%).

On July 7 the President of Ukraine has signed the Decree "On supplementary measures to attract foreign investment in Ukraine," which establishes the state stock company "Agency on foreign investment issues". It starts functioning January 1st of 2004. The major tasks of the newly created agency are defined as follows: to encourage investment inflow, form favorable investment image of Ukraine and provide

legal and economic consultation services to potential investors. However, this ad hoc measure is unlikely to stimulate the inflow of foreign investment including foreign direct investment. Traditionally, the major determinants of FDI in transition economies are stable financial climate and strict observance of property rights. Thus, only effective economic and legal reforms may create preconditions for sustainable FDI stock growth in Ukraine.

8. Balance of Payments⁷

- Deterioration of the current account balance in the second quarter
- Continued negotiations between Ukraine and IMF

In Q2 2003 the positive current account balance reduced by 32% compared with the first quarter. One reason for this is the high import growth rate, which exceeded export growth rate in the second quarter. Another reason is reduction of income balance in April – August by USD 27 million compared with the first quarter. The income balance in the second quarter equaled – USD 147 million. The positive balance of current transfers in the second quarter totaled USD 507 million which is 6% higher than in the first quarter of 2003.

In the first half of 2003 the current account balance equaled USD 1,815 million while in January–August of 2002 it totaled USD 1,453 million. The income balance in the first two quarters is USD (– 267) million (USD (– 280) million in January–August of 2002). Current transfers balance equaled USD 985 million (USD 885 million in the first half of 2002).

In the first half of 2002 the capital and financial account balance totaled USD (– 1,846) million, while it amounted to USD (–1,500) million in the first quarter and USD (–951) million in January–August of 2002. The balance of foreign direct and portfolio investment in Ukraine in Q2 2003 was USD 436 million and USD 688 million respectively. In January–August of 2003 the net increase of loans totaled USD 155 million (USD 130 million in the first half of 2002).

In 2003 the National Bank of Ukraine succeeded in enlarging its international reserves (see **Foreign Exchange Market**). Taking into account the increasing currency

reserves of Ukraine, it may be a timely measure to liberalize foreign currency market of Ukraine. In particular, the NBU has nice preconditions to reduce the rate of required selling foreign currency proceeds (currently 50%). According to the NBU council governor Anatoliy Galchynsky the actual rate of selling currency proceeds is about 21.1% which is a result of some exemptions for exporters. The IMF experts suggested that NBU initially reduce the required norm of selling the currency proceeds to 10% and later abolish the rule completely.

The end of August was marked by the announcement of the National Bank of Ukraine Chairman that NBU is going to repay the Ukraine's debt to the IMF by the end of 2003. This intention is motivated by the possibility to economize about USD 40 million on interest payments till 2009. However, the governmental officials do not support this NBU's decision. Such early repayment may challenge the financial stability of the Ukrainian market since current NBU's reserve volumes are slightly above the safety level.

In Q3 2003 Ukraine did not succeed in negotiations with IMF on resumption of financing under the Stand-by program, which presumes allocation of funds in case of special situation upon request of Ukraine. Initially the negotiations were postponed from August till October. But in October the group of experts, that examined the possibility to provide Ukraine with the IMF loan, deemed that Ukraine did not fully meet the requirements set by the IMF as precondition for crediting resumption. The major barrier for the IMF to launch the financing programs is poor refunding of value-added tax to exporters. Ukraine also has to reduce the VAT exemptions and expand the VAT tax base.

Last time Ukraine received the IMF loan in September 2001. As a result of cooperation with the IMF since 1994, Ukraine has received SDR 3.01 billion.

⁷ Our Balance of Payments analysis is one quarter behind the rest of the parts due to the delays in obtaining BOP data.



In December 2003 the World Bank is planning to restart disbursing loans under the second Programmatic Adjustment Loan amounting to USD 250 million. The previous tranche of this programme totalling USD 250 million was disbursed to Ukraine in 2001. The World Bank may allocate USD 75 million in December of 2003, while the disbursement of the remaining USD 175 million is contingent

upon the reforms in the energy sector and VAT refunding.

In October the World Bank approved its assistance strategy to Ukraine for 2004-2007, within framework of which about USD 3 billion in credits may be provided to Ukraine. In particular the World Bank might allocate to Ukraine up to USD 750 million in 2004. The strategy for assistance to Ukraine includes loans for reforms in agriculture, energy, social and other sectors.

Forecast of Economic Development for 2003 and 2004

9. Assumptions

9.1. External⁸

The development of the Ukrainian economy is very sensitive to the development of the world economy. Therefore, we provide our overview of trends in global economy, which is the basis for our forecast.

In global perspective we observe modest recovery. The US GDP grew surprisingly high (2.5% in Q2 2003) and provisional data for Q3 2003 indicates a continuation of positive trends. The growth was mainly provided by strong household consumption (in particular of durable goods, up 8.2% in Q2 2003, y-o-y) and a forming of fixed investment. On the external side, Q2 2003 saw a drop in exports (in annual terms) and moderation of imports. Good economic performance contributed to the stabilization of unemployment, with the seasonal adjusted rate at 6.1% in Q3 2003. Inflation rose in Q3 2003 to 2.3% in September.

The EU economy is in stagnation – annual GDP growth was about 0.5% (y-o-y) in Q2 2003. The recovery is not expected until the beginning of 2004. Neither export nor household consumption shows any optimistic tendency.

In Central and Eastern Europe the growth rates of the economies in Q2 2003 were more modest than in Q1 2003. The exceptions are Poland and Bulgaria. In Poland export contribution resulted in 3.8% GDP growth in Q2 2003. In Bulgaria investment and private consumption accelerated growth in Q2 2003 to 4.4% (y-o-y). The leaders in the region are Baltic States: Lithuania – 6.7% (y-o-y) GDP growth in Q2 2003; Latvia – 6.2% (y-o-y); Estonia – 3.5% (y-o-y).

In Russia economic growth accelerated in Q2 2003 to 7.2% from 6.8% in Q1 2003. Domestic demand, in particular very strong investment growth, and a solid increase in private consumption were the driving forces behind these results. Net exports contributed negatively to growth. Available preliminary data suggested that a similarly strong performance was maintained in Q3 2003.

In Asia the main engines of the regional growth are China and India. The Chinese economy is estimated to have grown about 8% (y-o-y) in Q3 2003, with exports expanding in range of 20%-30% (y-o-y). Industrial production increased by over 15% (y-o-y) in Q3 2003, and retail sales expanded by 10% (y-o-y) in the same period, indicating strong domestic demand. India grew by nearly 6% in Q3 2003, and is estimated to have sustained similar dynamics in Q3 2003.

The current external conditions are favorable for Ukraine and we can expect that economic development of the main trade partners of our country will be sustainable till the end of 2004.

⁸ On the materials of “Global Economy 4/2003 (12)”; www.case.com.pl

9.2. Internal

- Till the end of 2004 the official exchange rate will not exceed 5.38 UAH/USD;
- Growth rate of export will be smaller than the growth rate of import; however, net export will be positive till the end of the forecasted period;
- In year 2004 the interest rates are expected to be on the same level as at the end of the current year (uncertainty due to elections);
- In year 2004 the government is expected to repay UAH 3.9 billion of internal debt and to borrow UAH 4.49 billion on internal market;
- In year 2004 the government is expected to repay UAH 5.7 billion of external debt and to borrow UAH 5.4 billion on external market;
- The growth rate of value added in agriculture is expected to be on a high level in year 2004 (because the base 2003 year is very low);
- Revenues from privatization will amount to UAH 2.14 billion in year 2004;
- Foreign investments in 2004 will be approximately on the same level as at the current year;

10. Forecast

10.1. Gross Domestic Product and Value Added

Favorable external market conditions and increasing domestic demand constitute significant basis for economic growth.

In the next year, domestic demand will be the most stable and the most predictable factor of GDP growth: household's revenues will increase; moreover, tax rate

reduction in year 2004 will make population's income even more noticeable. Expansion of domestic demand will have two effects on the Ukrainian economy: increase of demand on high-quality domestic products and increase of import. At the current moment the growth rate of import exceeds growth rate of export. This pattern indicates that domestic consumers need cheap high-quality products which are not sufficiently supplied by domestic producers.

Growth of construction in 2004 is expected to be a bit smaller due to the boosting growth of the sector in the previous periods. However, there are premises for the sector to be in the next year as outstanding as it is in 2003: according to the new taxation rules interests on mortgage loans are not object for taxation.

Growth in agriculture will depend on the weather conditions; however, even if the harvest is average the growth rate will be high due to the low level at the basic year.

The development of the industry is hardly dependant on export opportunities. Two-digit growth rate numbers were caused by very high external demand on the products of machine building and metallurgy. We expect that external opportunities for our industry will remain approximately at the same level as at the current year. Real depreciation of hryvnia can have positive effect on the export (see **Money Markets**).

Fluctuations in domestic demand are related with changes in government consumption. The fluctuations in government consumption (**Table 10.2**) are related to the fluctuations in the volumes of budget debt payments and inflows of new credits.

Table 10.1. Value added by sectors, 2001-2003 (% , y-o-y)

	Value added	Industry	Agriculture	Construction	Market services*	Non-market services**
2001	8.9	14.2	10.4	9.0	10.0	3.8
2002	4.4	6.3	3.5	0.2	5.7	0.9
2003 (f)	8.6	14.9	-11.4	21.6	10.4	2.1
2004 (f)	10.1	9.4	17.5	7.8	9.5	1.3
2002 Q1	4.1	3.0	9.2	0.7	8.5	0.5
Q2	4.5	8.1	12.1	-7.9	2.4	-0.1
Q3	4.1	6.9	2.1	-1.2	8.3	-3.1
Q4	4.8	6.9	1.7	10.8	4.0	6.1
2003 Q1	7.7	10.4	4.4	18.1	8.4	2.2
Q2	9.0	12.6	-13.0	24.9	13.1	3.8
Q3***	5.5	20.0	-21.0	30.9	10.5	1.3
Q4	11.5	17.1	1.7	12.0	10.1	1.3
2004 Q1	11.4	10.6	9.2	7.6	9.1	1.2
Q2	9.2	9.4	17.0	7.9	9.3	1.4
Q3	11.9	9.6	25.0	7.8	9.6	1.3
Q4	8.0	8.7	10.0	8.0	9.8	1.3

* - includes Transport & Communication and Trade & Catering

** - includes Public healthcare service and Education

***- CASE Ukraine estimations on the basis of the express-information from State Statistics Committee of Ukraine

Source: The State Committee of Statistics of Ukraine

Table 10.2. Aggregate demand in constant prices, 2001-2003 (% , y-o-y)

	GDP	Domestic demand	Consumption		Investment	Export	Import
			Private	Gov-t.			
2001	9.1	9.5	9.1	9.6	8.3	2.9	2.2
2002	4.9	1.2	6.5	2.4	5.5	2.8	2.0
2003 (f)	7.7	11.4	13.1	14.3	15.6	8.1	14.9
2004 (f)	8.3	10.0	13.5	6.5	13.6	7.9	11.0
2002 Q1	4.1	2.0	7.6	3.0	1.4	3.2	-0.2
Q2	4.7	4.4	8.1	2.4	7.8	3.3	2.7
Q3	4.3	1.9	7.1	2.5	6.4	2.8	3.0
Q4	6.1	-2.3	6.9	2.4	6.7	2.2	2.5
2003 Q1	7.9	10.1	11.0	10.1	15.0	9.8	13.6
Q2	9.3	14.5	15.7	14.5	20.6	8.9	17.9
Q3***	4.5	7.4	12.8	13.1	11.9	8.9	10.8
Q4	8.5	12.9	12.9	19.8	14.9	6.5	14.8
2004 Q1	9.1	12.8	13.1	19.2	13.0	8.0	13.9
Q2	6.5	8.9	13.4	4.8	11.7	7.5	11.5
Q3	9.9	10.2	13.5	4.3	15.1	9.0	9.6
Q4	7.6	8.7	13.8	5.0	14.4	7.0	8.6

***- CASE Ukraine estimations on the basis of the express-information from State Statistics Committee of Ukraine

Source: The State Committee of Statistics of Ukraine

10.2. Main Monetary Indicators

We expect that at the end of 2003 and the beginning of 2004 money supply growth rates will be more modest than in the previous periods. First of all, this will be caused by contraction of NBU interventions on foreign exchange market - the main emission factor in the previous periods. NBU interventions will decrease due to deterioration of trade balance triggered by poor agricultural performance in Ukraine this year.

National bank of Ukraine also may conduct tighter monetary policy in Q4 2003 and Q1 2004 to reduce inflation risks caused by the surge of food prices.

At the same time, in 2004 (especially, in the second half) MS growth rate could accelerate taking into account presidential elections and significant budget expenditures connected with it.

In 2004 we also expect stable behavior of interest rates without significant fluctuations.

We expect stable nominal exchange rate with slight depreciation at UAH 5.33 - 5.38 per US dollar.

During the last quarter of 2003 we expect continuation of stable dynamics of UAH/USD nominal exchange rate although with insignificant depreciation. It will be caused by trade balance deterioration at the end of the year and, consequently, decrease of the volume of currency inflows. Trade balance worsening, caused by poor harvest this year, will affect foreign exchange market also at the beginning of 2004.

NBU will prevent significant nominal exchange rate fluctuations and provide stability because of considerable foreign debt payments next year and inflation risks. Taking account the first reason (external debt payments), we do not forecast significant increase of NBU's international reserves.

Real effective exchange rate of hryvnia will be stable too. Under the circumstances of inflation risks and hryvnia's nominal stability, depreciation of REER, observed since the end of 2001, obviously, will be interrupted.

Table 10.3. Main monetary indicators

<i>Period</i>	Monetary base		M3		Loan interest rate period average	Exchange rate USD/UAH period average
	bln. hrv.	y/y (%)	bln. hrv.	y/y (%)		
2001	23.050	37.4	45.060	40.4	32.4	5.37
2002	30.795	33.6	63.805	41.6	23.1	5.33
2003(f)	40.116	30.3	94.954	48.8	14.9	5.33
2004(f)	54.941	37.0	139.755	47.2	14.8	5.36
2002 Q1	25.100	49.9	47.400	43.4	27.7	5.32
Q2	26.200	37.9	51.200	38.6	25.0	5.33
Q3	29.200	42.9	57.700	45.6	20.1	5.33
Q4	30.795	33.6	63.805	41.6	19.5	5.33
2003 Q1	31.200	24.4	69.700	47.2	15.2	5.33
Q2	35.200	34.2	79.000	54.3	15.2	5.33
Q3	38.000	30.1	86.500	49.8	14.8	5.33
Q4	40.116	30.3	94.954	48.8	14.7	5.33
2004 Q1	41.433	32.8	101.445	45.5	14.6	5.34
Q2	46.847	33.1	115.040	45.6	14.8	5.34
Q3	50.356	32.5	126.849	46.6	15.0	5.36
Q4	54.941	37.0	139.755	47.2	14.9	5.38

Source: NBU, CASE Ukraine forecast

10.3. Prices

In the nearest future, significant risks of CPI increase remains. First, there is uncertainty about the development of food market. Poor agricultural performance in Q2-Q3 2003 will lead to food prices increase at the end of this year and at the beginning of the next one.

Next autumn presidential elections may significantly increase government consumption, which can stimulate CPI growth. But, at the same time, the

government will do its best to prevent inflation due to political reasons.

Another risk may be derived from rapid PPI growth rates this year. But there exist some stabilization factors. First of all, it is stable nominal exchange rate that has restraining effect on prices (especially on imports). Then, it is budget surplus that may help preventing considerable price increase during the end of 2003 - the beginning of 2004.

Table 10.4. Price indexes

<i>Period</i>	CPI		PPI	
	q-o-q	y-o-y	q-o-q	y-o-y
2001		106.1		100.9
2002		99.4		105.8
2003(f)		106.4		108.6
2004(f)		107.6		106.9
2002 Q1	98.9	102.2	99.5	99.5
Q2	99.3	98.9	105.0	104.0
Q3	98.5	98.9	100.9	104.9
Q4	102.8	99.4	100.4	105.8
2003 Q1	103.7	104.3	103.3	109.9
Q2	100.8	105.9	100.6	105.3
Q3	98.8	106.2	102.9	107.4
Q4	103.5	107.0	101.5	108.6
2004 Q1	103.5	106.7	102.0	107.2
Q2	101.0	106.9	102.2	108.9
Q3	99.0	107.1	101.5	107.4
Q4	104.0	107.6	101.0	106.9

Source: The State Statistics Committee of Ukraine, CASE Ukraine forecast

10.4. Budget

The budget revenues for the year 2003 will be higher than defined in the plan. However, we expect that budget expenditures will exceed budget revenues till the end of the year and deficit will constitute about 0.5% of GDP.

In case current economic trend endure, the perspectives of budget revenues in 2004 look very optimistic. Political reasons make government to underestimate future budget revenues (they consider pessimistic scenario). Conservative approach to budget

planning is a good feature of governing (underestimation of budget possibilities does not lead to sequestration of budget and to increase of foreign debt). However, our own estimations on the basis of available information produce much more optimistic results. The revenues for consolidated budget till the end of the year are expected to exceed the revenues in 2002 approximately by 20% (comparing the numbers in the table, by 22.5%), while for the year 2004 we expect only 10% increase of nominal revenues.

Table 10.5. Consolidated budget, 2001-2004 (billion, UAH)

	Revenues	Expenditures	Balance	
			billion UAH	% of GDP
2001	54.9	55.5	-0.6	-0.3
2002	61.9	60.3	1.6	0.7
2003(f)	75.8	77.2	-1.4	-0.5
2004(f)	83.9	85.8	-3.9	-1.3
2002 Q1	12.7	12.0	0.7	1.6
Q2	14.8	14.4	0.4	0.8
Q3	16.0	14.4	1.6	2.5
Q4	18.4	19.5	-1.1	-1.7
2003 Q1	15.3	13.4	1.8	3.6
Q2	17.9	17.3	0.6	0.9
Q3	20.1	18.5	1.5	2.1
Q4	22.5	27.9	-5.4	-7.1
2004 Q1	17.4	21.2	-3.8	-6.2
Q2	18.9	18.6	0.3	0.4
Q3	21.8	21.9	-0.2	-0.2
Q4	23.8	24.1	-0.3	-0.3

Source: Budget committee of Verchovna Rada of Ukraine; CASE Ukraine forecast

Center for Social and Economic Research – CASE Ukraine is a non-government non-profit organization founded by Polish CASE Foundation in early 1999. The aim of the Center is to promote research in the economic, political and social spheres and to contribute to the process of development of civil society in Ukraine.

CASE Ukraine has a substantial research background. Since 1995 our experts have worked in a number of joint projects with Harvard Institute for International Development (HIID), the Soros International Economic Advisory Group (SIEAG), the Barents Group and other.

CASE Ukraine is a member of the CASE Network, founded by CASE Foundation. The network includes think-tanks in Poland, Russia, Ukraine, Belarus, Moldova, Georgia, and Kyrgyzstan. As a member of the network CASE Ukraine can benefit from the experience, and include in the project staff local and international researchers working in CIS and Eastern European countries where CASE is present.

Areas of Concentration

Macroeconomic policy: tax reform, financial sector reform, fiscal imbalance measurement, demonetization, exchange rate policy and financial crises. A large part of our work is designated to the challenges that transition countries face in the sphere of institutional development: virtual economy, barter, arrears, property rights protection, non-monetary transactions and other.

Enterprise restructuring and development: study of effects of privatization on enterprise performance; conduct of enterprise surveys; studies on economic growth, competitiveness assessment, foreign direct investment, bankruptcy procedures, and taxation.

Banking sector: complex analyses of banking system functioning: the role of banks in enterprise crediting and growth of the economy, central bank's policies in the sphere of bank regulation and supervision.

Trade policy: studies on the issues of foreign trade policies in the context of WTO accession.

Social policy: conduct of household survey in 1999 and 2000 to get reliable information on living standards in Ukraine; analysis of informal labor market in the frames of development of the National program to combat poverty.

Public sector reform: strengthening the reform capacity. Our team assisted in many reform efforts in Ukraine, especially in developing the government programs: Pynzenyk comprehensive reform package "Economic Growth-1997" and the Yushchenko government's program "Reforms for Welfare" in spring 2000.

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