SigmaBleyzer

UKRAINE - ECONOMIC SITUATION

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Introduction

When Ukraine declared its independence in Aug 91, it became the 2nd largest European country in land mass and the 4th largest in population, with 50 million people.
It has a well-educated and skilled labor force. Its agricultural soil is extensive and rich: used to be the grain-basket of the former Soviet Union. It has good mineral resources (iron ore, coal) and reasonable infrastructure.

Despite these favorable conditions, Ukraine has one of the most difficult challenges in Eastern Europe, with a long recession going on for 9 years.

A bright point is that this recession may be coming to an end. Although for 9 years GDP declined, the rate was becoming less negative (-23% in 1994, -12% in 1995, -10% in 1996, -3.2% in 1997) and became positive during the first half of 1998. However, the Russian crisis caused a -1.5% decline in GDP for 1998.

The cumulative decline in GDP was 60%, but about 50% of this decline was offset by expansion of the Informal Economy. This has helped to contain the decline in living standards.

Why was the Recession so Long?

Ukraine was highly open and dependant on other FSU Republics (energy imports is still 15% of GDP). The collapse of the FSU cut these production & trade relations.

The country had a large percentage of Military Industries (25% of enterprises produced military goods), which found themselves without markets after the end of the cold war.

Due to negligible energy cost, many industrial processes were very energy intensive (Ukraine consumed 6 times more oil per unit of GDP than in Western Europe). These firms became uneconomic when energy cost increased 10 times.

All this meant that major corporate restructuring was needed.

What has been done to achieve this restructuring?

From 1991 to 1995, very little: the Government followed a "Preservation" strategy -- i.e., to maintain the status-quo of industrial and agricultural enterprises -- through the payment of direct subsidies to them.

Enterprises had little incentives to restructure themselves, remaining largely inefficient.

These subsidies led to large fiscal deficits, monetary financing of these deficits, and hyper-inflation, which reached 10,155% p.a. in 1993, and 401% in 1994.

BUT, in 1996 -1998, under President Kuchma, progress was made in economic reforms:

- Prices and international trade were liberalized.
- The small & mass privatization programs advanced.
- The NBU was strengthened and monetary policy was implemented wisely.
- A new currency (Hrivnia-UAH) was introduced successfully in September 1996, without confiscation.
- Ukraine accepted the IMF Obligations under Article VIII (convertibility for current account payments).
- Inflation was reduced to 10% in 1997.
- The exchange rate was maintained within a narrow corridor around 1.9 UAH per dollar.
- The NBU's international reserves increased.

Nevertheless, in 1997-1998:

The fiscal deficit remained high, at about 6% of GDP in 1997 and in first half of 1998.
The deficit was financed with short-term external borrowing: external debt increased from US$4.4 billion in 1994 to US$11 billion in 1998. T-bills increased from nil to Hr. 10 billion in the same period.

The deficit was also financed through the accumulation of wage and budgetary arrears.

In Addition, other structural reforms were slow: Structural reforms did not reach the critical mass needed to revive confidence:

- Barriers to Entry remained high: de-regulation (licensing & registration requirements) was slow to implement.
- Barriers to Exit were not removed (e.g., bankruptcy law)
- Privatization of large industries was stalled.
- Custom procedures (quality standards) constrained trade.
- Govt. continued interference at sector levels, particularly agriculture and energy.
- The banking and capital mkt. sectors remained weak.
- The legal system remained inadequate to protect commercial contracts/interests.
- Public Administration reform was slow.

The Financial Crisis of 1998

Given Ukraine's large fiscal deficit, and large short-term debt repayments, and insufficient structural reforms the Country was vulnerable to the August 1998 Crisis in Russia.

- Capital inflows dried up in mid-1998.
- International Reserves fell sharply.
- Large debt obligations were due in 1998.
- Interest rates increased sharply.
- The exchange rate came under pressure.

The Handling of the 1998 Crisis.

Despite the severity of the crisis, Ukraine faced the crisis successfully, much better than Russia:

- It was able to negotiate the restructuring of its debt.
- Monetary Policy was handled effectively, stabilizing the Hrivnia at 3.4 Hr/US$ -- an 80% depreciation.
- In September, October and November 1998, the fiscal accounts were in surplus. The deficit for 1998 was contained at 2.5 % of GDP (compared to 6% in 1997).
- Inflation for 1998 was 20%.

At the end of 1998, Ukraine had overcome the risk of total collapse.

The Short-Term Outlook: 1999

The Goal for 1999 is to retain the country's external and internal stability: That is, to contain inflation, minimize instability in the exchange rate, and move towards FX rate convertibility. For this, the country has two major goals:

- It has to deal successfully with foreign debt service payments of US$2.4 billion in 1999.
- It has to continue implementation of the Extended Fund Facility of the IMF and World Bank Operations.

External Debt Outstanding (Millions of US$)

The Total External debt of Ukraine is not large, representing only 40% of GDP. It is owed principally to multilateral and bilateral donors:

Multilateral:	
IMF	2,810
World Bank	1,750
EBRD	160
EC	350
Bilateral	
Russia	1,070
Turkmenistan	460
Germany/USA/Other	1,280
Japan	150
Private	
Private Creditors	1,650
Gazprom Bonds	1,200

TOTAL	US$10,880 million

Debt Service in 1999 (in Millions of US$)

However, debt service in 1999 will be significant.
Debt Service will be as follows (in US$ millions):

IMF	700
World Bank	160
EBRD/EC	16
Russia	98
Turkmenistan	214
Credit Lines	10
EU/Japan	22
Public Guarantees for SE	295
Gazprom	258
Private Creditors	570
Other	60
TOTAL	US$2,400 Million

Financing Sources for 1999

For 1999, the revival of the EFF is needed. If so, the IMF would be able to provide US$750 million in 1999.

Provided the EFF is revived -- and project conditionality is met -- the World Bank may provide US$730 million.

Provided the EFF is revived, the EC would provide US$180 million.

The above would amount to US$1,660 million.

The difference of US$740 could be provided through agreements with Russia (Sevastopol) and Turkmenistan (barter), and from International Reserves.

IN CONCLUSION: With the revival of the EFF, Ukraine has an excellent chance of turning around.

The EFF Program

The key for the IMF is agreement of the Fiscal Budget for 1999. The IMF requires a budget with a “realistic” plan for revenues and expenditures and a deficit if less than 1% of GDP.

On December 29,1998, Parliament approved a reasonable budget with a deficit of 1.0% of GDP, and consolidated expenditures of 38% of GDP.

This approval provided a good basis for the discussions with the IMF Mission in the second half of January 1999. However, the IMF wants to see further progress on structural reforms.

Structural Conditions in the EFF

In addition to the budget, the IMF Mission will require progress on key structural reforms needed to revive growth:

- Expand Treasury to cover extra-budgetary funds.
- Reduce Public Employment by 300,000 in 1999.
- Agricultural Sector: Stop Government interference in grain markets and continue privatization of Silos.
- Energy Sector: Carry out gas auctions for 20 billion cm, and increase utility tariffs to economic levels.
- Banking: Initiate restructuring of commercial banks, based on enforcement of prudential regulations.
- Privatization: Continue the privatization program, including telecomm and electricity.
- Deregulation: Implement agreed upon program.

World Bank Disbursements in 1999

The World Bank has 4 already approved balance-of-payments loans that could disburse in 1999, for a total of $730 million:

Financial Sector Adjustment	-	$210 million
Enterprise Development Adjustment	-	$200 million’
Coal Sector Adjustment	-	$150 million
Electricity Market	-	$170 million

In addition, a new adjustment loan of $200 million for Public Administration Reform is possible.

Scenario for 1999

Assuming that the IMF/World Bank Programs are revived, the following scenario is possible:

- GDP would decline, but not excessively, by between -1% to -2% (compared to -6% for Russia).
- The IMF forecasts inflation at 24% by the Ministry of Finance and 30%.
- The FX rate is expected to move to 4.1 Hr/$ by end of 1999, a 20% depreciation from current rates. The NBU has pledged to contain the depreciation to 9%.

Medium-Term Scenario

The medium-term scenario will depend on the outcome of the October 1999 Presidential elections.

Most donors are using the assumptions that:
(a) the country will continue its transition from a planned to a market economy; and
(b) the IMF/World Bank programs will continue.

The IMF/World Bank programs in Ukraine are important to revive economic growth.

They will assist the country in reviving growth by increasing business confidence and attracting domestic and foreign investments.

A number of measures are now being now actively discussed with the Government to achieve this goal, including the following:

Key areas of Reform to revive Growth.

1. Deregulation and Private Sector Development

- Issue transparent regulations for privatization
- Carry out case-by-case privatization based on majority private ownership
- Implement the Government's deregulation strategy and plan of action
- Enact a satisfactory bankruptcy law

2. Public Administration Reform

- Redefine the role of Government
- Reorganize the Cabinet of Ministers
- Consolidate Ministries and State Committees
- Carry out functional and operational reviews
- Reduce public employment

3. Financial Sector Reform

- Enact Law of the NBU that ensures autonomy
- Initiate restructuring of commercial banks
- Enforce new prudential regulations and loan loss provisioning
- Develop contingency plans to deal with possible troubled banks.

4. Agricultural Sector Reform

- Liberalize agricultural markets, eliminating Government interference with grain movements.
- Privatize agricultural silos
- ensure competitive procurement of Government grain purchases
- Remove export duties and other trade barriers
- Establish a single land registry.

Energy Sector Reform

- Implement the financial recovery plan for the sector, including tariff adjustments
- Eliminate constraints in the operations of the electricity markets.
- Carry out auction for gas for 20 billion m3
- Further privatize electricity companies.
- Continue with the restructuring of the coal sector.

Prospects

On the basis of Ukraine's ongoing programs, Ukraine should be able to keep its fiscal deficit under control and achieve economic stability. It should be able to show positive rates of economic growth starting in the year 2,000.

Growth would be based principally on a recovery of agriculture and related industries, and on the expansion of small/medium sized industries. Agricultural output today is less than 50% of the outputs already achieved in 1990. The potential for growth is clear.