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Ukraine - Economic Situation

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Economic Growth.

During July 2000, the Ukrainian economy continued to grow, showing a real GDP growth rate of 4.7% compared to the same period last year. In the previous month, June 2000, the rate of real GDP growth was 3.4% compared to June 1999. During the first seven months of the year, real GDP growth was 5.0%.

The driving force for this GDP growth continued to be the industrial sector, with industrial output increasing by 16.1 % in July 2000 compared to July 1999. During the first seven months of the year, iindustrial output grew by 11.7%, compared with the same period last year. The highest rate of growth was achieved in the light industry (38 % growth rate); the timber-processing and paper-making industries (35.8 % growth rate); the food industry (30.3 % growth rate); and the non-ferrous metallurgy (22.1 % growth rate). All these are branches of industry in which 90 percent of property is owned by the private sector. The only large industry whose output was dropping was the energy fuel industry, with an output drop of 10.5% in January-July 2000, compared to the same period last year.

The agricultural sector has continued to perform poorly. For the period January-July 2000, agricultural output declined by 5.7%, compared to the same period last year. Although the weather played a role in this poor performance of agriculture, the main reason was the inadequate use of fertilizers, agricultural machinery and other agricultural inputs, due to lack of credit, both from foreign suppliers and from the Government.

During the second half of 2000, GDP should continue to grow, but it is like to desaccelerate as capacity utilization in key growth subsectors is reached. GDP growth for 2000 should be in the range of 2% to 3%.

Fiscal Policies.

During the first six months of the year, the fiscal budget was close to balance, principally due to restrictions in Government expenditures. During this period, consolidated budget revenues amounted to UAH 19.4 billion or 45.9% of the amount that the Finance Ministry projected for the entire year. In August, shortfalls in fiscal revenues continued. To avoid missing its fiscal balance targets, the Government has submitted to Parliament a number of laws, including a Tax Code that would expand the tax base and eliminate a number of tax exemptions, including laws on real estate taxes, income tax, and local taxes and duties. Although draft laws were submitted to Parliament early in the year, they have not yet been enacted. On August 17, the Government announced that, if fiscal revenues are not increased, and if external credits are not revived, it will cut Government budgetary expenditures during the rest of the year. The measures basically envisage a proportionate reduction of expenditures across all ministries and departments, with

the exception of protected social areas. The Cabinet of Ministers is hoping that the International Monetary Fund will resume disbursement of loans to Ukraine in October.

Based on restricted expenditures, the Government is confident that the IMF would agree to the current budget for year 2000. But a realistic budget for 2001 has become one of the main issues in the most recent discussions with the IMF. In particular, IMF experts are concerned about the possibility of a sharper decline in budget revenues after the Tax Code, which significantly reduces tax rates (including the VAT and the profit tax), goes into effect. The Government has indicated that it will agree to significantly reduce tax rates in line with the Tax Code only if Parliament passes the package of draft laws expanding the tax base simultaneously with the Tax Code. The Government expects to solve this issue with the 2001 budget by September 15, when the draft budget is submitted to Parliament for review.

Monetary Policies.

In July 2000, inflationary pressures were contained, following several months of accelerated inflation rates (1.7% in April, 2.1% in May and 3.7% in June). In fact, in July 2000, the consumer price index (CPI) dropped by 0.1 %. A preliminary estimate of inflation for August is 0.6%. Over January- August 2000 period, inflation reached 19.3 percent, surpassing the Government's original inflation target for the entire year of 19%. Food prices and Paid Services led the increases in prices.

The high rate of inflation so far was due principally to a high rate of monetary expansion (money supply increased by almost 30% from January to August). This expansion in money supply since the beginning of the year was caused in part to finance the purchases by the NBU of US$1.1 billion of foreign exchange in the open markets, in order to serve the country's foreign debt. Other contributors to the high inflation rate were increased charges for housing, utility and communication services, and the introduction of market prices in the agricultural sector.

For the entire year, Ukraine's inflation rate is expected to be in the range of 25% to 30%. The lower rate is based on the assumption that the International Monetary Fund would restart the US$2.6 billion EFF lending program.

In spite of the above-mentioned increases in money supply and the relatively high inflation rate, during the first half of the year, the exchange rate for the Hryvnia has remained stable at around 5.4-5.5 Hryvnias/US$.

Since the beginning of the year, the NBU has also managed to maintain relative stability in the level of international reserves. As of August 15, the liquid gross international reserves of the NBU stood at US$1.0 billion. This stability was achieved in spite of the fact that the country had to make significant repayments on its foreign debt from its own resources, including its international reserves.

External Debt

Since September 1999, for about one year now, the Government has not borrowed externally, but it was able to service most of its obligations. In the first half of the year, Ukraine's external payments amounted to US$955 million, of which about US$450 million were for the IMF. In the second half-year, foreign debt service obligations are due to reach $750 million, excluding bilateral debt which is currently under suspension and is expected to be rescheduled following the renewal of the EFF Program.

Foreign debt service obligations were met partly through private debt restructuring, debt reduction agreements with Russia, and repayments of debt in cash. As a result, the level of external debt declined from US$12.4 billion in January 2000 to US$10.3 billion in August 2000, a reduction of US$2.1 billion. External debt now represents only 30% of GDP.

About US$1.1 billion of the US$2.1 billion debt reduction was due to an agreement with Russia (in March this year) to write off debt in connection with the agreements on the Black Sea Fleet. An additional amount was due to agreements with Russia and Turkmenistan on natural gas debts (exchanging debt for grain and other commodities). The rest of the reduction was made by payments made by the Government in cash, from its purchases of US$1.1 billion of foreign exchange.

International Trade.

The aggregate volume of foreign trade in goods grew by 20.2% compared to the same period last year, reaching US$13.0 billion. Exports reached US$6.3 billion (18% growth), while imports amounted to US$6.7 billion (22.3% growth). The trade balance showed a deficit of around US$410 million. The largest volumes of goods were exported to Russia (22.8% of the total), Turkey (6.5%), USA (5.9%), Germany (5.3%), China (5.1%), Italy (4.1%), Bulgaria (3.5%), and Poland (3.4%). The largest volumes of imports came from Russia (47%), Germany (7%), Turkmenistan (5.3%), Belarus (4%), Italy (2.6%), USA (2.5%), and Kazakhstan (2.3%).

The IMF Program

Given the size of its foreign debt service obligations in the second half of the year, financial stability will depend on the renewal of the IMF lending operations. A Government mission visited Washington in early August 2000 to discuss the possibility of reviving the EFF Program, which was suspended in September 1999. Following this visit, it was announced that the IMF was not ready to resume the EFF Program. Progress had been made in several areas, including the fiscal budget for year 2000 and increases in communal and utility tariffs. However, there were still a number of conditions that needed to be carried out by the Government, including (i) the abrogation of the customs tariff on exports of sunflower seeds; (ii) the closure of free economic zones; (iii) non-intervention by the Government in the grain market; (iv) maintaining the level of fiscal revenues in the fiscal budget for year 2001; (v) reforms in the banking system, including the enactment of the Law of Banks and Banking Activities; (vi) further reforms in the energy sector; (vii) acceleration of privatization.

In mid-September, an IMF mission is expected to come to Ukraine to review the above reform program. The mission may be able to compromise on some issues -- such as the closure of free trade zones-- if overall progress is satisfactory. The Government is confident that there will be no insoluble problems during September IMF mission and that the IMF would be able to renew the EFF Program during October 2000.

Another important factor conditioning the resumption of the IMF Program is the results of the NBU audit. The audits showed that Ukraine had not misused the funds received from international financial organizations, but had overstated the level of NBU currency reserves. This overstatement led to IMF disbursements that would have not been made otherwise. A session of the IMF Board of Directors on the outcome of the audit will be held in early September. On the anticipation that the IMF would require the Government to pay back funds it released based on misleading information, on August 22, the Ukrainian government and the NBU made a voluntary reimbursement of $94 million to the IMF. This amount corresponds to the two disbursements made to Ukraine in December 1997 and February 1998 -- the two ones

that were based on the overstated reserves. The NBU decided to reimburse the funds in a show of goodwill and with a view toward resuming its relations with the IMF.

Following the renewal of the EFF program, the IMF may be able to disburse US$500 million by the end of the year. Furthermore, both the World Bank and the European Union may be able to renew disbursements under their current balance-of-payment loans. Revival of the EFF Program is also a condition for the restructuring of bilateral debt to the members of the Paris Club of creditors.

Outlook

The Government of Ukraine should be upbeat about the recent economic improvements, which include a revival of economic growth, a reduction in the size of public debt, the control of inflation, growing revenues from exports, and an stable foreign exchange rate. Furthermore, all this was achieved without any external credits or aid. In fact, September 10 will mark the first year in which Ukraine lived without external borrowings.

This is a strong indication that Ukraine is bringing about financial discipline and discipline of Government expenditures. However, as indicated earlier, to serve its foreign debt in this year, the NBU had to print Hryvnias heavily to be able to buy foreign exchange in the open markets. If these purchasing trends were to continue -- with the NBU issuing Hryvnias and buying foreign exchange to serve its obligations -- money supply will be quite high for the year (the trend of the last seven months implies an annual rate in money supply growth of about 50%). Monetary stability -- both external (the exchange rate) and internal (inflation rate) -- would then suffer accordingly.

It should be possible for the Government to keep stability until around October (when significant external debt payments are due). But after that time, the resumption of external borrowings is needed. In particular, it is imperative that the IMF lending program is revived, not only for the resources in will provide, but also because it will trigger increased lending from other institutions. If the IMF program is not re-established by October this year, the longevity of the current Cabinet will be in jeopardy.

Assuming that the IMF is re-established, future growth in year 2001 will depend on a revival of investments, which in turn will depend on an acceleration of economic reforms. The Government forecasts that real GDP growth in year 2,001 will be 4%, with industrial and agricultural output rising by 4% and 2% respectively. Inflation in year 2001 is estimated at around 15%.