Ukraine - Economic Situation

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Economic Growth.

The economic recovery of Ukraine that started in the third quarter of 1999 has continued to gain momentum. In fact, during the first quarter of 2001 Ukraine's industrial production grew by a spectacular rate of 17.4% compared with the same period last year (year-on-year- y/y). This growth rate was the highest rate among the former Soviet Union republics and one of the highest rates of growth in the world. On a monthly basis, in March 2001 industrial output grew by 18.1% y/y.

The recovery of industrial production has been robust and broad-based, with output increasing not only in traditional subsectors, but more substantially in subsectors aimed at final consumers. This is bringing about a very positive change in the structure of industry in Ukraine. During the first quarter of the year, the highest rates of growth on a year-on-year basis, were experienced in the wood processing industry at 28.6%, the textile/apparel industry - 27.4%, the cellulose-paper industry - 26.6%, the food industry - 22.7%, and the machine building industry - 22.6%. Despite the economic slow-down in many parts of the world, output of the export-oriented metallurgic industry grew by 20.8% in the first quarter of 2001. The building materials subsector grew by 18.4% y/y, and the chemical and petrochemical industry, by 13.8% y/y. In the energy sector, the production in January-March increased only by 0.1% y/y, an indication that the energy consumption in Ukraine is becoming more efficient. During the Soviet times, Ukraine was one of the world's most energy inefficient countries, consuming 5 to 10 times more energy per unit of GDP than Western economies.

During the last few months, the agricultural sector in Ukraine has also join the sectors with good recovery, though at a slower pace than industry. During the first quarter of 2001, agricultural output grew by 5.1% compared to the same period last year.

Led by industry, real GDP growth during the first quarter of 2001 remained high at 7.7% y/y. As noted below, except for Transport and Healthcare, all other sectors of GDP experienced good rates of growth during the first quarter of 2001.

Sector Composition of GDP Growth
January-March 2001, year-on-year

SECTOR	VALUED-ADDED GROWTH, Y/Y
Agriculture	5.1%
Primary Industries	3.2%
Manufacturing	23.7%
Mining	3.2%
Construction	8.6%
Wholesale/Retail trade	9.0%
Transportation	-1.9%
Education	0.2%
Healthcare	-1.7%
Total	**7.7%**

Source: Ukraine State Statistics Committee

Fiscal Policies.

The Ministry of Finance has reported that the fiscal revenue targets for the consolidated fiscal budget were fully achieved during the first quarter of 2001. The collection of consolidated fiscal revenues during this period, as a percentage of targeted annual revenues, represented the highest rate achieved in the 10 years since independence. The Government collected UAH 10 billion, or 19% of the targeted revenues for 2001, a collection rate that compares well with the 16% rate achieved last year, when Ukraine had its more successful fiscal year so far. Good fiscal performance has been due to the continuing growth of the economy, particularly industry and the sharp decline in barter operations.

During April 2001, fiscal revenues fell sharply due to the implementation of the recent tax law that allows for write-offs of tax arrears and the cancellation of the power of the Government to make withdrawal of the funds from the tax-payers' accounts against their overdue tax liabilities. Although these measures are expected to reduce the informal economy, improve the business climate and enhance long term economic prospects, over the short term they are reducing fiscal revenues. To compensate for revenue shortfalls, the Government is seeking measures to expand the tax base by removing special privileges to individual sectors.

Another uncertainty in the year 2001 fiscal budget is the possibility that IMF financing and privatization revenues would be below expectations. The fiscal budget for year 2001 was prepared on the basis that Ukraine would receive four quarterly tranches of US$190 million each for the IMF Program. As noted below, the IMF's March 2001 tranche was not disbursed. The budget also assumed that Privatization revenues in year 2001 would reach UAH5.9 billion (about US$1.1 billion). This amount is now unlikely to materialize given delays in the privatization of key large state enterprises. To deal with these revenue shortfalls and maintain its fiscal deficit target, the Government will need to cut fiscal expenditures during the rest of the year.

Monetary Policies.

During the first quarter of 2001, Ukraine continued to implement sound tight monetary policies. During this period, money supply (M3) grew by only 2.2%, a rate which is below the targeted annual rate of increase of 19% for money supply in 2001. During March 2001, money supply (M3) actually declined slightly.

Sound monetary policies helped to control the rate of inflation during the first quarter of 2001 to 2.7%. Following a high monthly inflation rate of 1.5% in January, inflation went down to 0.6% in February and O.6% in March. The inflation target for 2001 is 13.9%.

The Hryvnia foreign exchange has remained relatively stable at about 5.4 Hryvnias/US$ for the last twelve months. NBU gross reserves have also remained relatively stable during the last four months at about US$1.8 billion, despite foreign debt service payments of about US$350 million during the first quarter of the year. About US$120 million of this amount was to serve private foreign bonds and about US$140 million for the IMF. To maintain its level of international reserves, since the beginning of the year, the NBU has bought about US$380 million of foreign exchange in the open markets.

The Government has so far able to maintain financial stability, with stable exchange rates and low inflation. There is the risk however that inflation may accelerate during the rest of 2001 if international lending to Ukraine is not renewed. In 2001, Ukraine's foreign debt payments are expected to be US$1.8 billion, of which about US$610 million are owed to the IMF. This amount excludes about US$1.0 billion due to the Paris Club as repayments to the Paris Club were suspended by Ukraine in early 2000 pending proposed negotiations on bilateral debt restructuring. Without a Paris Club debt rollover deal and revival of IMF lending, Ukraine may have difficulties in meeting its foreign debt payments in a non-inflationary manner. If to serve its foreign debt Ukraine were to rely on purchases of foreign exchange in the open markets, domestic financial stability may be in jeopardy.

International Trade

So far during this year, Ukraine’s international trade has been favorable. Over January–February 2001, Ukraine’s merchandise trade balance was positive, with a US$140 million surplus, compared to a US$517 million deficit in the same period last year. During January/February 2001, merchandise trade increased by 4.2% y/y, totalling US$4.6 billion, of which US$2.4 were exports and US$2.2 million were imports. Ukraine’s main markets were Russia (24%), Turkey (6%) and Italy (5%). Imports came primarily from Russia (42%), Turkmenistan (11%), Germany (8%) and Kazakhstan (5%).

It is expected that international trade will continue to be favourable during the rest of 2001, despite the slow down of the Russian economy and restrictions imposed by Russian on Ukrainian exports of metal products. Exports to China, Turkey and Germany are expected to make up for declines in exports to Russia.

Multilateral Programs

The IMF Program

The IMF mission that visited Ukraine in February 2001 did not recommend that the IMF disburse the US$190 March tranche under the EFF Program. The IMF has indicated that the Government will need to comply with certain conditions before disbursing the March tranche. These conditions include:

(i) The modification of the recent tax law that provides for tax amnesties and other privileges that would reduces the tax revenues.
(ii) Tangible progress in the privatization of State enterprises.
(iii) The acceleration of financial sector reforms and the restructuring of troubled banks (in particular, the Ukraina Bank and the Savings Bank.)
(iv) The reduction of the sunflower export duty from the current level of 23%, leading to its eventual elimination.
(v) Progress in the tightening of payment discipline in the energy sector by increasing cash collections.

As noted earlier, in 2001, the Government will need to serve significant amounts of foreign debt (about $1.8 billion in principal and interest rates). Following the resignation of the Government in April 2001, the new Government will need to take quick action to deal with these repayments in a non-inflationary manner. The current expectation is that the EFF may be continued in May/June 2001, at the earliest, if an IMF mission expected for May 2001 were to find that the Government has implemented the above mentioned measures.

World Bank Program

During 2000, the lending activities of the World Bank were limited, due in part to the suspension of the IMF Program. Following the revival of the IMP Program in December 2000 and enactment of the Banking Law, in February 2001, the World Bank made the final disbursement of $60 million from a tranche of $100 million under the Financial Sector Adjustment Loan (FSAL). The equivalent to $40 million was cancelled since Ukraine did not meet other conditions, including the enactment of the Law on Deposit Insurance and the restructuring of the Savings Bank.

Discussions with the World Bank about a proposed Programmatic Adjustment Loan (PAL) for $750 million have been postponed until September 2001. If successfully implemented, it would allow for $250 million of Bank disbursements in October 2001. The World Bank delayed consideration of this loan due to limited progress in the restructuring of the Ukraine Bank and delays in the completion of the audit of Naftohaz Ukraine.

European Bank Program

In early March, the Government held discussions with EBRD management on a proposed loan of $243 million to complete the construction of two nuclear power plants. The discussions were successful and Ukraine will be able to receive these funds once it has created an independent regulatory body for the nuclear sector and has successfully negotiated the restructuring of its bilateral debt with the Paris Club.

Bilateral Debt

On March 6, 2001 Ukraine started negotiations with the Paris Club of bilateral creditors to reschedule $1.0 billion of bilateral debt due in 2001. Ukraine had suspended payments to the Paris Club in early 2000, in conjunction with the rescheduling of $2.6 billion of foreign private debt. Further discussions, however, have been postponed due principally by disagreements among bilateral donors on the handling of individual loans.