UKRAINE - Status of Economic Situation and Reforms

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As noted during the January 1999 Advisory Board Meeting in London, from 1995 to early 1998, Ukraine made reasonable progress in the implementation of its economic reforms, particularly in the areas of price and trade liberalization, monetary and foreign exchange management, and privatization of small and medium-sized industries. By mid-1998, it appeared that inflation had been controlled and that the country's long economic recession was ending, with a GDP growth of 1% projected for 1998. However, the country was quite vulnerable to negative international events due to a high fiscal deficit of around 6% of GDP, which was financed principally by short-term debt. In addition, by early 1998, private sector confidence started to deteriorate as the pace of structural reforms weakened during the Parliamentary elections.

When the financial crisis in Russia erupted in mid-1988, Ukraine's vulnerability became evident, with the country facing significant debt service obligations. As international financing dried up, Ukraine was unable to service its debt, international reserves fell significantly, interest rates increased sharply, and the exchange rate came under pressure. In the second half of 1998, the Hrivnia (UAH) depreciated from around 1.9 UAH/US$ to 3.4 UAH/US$.

Nevertheless, during the second half of 1988, Ukraine was able to confront the crisis successfully. It was able to bring investors to the table to restructure its debt. Monetary policy was handled effectively, stabilizing the Hrivnia at around 3.4 UAH/US$. The level of international reserves increased, due principally to administrative restrictions on foreign exchange transactions imposed by the National Bank of Ukraine. Furthermore, for several months in 1998, its fiscal accounts were in surplus, containing the fiscal deficit for 1998 to 2.7 % of GDP (compared to 6% in 1997 and early 1998). Inflation for 1998 was 20%. The decline in GDP during 1998 was -1.7%.

The future success of Ukraine's economic situation in 1999 will depend on how well the country is able to meet its external debt obligations. During 1999, Ukraine will need to service foreign debt obligations of about US$2.0 billion (including amounts due to multilaterals, bilaterals, Russia, Turkmenistan, Gazprom, private creditors and amounts due under publicly guaranteed debt).

During January to March 1999, due to lack of external financing, the Government was forced to use NBU's international reserves to serve foreign debt obligations. These foreign obligations included US$155 million due on February 5 on a eurobond issue, 160 million deutsche-marks (US$97 million) interest payment due on February 26 on a DM 1 billion eurobond issue, and 74 million euros (US$92 million) of interest payments due on

March 17 on an Euro 500 million eurobond. So far, Ukraine has been able to serve its foreign debt from its international reserves.

However, the level of international reserves at the NBU is already low. The NBU has reported that, as of December 31, 1998, the level of international reserves was US$685 million, excluding gold and other non-liquid items, but including gold held at foreign banks. Payments in January to March have reduced this level further. As of February 22, international reserves had declined to US$502 million. Currently, reserves are even lower and insufficient to serve future debt payments. Given this situation, in the un-official market, currency dealers are buying dollars at a rate of 4 UAH/US$. As of March 26, the official exchange rate quoted by the NBU was 3.91 UAH/US$.

A tight fiscal situation also forced the Government to convert domestic debt held by domestic commercial banks due in February. About Hr 173 million of T-bills due on February 5, were re-scheduled for payment in the second half of 1999. Although eight banks had agreed to the conversion, other banks are currently challenging this decision, calling it a *de facto* default by the Government. They have sued the Ministry of Finance to reverse the decision. Nevertheless, the NBU has indicated that if the T-bill conversion were to be reversed, the financing will need to be provided by the NBU. To avoid excess liquidity, the NBU would need to increase reserve requirements by about 3%. For many banks, this may be a less favorable situation.

Given the low level of international reserves, and since very little private external financing will be available in 1999, the country's will require IMF/World Bank financing to cover other debt service obligations due in 1999. In particular, the re-initiation and the continuation throughout 1999 of the Extended Fund Facility (EFF) of the International Monetary Fund -- which was suspended in November 1998 – is a key condition for stability in 1999. This could lead to IMF disbursements of about US$750 million in 1999. The revival of the EFF is will also facilitate balance-of-payment financing in 1999 by the World Bank (ranging from US$450 million to US$700 million), by the European Commission (about US$180 million), and by Japan. The acceleration of the privatization program, particularly in telecommunications and energy, would also be important to provide additional resources to the Government in 1999. In fact, the fiscal budget for 1999 assumes privatization receipts of about US$160 million. If the financing currently envisaged by the multinational and bilateral agencies were to materialize, Ukraine should be able to handle its debt service obligations in 1999.

IMF missions visited Kiev in January and February to ascertain the status of the EFF Program and to establish whether it could recommend to the IMF's Board of Directors the continuation of disbursements under the program. The IMF missions made good progress in a number of areas, particularly regarding agreement on the country's fiscal deficit and monetary targets for 1999. The main concerns of the IMF mission were in the areas of structural reforms. Also, Senior Ukrainian Government officials visited Washington in February to seek agreement on these outstanding areas.

During the month of March, the Government took a number of actions to improve its economic situation and meet IMF conditions. Some of the key measures were as follows:

- Within the fiscal deficit of 1% of GDP already approved by Parliament, the Government agreed to make reductions in the absolute level of expenditures in 1999. This will make budget projections more realistic and achievable.

- The Government took steps to further strengthen the operations of the Treasury, particularly by extending Treasury's control on extra-budgetary funds, starting with the Ministry of Health, the State Tax Administration, and the Customs Administration.

- The National Bank agreed to further tightening of monetary policies, including foreign exchange policy – particularly the establishment of an exchange rate corridor with a wide band and removal of constraints in the foreign exchange market.

- The Government took important structural reforms in the gas sector, particularly by implementation of the agreed upon auction of natural gas.

- The Government was able to get a reversal, by the Constitutional Court, of the law that prohibited increases in utility tariffs for community services, and inhibited cost recovery for these services.

- Steps were taken to reform Public Administration, including the issuance of a Presidential Decree to consolidate State Committee and restructure the Ministry of Finance.

Based on the progress achieved, on Mach 26, the IMF Board of Directors agreed to re-establish the Extended Fund Facility. This led to disbursements of two tranches of its US$2.2 billion Extended Fund Facility for Ukraine, or US$153 million. Further disbursements during 1999 will be determined during the next IMF review of the Extended Fund Facility, which is now planned for May 1999.

Following IMF Board decision, the World Bank should be also able to disburse about US$150 million in early April. In addition, the EBRD may also be able to disburse US$56 million under the first tranche of a balance of payment loan. If all these disbursements were to take place, the NBU expects that the level of international reserves would recover to more sustainable levels.

On the above basis – and a fiscal deficit of no more than 1% of GDP – the NBU expects that money supply during 1999 would increase by only 10%. It believes that inflation could be controlled to 19% in 1999. It also forecast that, by the end of 1999, the exchange rate could be maintained within the ceiling of the band at 4.6 UAH/US$.

Although the above is a possible scenario, most international analysts believe that a most likely result for 1999 – assuming continuation of the EFF reform program and continuation of fiscal discipline -- would be as follows: a higher growth in money supply, (around 15-20%), higher inflation (25-35%), an exchange rate of 4.6-5.5 UAH/US$ by the end of the year, and a decline in GDP of 2-3%. With a significant drop in imports, for the first time since independence, in 1999, Ukraine could show a positive current account balance in 1999.

Key Economic Statistical Information

	1996	**1997**	**1998**	**1999P**
Real GDP (% change YOY)	-10	-3.0	-1.7	-3.0
GDP (UAH bn)	81	93	104	132
GDP per Capita (US$)	860	980	810	670
Fiscal Balance (% of GDP)	-3.2	-5.6	-2.7	-1.0
Fiscal Revenues (% of GDP)	36.7	38.4	36.1	36.3
Fiscal Expenditures (% of GDP)	39.9	44.0	38.8	37.3
Consumer Price Index (% change YOY)	40	10	20	30
Money Supply-M2 (% change YoY)	32	38	24	20
Exchange Rate (end of period, UAH/US$)	1.89	1.90	3.43	5.00
Merchandise Exports (US$bn)	15.5	15.4	12.8	13.0
Non-Factor Service Exports (US$bn)	4.8	4.9	4.2	4.2
Merchandise Imports (US$bn)	19.8	19.6	15.8	15.5
Non-Factor Service Imports (US$bn)	1.6	2.3	2.5	1.9
Trade Balance (US$bn)	-4.3	-4.2	-3.0	-2.5
GNFS Balance (US$bn)	-1.1	-1.5	-1.3	-0.2
Current Account Balance (US$bn)	-1.2	-1.3	-1.6	+0.1
Net Foreign Direct Investments (US$bn)	0.5	0.6	0.7	0.6
Gross International Reserves (US$bn)	1.9	2.3	0.7	1.20
External Public Debt (US$bn)	8.8	9.6	11.5	12.6
External Debt Service (US$bn)	1.2	1.2	1.8	2.0
Domestic Public Debt (US$bn equiv.)	1.3	4.6	4.0	3.2