UKRAINE - Status of Economic Situation and Reforms

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The recent resumption of the IMF's Extended Fund Facility (EFF) for Ukraine enabled the country to receive total balance-of-payments support of US$408 million. Of this amount, US$153 million was provided by the IMF, US$150 million by the World Bank, US$70 million by the European Union (available in June), and US$35 million by the Japanese Government.) These funds have helped Ukraine to restore its international reserves to a level estimated at US$650 million on April 25, 1999.

Further disbursements from these lenders are expected during 1999, following formal reviews of their programs by the IMF and the World Bank, now planned for May 1999. The Government could receive a total of about US$740 million from the IMF, about US$500 million to US$700 million from adjustment loans of the World Bank, and US$170 million from the European Union. These resources should enable Ukraine to meet its foreign debt service obligations during 1999, which would include payments of US$155 million in June 1999 for a Eurodollar issue arranged by ING Barings, US$680 million due to the IMF, and US$105 million due to the World Bank. In 1999, there are also significant repayments of bilateral debt, principally to Russia and Turkmenistan, related to the supply of oil and gas to Ukraine. The Government has already made arrangements to service this bilateral debt, including payments through commodity and asset swaps, payment through construction services, and debt cancellation with Russia in connection with agreements on the Black Sea Fleet.

To receive the expected resources from multinational agencies, Ukraine will need to meet its commitments under its agreements with these agencies, particularly regarding fiscal budget discipline and implementation of economic reforms. During this year of Presidential elections, the Government is fully aware of the need to resist pressures to print money to cover politically sensitive obligations, such as wage and pension arrears. The Government is fully aware of the inflation risks inherent in printing money in the current fragile situation of the economy. If money were to be printed to cover all pension and wage arrears (about US$1.0 billion), money supply would increase by 55% (compared to 10% planned by the NBU) and inflation could reach 50-60% in 1999. President Kuchma, Prime Minister Pustovoitenko and NBU Chairman Yushchenko have made recent strong statements indicating that the Government and the NBU will not resort to inflationary financing of Government expenses. The economic outcome for 1999 will depend on the Government's will to keep this promise.

I. Status of the Real Economy

(a) Output

The decline in Gross Domestic Product (GDP) that started in 1991 decelerated gradually over the last three years to a virtual standstill in early 1998. Output started to recover and 1998 was expected to be the first year after independence with positive growth. However, these positive developments were reversed in the second half of 1998, following the crisis in Russia. As a result, GDP declined by 1.7% in 1998.

The recovery of growth until mid-1998 was concentrated in the industrial and construction sectors, with agriculture and livestock still lagging behind with negative rates of growth. In industry, the recovery was widespread, including ferrous and non-ferrous metals, chemicals, petrochemicals, wood and pulp, construction materials, and food and apparel industries. In the second half of 1998, following the crisis in Russia, there was a sharp drop in exports to Russia and to Asia, particularly in metallurgy, machine-building and chemicals. As discussed below, this decline in exports was somewhat mitigated by good performance in other industries, particularly food processing. Domestic industrial production was seriously affected by the lack of imported inputs and the increase in imported input prices, due to the sharp depreciation of the Hryvnia and lack of import financing.

The situation in the agricultural sector has been more negative. Agricultural output, which by 1996 was less than 60% of its 1990 level, decreased by 2% in 1997, due mainly to a decline of 12% in animal production. In 1998, agriculture further declined by 8%, with a grain harvest 25% lower than in 1997. Trends in agricultural productivity were also unfavorable. In 1998, yields for cereals and sunflower decreased by 13% and 17% respectively. This was due mainly to the use of outdated equipment and insufficient fertilizer use. As a result, today as many as 80% of all agricultural enterprises are not profitable.

The potential for growth in agricultural activities is enormous. The country has already demonstrated its capacity to produce twice as much output as it is producing now. A key will be the implementation of reforms that would remove Government interference in the sector and would provide incentive to agricultural firms to improve productivity. The privatization of agricultural silos has been identified as a key measure to eliminate the Government capacity to intervene in the movement of grains. Over the medium term, the availability of modern agricultural machinery, agricultural inputs, and credit will be key factors to recover agricultural output.

The prospect for 1999 is that GDP will decline by about 3%. During January to March 1999, GDP declined by 4.8% compared with January/March 1998. The major decline has been in the chemical and construction sectors, with output declining by 14% and 9%, respectively, when compared to the same period last year. But there are already signs of recovery in the industrial and agricultural sectors. Industrial output declined by 1.8%

from February, compared to January; but it increased by 12.7% in March, compared to February, due to the greater availability of foreign exchange to import industrial inputs.

(B) Prices and Inflation

From 1996 to early 1998, Ukraine made considerable progress in reducing inflation, which was contained to 10% pa in 1997 and to 7%, on a year-to-year basis, during the first eight months of 1998. This progress was due mainly to sound monetary policies. However, due to the sharp depreciation of the Hryvnia (UAH) in the second half of 1998, inflation reached 4% in September, 6% in October, and 3% in November and December 1998. For the entire 1998, inflation reached 20%.

During the months of January to March 1999, inflation was under control, with monthly rates of 1.5% in January, 1% in February, and 1% in March. If these rates were to continue during the rest of the year, inflation would be at around 20%. However, the recent increases in utility and transportation prices will be reflected in inflation rates of about 2.5% and 4.0% in April and May, respectively. In addition, the recent liberalization of exchange rate transactions will further affect the exchange rate. Taking these two developments into account, it is expected that inflation for 1999 would be around 25%-30%. This would still be a major stabilization achievement, given that the Hryvnia has depreciated by around 100% since the start of the crisis in August 1998.

II. Fiscal Budget Situation

Weaknesses in Public Finance has been at the core of the economic difficulties experienced by Ukraine, despite the progress made in other economic areas. In 1997 and the first-half of 1998, shortfalls in fiscal cash revenues, accompanied by week expenditure controls—mainly in health and education, led to fiscal deficits of about 6% of GDP. These deficits were accommodated mainly by the easy availability of external credits. However, since most of these credits had short term maturities, their large debt-service obligations put the country in a vulnerable position to negative international developments.

In the second half of 1998, as international financing dried-up, the dept of the financial crisis motivated the Government to improve its fiscal policies. The transparency of Government operations was improved with the strengthening of the Treasury. With World Bank assistance, the Treasury is now fully operational, recording most central cash and noncash expenditures, and gradually taking over budgetary payments at the Center and Oblast levels. Also, the tax burden was redistributed in a more rational way. More importantly, Government expenditures were reduced considerably, principally in non-priority areas. Overall, expenditures were cut by 6% of GDP in 1998 in relation to the approved budget. This was enough to offset a decline in fiscal revenues of 3% of GDP with respect to the original plan. As a result of actions in the second half of 1998, fiscal surpluses were shown during several months, reducing the fiscal deficit for 1998 to 2.7% of GDP, a remarkable achievement.

The fiscal prospects for 1999 are even more favorable. The Fiscal Budget for 1999 envisages Consolidated Revenues amounting to 36.3% of GDP, and Consolidating Expenditures of 37.3% of GDP. The Fiscal Deficit would represent 1% of GDP, compared to deficits of 2.7% of GDP in 1998 and 5.6% of GDP in 1997. The 1999 Budget contains many measures that are important to sustain macroeconomic performance in Ukraine. Some of the important fiscal measures included in the Budget and approved by Parliament include:

(a) Increases in gasoline taxes that will permit increases in excise taxes from 1.2% of GDP to 2.3% of GDP.
(b) The tax for the Chernovyl Fund was eliminated.
(c) The value-added tax liability will be computed in an accrual basis.
(d) The introduction of a 3% tax on the purchase of jewelry.
(e) An additional tax of UAH 100 on purchases of automobiles.
(f) A tax of 1% on the purchase of foreign exchange.
(g) Payroll taxes were reduced from 48% of the wage bill to 38%, to improve the business environment.

The 1999 Fiscal Budget approved by Parliament is probably the best so far undertaken by the Government since its independence. Its deficit of 1% of GDP, about US$300 million, could be financed by external sources (US$150 million) and internal sources (US$150 million equivalent). These numbers are plausible and should not impose major difficulties.

During the months of January and February 1999, the consolidated budget of the Government showed a surplus of over UAH 100 million. During the first quarter of the year, the collection of revenues was 11% lower than planned, but the Government took measures to reduce expenditures accordingly, keeping the overall fiscal deficit for the quarter within planned levels. This budget performance so far is quite encouraging, as there are no signals yet that fiscal discipline will not be maintained.

Notwithstanding these accomplishments, more reforms are needed to ensure the sustainability in the control of Government expenditure programs. This is an area in which the IMF expects to concentrate in the future.

III. Monetary and Exchange Rate Situation

Tight monetary policies of the National Bank of Ukraine (NBU) can be credited with the significant progress made by Ukraine towards financial stabilization, despite inconsistent fiscal policies. Up to the third quarter of 1997, the availability of foreign financing allowed the fiscal budget deficit to be financed without recourse to borrowing from the NBU. However, the Asia Crisis in September 1997 and delays in Ukraine in fiscal and structural adjustments, started to change investors perceptions of Ukraine. During the first half of 1998, capital outflows accelerated and the NBU had to sell a considerable amount of foreign reserves to protect the exchange rate. Foreign reserves were supplemented by the placement of two large Eurobond issues for a total of US$1.1

billion. However, during the second half of 1998, continuing loss of investor confidence, combined with the Russia crisis, made foreign financing unavailable to Ukraine. With international reserves declining rapidly, in September 1998, the NBU had to stop selling foreign exchange. The Hryvnia depreciated sharply from about 2.1 UAH/US$ in January 1998 to 3.5 UAH/US$ in September 1998. The NBU introduced administrative measures to reduce demand for foreign exchange. As noted earlier, since September 1998, fiscal and monetary policies have been improved considerably, bringing relative stability to the exchange rate.

During the first quarter of 1999, the NBU followed even more strict monetary policies. In January 1999, the monetary base actually contracted and increased by a small margin in February and March 1999. As a result, exchange rate pressures eased. With the approval of the EFF, the NBU started to remove the foreign exchange administrative controls imposed earlier. Foreign exchange was allowed to the traded in the over-the-counter interbank market. The NBU also lifted the restriction on the margin by which exchange rates may deviate from the official rate. By June, the NBU expects to remove the restriction that exporters must sell 50% of their foreign exchange earnings at official rates. These foreign exchange liberalization measures have resulted in some depreciation of the currency, to a level of 3.93 UAH/US$ in the official market, as of April 27, 1999. In the cash market of Kiev, the exchange rate was 4.0 UAH/US$. With further liberalization of controls planned for the future, the exchange rate is likely to have wider fluctuations than in the past. Tight monetary policy, however, is likely to maintain the exchange rate from depreciating sharply, with a rate not exceeding 5.0 UAH/US$ expected by the end of this year.

IV. Balance of Payments Situation.

Merchandise exports and imports in 1998 declined by about 18% from the levels achieved in 1997. Nevertheless, updated information on exports and imports for 1998 shows more favorable results than anticipated earlier. Merchandise exports reached US$13.5 billion in 1998 (compared to the earlier estimate of US$12.8 billion). Merchandise imports amounted to US$16.1 billion. The deficit in the current account was only US$600 million, compared to deficits of around US$1.2-1.3 billion in 1996 and 1997.

During the last two years, there have been important changes in the composition of Ukrainian exports and imports. Exports to traditional partners (the former Soviet Union, particularly Russia) have declined substantially, from 57% of total exports in 1995/96 to about 40% in 1998. On the other hand, exports to non-traditional partners (particularly China, Turkey and Germany) have performed quite well, partly offsetting the shortfall to Russia. In terms of composition of exports, the importance of ferrous and non-ferrous metals continued to increase, accounting for more than 40% of exports in 1997/98. Two other important export items, chemicals and machinery, represented 25% of the total. Agricultural exports have continued its decline, representing only 10% of total exports in 1997/98 (down from 20% in 1996). Policy shortcomings in agriculture explain part of the decline in food production and imports.

The direction of imports followed a similar pattern, with imports from the former Soviet Union declining from 65% of the total in 1995/96 to 55% in 1998. The major import items continued to be energy products (oil and gas) which represented about 35%-40% of the total in 1997/98. Other leading imports include machinery and equipment, chemicals, and some food items.

Ukrainian Trade Policy remained generally liberal during 1997-98. The response to the crises in Russia has been to attempt to liberalize the export regime further, while the changes in the exchange system have effectively restricted imports.

Direct foreign investments grew in 1997 and 1998, though from a low base. Net Direct foreign investments amounted to US$624 million in 1997 and US$700 million in 1998. Direct foreign investment flows into Ukraine are among the lowest in the region. A large potential for future increases exists, and its realization would depend on the investment climate in the future.

The overall balance-of-payment situation during 1998 deteriorated substantially, due to the intensification of short-term capital outflows and the financial crises in Russia. Short-term capital outflows exceeded US$1 billion in 1998. As a result, the level of international reserves declined from US$2.4 billion at the end of 1997 to US$685 million at the end of 1998. During the first quarter of 1999, reserves declined substantially due to large foreign debt service payments. The recent disbursements from international agencies have brought international reserves to US$650 million. This level of reserves, and expected future disbursement form international and bilateral agencies, should ensure financial stability during the rest of 1999.

V. Prospects for the year 2,000

The Government has recently recognized publicly that the year 2,000 will be a particularly difficult year for Ukraine. In that year, two large Eurobonds will mature, involving total debt service of US$1.3 billion. In addition, other large debt service obligations will include US$ 900 million due to the IMF, US$200 million due to the World Bank, US$220 million due under Gazprom bonds, US$260 million due to Russian and Turkmenistan, and US$300 million due under publicly guaranteed debt. The total debt service due in year 2,000 will be US$3.2 billion (US$2.6 billion in principal payments and US$670 million in interests due), compared to US$2.0 billion in 1999.

In order to serve its foreign obligations, the Ministry of Finance has recently acknowledged that a larger proportion of the state budget in the year 2,000 will be required to repay foreign debt. It is currently drafting a budget for the year 2,000, which is expected to contain a fiscal surplus. As a second source of financing, the Government will seek to increase cash receipts from privatization of state enterprises, particularly telecommunications and electric utilities. Thirdly, the Government believes that in the year 2,000, new foreign borrowing could be possible. In fact, these three financing options could be possible in 2,000 if the investment climate in the country were to improve. The incoming Government after October 1999 will need to demonstrate a renewed commitment to economic reforms and to improve Ukraine's business climate. If so, a combination of the above three elements should allow Ukraine to serve its foreign obligations in the year 2,000 and avoid debt renegotiations and another financial crisis. After the year 2,000, the debt service obligations of Ukraine will fall sharply. This highlights the fact that the size of the total foreign debt of Ukraine is not large, but its maturity is quite short.

In summary, the economic/financial situation of Ukraine will remain serious for a couple of years. But it can be managed: the success of this will depend on the fiscal budget stance of the Government and the dept of further economic reforms to be undertaken by the new Government.

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$bn)	15.5	15.4	13.5	13.0
Non-Factor Service Exports (US$bn)	4.8	4.9	4.7	4.2
Merchandise Imports (US$bn)	19.8	19.6	16.1	15.5
Non-Factor Service Imports (US$bn)	1.6	2.3	2.5	1.9
Trade Balance (US$bn)	-4.3	-4.2	-2.6	-2.5
GNFS Balance (US$bn)	-1.1	-1.5	-0.4	-0.2
Current Account Balance (US$bn)	-1.2	-1.3	-0.6	+0.1
Net Foreign Direct Investments (US$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