SigmaBleyzer

UKRAINE -- ECONOMIC SITUATION

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I. Introduction

After 9 years of GDP decline, 1998 was expected to be Ukraine's first year with positive economic growth. In fact, from January to June 1998, GDP growth was slightly positive. But the Russian crisis of mid-1998 led to a reduction of Ukrainian exports and international reserves, lack of foreign exchange, a major devaluation of the Hryvnia and a financial/debt crisis. Domestic production declined, principally in industries dependent of imported inputs. For the entire year 1998, GDP declined by 1.7%.

The crisis in Ukraine was deepened and made more difficult by the significant amounts of international debt, including short-term private debt, that Ukraine had contracted in the previous two years. Although the level of international debt, at US$10 billion at the end of 1997, was not high (20% of 1997 GDP), its maturity was short, with significant repayments due in 1998, 1999 and 2,000. After the mid-1998 crisis, Ukraine lost access to private foreign financing and servicing foreign debt became a key issue.

Ukraine managed the 1998 crisis fairly well: It was able to refinance its short-term foreign debt on a "negotiated " manner. Monetary policy by the NBU was handled effectively, stabilizing the Hryvnia at 3.4 UAH/US$ by December 1998. Inflation for 1998 was contained to 20%. The fiscal deficit was contained to 2.5% of GDP in 1998, compared to 6% in previous years.

Following the 1998 crisis, the major challenges for the country are to retain internal and external stability and to revive economic growth. For this the country must accelerate implementation of economic reforms, and deal successfully with large foreign debt service obligations.

II. Progress in Implementation of Economic Reforms

Economic reforms in Ukraine started only in 1996, after President Kuchma was elected. During 1996-1998, the following reforms were undertaken:

- 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 (Hryvnia-UAH) was introduced successfully in September 1996, without confiscation.
- Ukraine accepted the IMF Obligations under Article VIII (foreign exchange convertibility for current account).
- 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 to US$2.3 billion by the end of 1997.

But Fiscal Policy remained weak, with a fiscal deficit at about 6% of GDP until mid-1998. In addition, many areas of reform were slow in being implemented. For example:

- Competition was limited by high barriers to enterprise entry and exit, such as excessive Government regulations (such as licensing & registration requirements).
- Privatization of large industries was stalled.
- Cumbersome custom procedures constrained trade.
- The Government was unable to control interference at sector levels, particularly in agriculture and energy.
- The banking and capital market sectors remained weak.
- The legal system remained inadequate to protect commercial/contracts interests.
- Reform of Public Administration reform was slow.

These issues made Ukraine vulnerable to the 1998 crisis.

But the 1998 crisis had the positive effect of amalgamating the Government in its efforts to carry out a major revision of economic policies. In particular, the Government is now fully committed to fiscal budget discipline, which was the major reform issue before. Despite the Presidential elections, fiscal discipline has been maintained. The Government is also proceeding with the implementation of economic reforms, though at a relatively slow pace. Under the EFF program agreed with the IMF, the Government has taken recently the following reform measures:

- The new Treasury, under the Ministry of Finance, has been created and strengthen to assume better control of expenditures, including extra-budgetary funds. With World Bank assistance, the Treasury is now fully operational, recording most central cash and non-cash expenditures, and gradually taking over budgetary payments at the Center and Oblast levels.
- The NBU continues its reasonable monetary policy, as will be discussed later on.
- Public Administration reform has been initiated, with the consolidation of State Committees and the restructuring of the Ministry of Finance.
- De-regulation of private sector activities is proceeding, with the reduction in the number of "licenses" and agencies that have "supervisory" power over private enterprises.
- Financial Sector reform is proceeding, following the approval of the Law on the NBU and improvements in the capacity of the NBU to supervise commercial banks.
- In Agriculture, land markets are being developed through land leasing and use of land as collateral.
- In Energy, purchases of gas are being made more transparent by the use of gas auctions.

Based on this reform program, and on the favorable fiscal stance of the Government, the international institutions (IMF, World Bank, European Union) have continued their assistance programs, but not at a high level. This financing has been key to assist the Government in servicing its foreign debt in 1999.

However, more substantive financial support from the International Community will depend on the results of the Presidential elections in October 1999, and on acceleration of economic reforms. President Kuchma is aware that, if re-elected, future support will depend on a major acceleration of reforms. His Government is already working on such a program, which would include the following items:

- Redefinition of the Role of the Government, reducing Government interference with private sector activities.
- Public Administration Reform
- Deregulation and Facilitation of Private Businesses.
- Pension Reform
- Reform of Community Financing

III. Foreign Debt Service

To maintain stability and revive growth, in addition to accelerating implementation of economic reforms, the Government must meet its large debt service obligations due in the next 2 years. The following tables give the total amount of foreign debt outstanding and debt service in 1999, 2000 and 2001.

UKRAINE - External Debt Outstanding
(Millions of US$, at the end of 1998)

Multilateral:	
IMF	2,795
World Bank	1,586
EBRD	227
EC	333
Bilateral	
Russia/ Gazprom Bonds	3,051
Turkmenistan	458
Germany	501
USA	414
Japan	150
Other	216
Private	
Eurobonds/Private	1,650
Non-Resident T-Bills	117

TOTAL	US $11,500 million

UKRAINE - Foreign Debt Service
(in Millions of US$)

	1999	2000	2001
IMF	685	907	663
World Bank	105	196	248
Russia	98	98	98
Turkmenistan	163	161	151
Credit Lines & Pub.Guarts	311	302	271
EU/Japan	18	26	53
Gazprom	236	224	213
Eurobonds & Fiduc.Credits	379	1,323(a)	667
TOTAL	1,995	3,237	2,364

(a) Includes ECU500 million eurobond arranged by SBC Warburg due March 2000, US$504 million euronote arranged by Merrill Lynch to restructure T-bills, due September 2000 (of which US$240 million have been moved to 2001), and US$82 million credit arranged by Chase Manhattan, due October 1998 .

Debt Service for 1999 was assured by the continuation of disbursements from the IMF, World Bank and EU.

The IMF has recently completed a major review of its EFF Program. Following meetings with Government officials in Washington in mid-August, US$180 million was disbursed on September 7. Including the September 7 tranche, since January, the IMF have disbursed US$630 million. Subject to a EFF Program reviews, an additional US$305 million is expected to be disbursed at the end of 1999. The total amount of IMF financing for 1999 would be US$935 million. Since January, the World Bank has disbursed US$340 million under adjustment loans. An additional US$40 million will be disbursed by year-end. In early August, the European Union disbursed US$63 million, as the first tranche of a US$163 million loan. This availability of official international financing shows the confidence of international organizations on the current situation in Ukraine.

Other debt service obligations in 1999 include repayment to bilateral donors, particularly Russia and Turkmenistan, related to the supply of oil and gas to Ukraine. Arrangements has been made to serve this bilateral debt including payments through commodity and asset swaps, payments through construction services, and debt cancellation in connection with agreements on the Black Sea and Air Force fleets.

Private debt due in 1999, has also been served, except for US$165 million due to ING Barings in June 1999 which was restructured recently. Under this restructuring program, 80% of the US$165 million bonds were converted into DM obligations with a 16% interest rate and with a maturity of February 2001. The remaining 20% was paid in cash.

However, the year 2000 will impose greater difficulties for the Government to serve its US$3.2 billion of foreign debt due that year. Multilateral financing and international reserves (at US$1.2 billion) will not be sufficient to cover these debt service obligations. To serve its year 2000 foreign debt, the Government will need to resort to several measures, including:

- a larger proportion of the state budget in the year 2,000 will be required to repay foreign debt.
- increases in receipts from privatization of large state enterprises, particularly telecommunications and electric utilities.
- in the year 2,000, new foreign borrowing could be possible.
- the Government expects to negotiate, on a voluntary basis, the restructuring of some of the foreign debt due in the year.

In fact, debt re-negotiation on a voluntary basis is likely to be an important element of the debt service program. The Government has already initiated this process with the conversion of about half of a US$504 million Euronote arranged in September 1998 by Merrill Lynch into Deutsche Mark bonds, with an interest rate of 16% pa. This conversion changed the notes's maturity from September 2000 to February 2001.

An August Cabinet of Ministers Resolution directed the Ministry of Finance to propose a similar conversion for US$82 million of 16.75% bonds arranged by Chase Manhattan in October 1998 and maturing in October 2000. The proposal is to denominate them in DM with an interest rate of 16% and a maturity of February 2001. This proposal is now on hold.

As noted in the previous table, after the year 2,000, the debt service obligations of Ukraine will fall sharply (to US$2.4 billion). This highlights the fact that the size of the total foreign debt of Ukraine is not large, but its maturity is quite short.

IV. Performance in 1999

The Real Economy.

During January-March 1999, GDP declined by 4.8% compared with 1998. Foreign exchange restrictions and reduction in imported inputs were a major cause of the reduction in output after the 1998 crisis. The major decline was in the chemical and construction sectors, with output down by 14% and 9%, respectively.

Since April, there are signs of recovery in the industrial sector. During April-June, industrial output grew by 0.2%. Industrial growth in June and July were 4.7% and 2.2%, respectively. Positive growth were shown in the energy, non-ferrous metallurgy, timber processing, and food industry. This improvement was due partly to greater availability of foreign exchange to import industrial inputs. Negative rates remained in the ferrous, chemicals, machine-building and metal-working industries. Agricultural output also declined. Industrial recovery helped to contain the fall in GDP, which declined by only 3% in January-June, compared to the same period last year. Future improvement in output should come from further foreign exchange liberalization that would facilitate imports of industrial inputs and raw materials.

The prospect for 1999 is that GDP will decline by about 3% (estimates range from minus 2% to minus 4.5%). The year 2,000 should show positive rates.

Fiscal Budget Situation.

Weaknesses in Public Finance has been at the core of the economic difficulties experienced by Ukraine, despite progress made in other economic areas. As noted earlier, 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 financed by external credits. 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 fiscal deficit for 1998 was reduced to 2.7% of GDP, a remarkable achievement. The 1999 Fiscal Budget approved by Parliament is probably the best so far undertaken by the Government since its independence. It envisages Consolidated Revenues amounting to 36.3% of GDP, and Consolidating Expenditures of 37.3% of GDP. The Fiscal Deficit for 1999 would represent 1% of GDP.

The 1999 Fiscal 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.

During the first half of the year, the collection of revenues was 90.5% of the planned figure, due to low collection of taxes. But the Government took measures to reduce expenditures accordingly, keeping the overall fiscal deficit for the quarter within manageable levels. In the first half of the year, the budget deficit amounted to UAH974 million, or 1.8% of GDP. The Government and the IMF have recently agreed on measures to be taken in the second half of 1999 to increase revenues (including reductions in barter trade and mutual-account payments) and to further reduce expenditures. The 1999 budget performance so far is quite encouraging, as there are no signals yet that fiscal discipline will not be maintained.

Monetary and Exchange Rate Situation.

In the past, tight monetary policies of the National Bank of Ukraine (NBU) were credited with the significant progress made by Ukraine towards financial stabilization, despite fiscal budget issues. However, the Asian and Russian Crises in 1997/98 and delays in Ukraine in fiscal and structural adjustments, changed investors perceptions of Ukraine. During the second half of 1998, foreign financing became 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. 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.

With the approval of the EFF in late March 1999, the NBU started to purchase foreign exchange in the open market. This led to money supply increases of 7.5% and 6.8% in April and May. In June and July, monetary policy was again tightened. In July 1999, money supply increased by 1% only.

In March 1999, the NBU also started to remove the foreign exchange administrative controls imposed earlier (foreign exchange was allowed to be traded in the over-the-counter interbank market and the NBU also lifted the restriction on the margin by which exchange rates may deviate from the official rate.) These liberalization measures resulted in a depreciation of the currency, to 3.93 UAH/US$ by June 1999. International reserves stood at US$1.2 billion, as of mid-August 1999.

Recent Exchange Rate Developments

Since July 20, the Hryvnia has fluctuated widely. On August 10, at the interbank currency market, the dollar traded at 5.25-5.30 UAH/US$. By mid-September, the rate had come to 4.5 UAH/US$.

The depreciation was caused principally by poor Government actions. Early in the year, it imposed restriction on imports of petroleum product and withdraw import privileges to a number of companies. Subsequently, it was announced that the VAT on oil products would be waived for 60 days, starting on August 15. Naturally, oil traders stopped imports to take advantage of this exemption. These two measures led to scarcity of oil products throughout the country and high increases in oil prices, in many cases by 300% (from UAH1.60/lt for premium gasoline to almost UAH5.00/lt).

As sale of oil products became very profitable, oil traders started to import oil in a rush, to met demand and make large profits under high oil prices. This led a large increase in the demand for dollars -- since oil products represent 40% of imports -- putting substantial pressure on the exchange rate. At the same time, exporters, who must sell to the NBU only 50% of their export-generated foreign exchange, stopped selling their remaining 50%, speculating that, by waiting, they will benefit from the devaluation.

In late August, the Government took a number of measures to alleviate the situation. In particular, it liberalized and facilitated imports of oil products. It has also told commercial banks that it will enforced forcefully its Hryvnia reserves requirements.

Increased oil supplies is helping in bringing oil prices down, to about UAH2.70/lt for premium gasoline (still about 70% above prices before this crisis). With the completion of the harvesting season, there should be a further reduction in the demand for oil. Similarly, demand for dollars has also been reduced. By mid-September, the Hryvnia was trading at about 4.5 UAH/US$. The Government expects that this rate can be maintained until the elections in October 1999.

The Government has also made clear that it will not enforce price controls, or other administrative or central planning measures, as these would be bound to fail. This again show a commitment to market-oriented measures.

Prices and Inflation.

From 1996 to mid-1998, Ukraine made considerable progress in reducing inflation, which was contained to 7%, on a year-to-year basis, during the first half 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 July 1999, inflation has been under control, with monthly rates of 1.5% in January, 1% in February, and 1% in March, 2.3% in April, 2.4% in May, 0.1% in June and minus 1% in July.

In July, inflation was negative, despite increases in oil prices, because the price of foodstuffs decreased by 3.2% (due to increased supply from private farms in the informal sector). Prices for services decreased by 0.3%. For the January-June period, inflation was 7.5%, or about 16% on an annual basis. Given the significant oil price increases in July and August, inflation is likely to increase in the rest of 1999: inflation for the year should be 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.

Balance of Payments Situation

In 1998, due to the financial crisis, merchandise exports and imports declined by about 18% from the levels achieved in 1997. In 1998, merchandise exports reached US$13.5 billion, whereas merchandise imports amounted to US$16.1 billion. The Trade Balance was minus US$2.6 billion. Due to a positive balance on non-factor services, the deficit in the current account was only US$600 million in 1998, compared to current account deficits of around US$1.2-1.3 billion in 1996 and 1997.

During January-June 1999, foreign trade has continued to decline (by about 25% from the levels in 1998), with a more rapid decline in imports (by 29%) that in exports (by 19%). During January-June 1999, merchandise exports amounted to US$5.3 billion, whereas merchandise imports was US$5.5 billion. The deficit in the trade balance was only US$165 million. The current account deficit in 1999 is expected to be below US$1 billion (the IMF/World Bank estimate a current account deficit of US$900 million, but others believe that it could be significantly less, even slightly positive).

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 well, partly offsetting the shortfall to Russia. 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 1997-99. 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.

Prospects for Near Future

The following table shows the possible outcome for 1999.

	1996	**1997**	**1998**	**1999-P**
Real GDP (% change YOY)	-10	-3.0	-1.7	-3.0
GDP (UAH bn)	81	93	104	132
GDP per Capita (US$)	860	980	810	670
Fiscal Balance (% of GDP)	-3.2	-5.6	-2.7	-1.0
Fiscal Revenues (% of GDP)	36.7	38.4	36.1	36.3
Fiscal Expenditures (% of GDP)	39.9	44.0	38.8	37.3
Consumer Prices (% change YOY)	40	10	20	25-30
Money Supply (% change YoY)	32	38	24	30
Exchange Rate (UAH/US$)	1.89	1.90	3.43	5.0
Merchandise Exports (US$bn)	15.5	15.4	13.5	13.0
Non-Factor Serv Exports (US$bn)	4.8	4.9	4.7	4.2
Merchandise Imports (US$bn)	19.8	19.6	16.1	15.5
Non-Factor Serv Imports (US$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$bn)	-1.2	-1.3	-0.6	+0.1
Net Foreign Direct Invest(US$bn)	0.5	0.6	0.7	0.6
Gross Internt Reserves (US$bn)	1.9	2.3	0.7	1.20
Domestic Pub Debt (US$bn equiv.)	1.3	4.6	4.0	3.2

The outcome for the year 2,000 will depend on three factors:

- The results of the Presidential elections in October 1999.
- The success of the new Government in accelerating implementation of economic reforms.
- The success in dealing with the Country's large debt service obligations in 2,000.

If the outcome in these three matters is favorable, GDP growth in the year 2,000 will become positive, the exchange rate will be stabilized, and inflation will be contained to around 20% pa.