SigmaBleyzer

Ukraine -- Economic Situation and Proposed Reforms

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November 1999

Introduction

1. When Ukraine declared its independence in August 1991, it became the second largest European country in landmass and the fourth largest in population, with 50 million people.
It has a well-educated and skilled labor force. Its agricultural soil is extensive and rich: Ukraine used to be the grain-basket of the former Soviet Union. It has good mineral resources (iron ore, coal) and reasonable infrastructure.

2. Despite these favorable conditions, Ukraine has had one of the most difficult economic challenges in Eastern Europe, with a long economic recession going on for 9 years. However, the decline in Gross Domestic Product (GDP) that started in 1991 decelerated gradually over the last few years. In fact, the rate of GDP decline was becoming less negative (-23% in 1994, -12% in 1995, -10% in 1996, -3.2% in 1997) and became positive during the first half of 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.

3. The year 1998 was expected to be the first year after independence with positive rates of growth. However, these positive developments were reversed in the second half of 1998, following the crisis in Russia. As a result of the crisis, there was a sharp drop in exports to Russia and to Asia, particularly in metallurgy, machine-building and chemicals. This decline in exports was somewhat mitigated by good performance in other industries, particularly food processing. But from mid-1998, domestic industrial production was also 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. As a result, GDP declined by 1.7% in 1998. The expectation is that GDP will decline by O.5% in 1999, with the year 2000 showing positive rates of growth.

4. The recession in Ukraine since 1991 has been long because the country was highly open and dependent on other Former Soviet Union Republics. The collapse of the FSU cut these production and trade relations. In addition, the country had a large percentage of military industries (25% of enterprises produced military goods), which found themselves without markets after the end of the cold war. Furthermore, due to negligible energy cost during the Soviet times, many industrial processes were very energy intensive (in the early 1990's, Ukraine consumed 6 times more oil per unit of

GDP than in Western Europe). Energy imports still represent 15% of GDP. These high-energy firms became uneconomic when energy cost increased 10 times after independence.

5. The cumulative decline in GDP since 1991 has been 60%, but about one-half of this decline was offset by expansion of the Informal Economy. This has helped to contain the decline in living standards in the country. For the future, the potential for growth in Ukraine is high, particularly in agricultural activities: the country has already demonstrated its capacity to produce twice as much agricultural output as it is producing now.

The Early Economic Reform Program

6. The structural weaknesses of Ukraine during the Soviet times meant that major corporate restructuring was needed after independence. Unfortunately, from 1991 to 1995, very little was done: the Government followed a "preservation" strategy. It tried to maintain the status-quo of industrial and agricultural enterprises through the payment of large direct subsidies to them.

7. Relying on Government subsidies for their existence, state-owned enterprises had little incentives to restructure themselves, and remained largely inefficient. These Government subsidies led to large fiscal deficits, monetary financing of these deficits, and hyper-inflation, which reached 10,155% p.a. in 1993, and 401% in 1994.

8. In 1995, Mr. Leonid Kuchma was elected President on the basis of a reform agenda. During 1996 -1998, under President Kuchma, significant progress was made in many areas of economic reforms:

- Prices and international trade were liberalized.
- The small & mass privatization programs were completed.
- 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 (which requires foreign exchange convertibility for current account payments).
- 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.

9. This reform agenda started to yield benefits. As noted above, the rate of decline of GDP was halted by the beginning of 1998.

10. However, despite this progress, during 1997-1998 the fiscal deficit remained high, at about 6% of GDP. This fiscal deficit was financed with short-term external borrowing. As a result, external debt increased from US$4.4 billion in 1994 to US$11.5 billion in

1998. T-bills increased from nil to Hr. 10 billion in the same period. The deficit was also financed through the accumulation of wage and budgetary arrears.

11. In addition, other structural reforms were slow in implementation. As a result, structural reforms did not reach the critical mass needed to revive investments and growth on a sustainable basis. For example:

- Competition was limited by high barriers to enterprise entry and exit. In particular, excessive Government regulations (such as licensing & registration requirements) were slow in being simplified.
- Privatization of large industries was stalled by Parliament.
- Custom procedures (such as stringent quality standards) 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.
- Public Administration reform was slow in implementation.

The Financial Crisis of 1998

12. Given Ukraine's large fiscal deficit, large short-term debt repayments, and slow implementation of structural reforms, the Country was vulnerable to negative external events. The Asia Crisis of 1997 started to put pressures on the foreign exchange market. And the Russian crisis of August 1998 triggered a financial crisis for Ukraine. As a result of this crises:

- Capital inflows dried up in mid-1998.
- International Reserves fell sharply.
- Large debt obligations due in 1998 could not be repaid.
- Interest rates increased sharply.
- The exchange rate came under pressure.

13. Despite the severity of the 1998 financial crisis, Ukraine faced it successfully, much better than Russia:

- It was able to negotiate voluntarily the restructuring of its debt.
- Monetary Policy was handled effectively.
- In September, October and November 1998, the fiscal accounts were in surplus. The deficit for 1998 was contained at 2.5 % of GDP (compared to 6% in 1997).
- Inflation for 1998 was 20%.

Economic Goals

14. At the end of 1998, Ukraine had overcome the risk of a financial collapse. The goals for the future are to retain the country's external and internal stability and to revive

economic growth. The country will need to contain inflationary pressures, minimize instability in the exchange rate, and complete foreign exchange convertibility. It needs to provide the basis for sustainable economic growth. For this, the country has two major tasks:

- The Government has to continue and accelerate implementation of economic reforms to build private sector confidence and revive growth.

- The Government has to deal successfully with relatively large foreign debt service payments of US$3.2 billion in year 2000.

15. Future reforms will depend on the outcome of the Presidential elections. The first round of the Presidential elections (on October 31,1999) showed that President Kuchma has a strong backing of the electorate. He obtained 37% of the votes (early polls had suggested about 30%). The second candidate, the Communist Party candidate, got only 22%. On November 14, there will be a second round of elections. Most political analysts are assuming that Mr. Kuchma has a good chance of winning the second round.

16. For most international observers, the key question is what kind of government the President will institute and the depth of economic reforms that the new government will implement. There is consensus in the international community in Kiev that the current pace of reforms is not sufficient to bring investments and yield growth. A major acceleration of economic reforms is needed for the country to revive growth and avoid international default. Attachment 1 provides the major areas of economic reform that have been under discussion with multilateral financial institutions, and which could provide the agenda for future reforms.

17. Regarding the second goal -- serving Ukraine's external debt -- as noted in Attachment 2, the total external debt of the country, at the beginning of 1999, amounted to about US$11.5 billion. This amount is not large, representing only 35% of GDP. Furthermore, it is owed principally to multilateral and bilateral donors. However, debt service obligations in year 2000 will be significant. As shown in Attachment 3, Debt Service in year 2000 will amount to US$3.2 billion. 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 debt service obligations to Russia and Turkmenistan are related to the supply of oil and gas to Ukraine. The Government has already made arrangements to service this energy-related bilateral debt, including payments through commodity and asset swaps, payment through construction services, and debt cancellation with Russia in connection with agreements on the Air Force and Black Sea Fleets.

18. In order to serve its other foreign obligations, the Government has recently acknowledged that a larger proportion of the state budget in the year 2,000 will be required to repay foreign debt. As a second source of financing, the Government will

seek to increase cash receipts from privatization of large state enterprises, particularly telecommunications and electric utilities. Thirdly, the Government believes that in the year 2,000, new foreign borrowing could be possible, both from multilateral institutions and private foreign banks. Fourthly, the Government expects to negotiate, on a voluntary basis, the restructuring of some of the foreign debt due in the year.

19. It is likely that a combination of the above financing options will be able to address debt repayments in the year 2,000, provided that the new Government improves the investment climate in the country, based on an acceleration of economic reforms. The incoming Government after October 1999 will need to demonstrate the continuation of its commitment to economic reforms and to improve Ukraine's business climate. As noted in Attachment 3, 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.

Economic Prospects for 1999 and 2,000

Attachment 4 provides some key economic statistics.

(a) The Real Economy.

20. There are strong signals that the economy is finally turning around. Industrial production grew by 18.1% in September 1999 and by 10.1% in October 1999, compared to September and October 1998 (when the economy was at a low point after the crisis). In total, during January-October 1999, industrial production rose by 3.1% compared with the same period last year. Industries oriented towards the domestic market performed well, as a result of the import substitution effect of the Hryvnia's real depreciation. Wood processing and food processing showed strong performances. The electricity industry also performed well, while the chemical and machine-building industries continued to decline. Services -- a sector hit hardest by the Russian crisis -- continued to stagnate with trade turnover and transportation volumes below their pre-fall 1998 peaks.

21. GDP grew by 4.6% in September 1999 compared to September 1998. But for the period January-September 1999, GDP declined by 1.7% compared to the same period last year. For 1999 as a whole, GDP is expected to decline, but by a much smaller amount than previously anticipated. It is now forecast that GDP will decline by only 0.5% in 1999 (compared to a decline of 1.7% in 1998). The year 2000 is expected to show a positive rate of growth.

(b) Prices and Inflation.

22. 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 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%.

23. During the months of January to October 1999, inflation was brought back into control. Inflation in October 1999 was 1.1%. The cumulative inflation, for the first ten months of the year, was 11.3% (or 14% on an annual basis). Based on these excellent results, most analysts have now revised downward their projections for inflation in 1999, with December-to-December inflation forecasts of about 15%-20%.

(c) Fiscal Budget Situation.

24. Weaknesses in Public Finance has been at the core of the economic difficulties experienced by Ukraine, despite the 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 accommodated mainly by the easy availability of external credits.

25. 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 significantly. 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.

26. The fiscal prospects for 1999 are even more favorable. The 1999 Fiscal Budget 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 would represent 1% of GDP, compared to deficits of 2.7% of GDP in 1998 and 6% of GDP in 1997. 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.

27. It is reassuring that, in spite of the Presidential elections in October 1999, the Government has succeeded in controlling its fiscal accounts. Up to the end of September 1999, Budget performance had remained largely in compliance with the targets set under the IMF Program.

28. As required under the Constitution, on September 15, 1999, the Government submitted to the Parliament a draft 2000 budget providing for a consolidated budget deficit of 1.3% of GDP, based on the IMF methodology. Under the Ukrainian methodology, which puts privatization proceeds above the line, the draft budget has a surplus of 0.4% of GDP. The draft budget lowers the tax burden compared to previous years.

(d) Monetary and Exchange Rate Situation

29. Tight monetary policies of the National Bank of Ukraine (NBU) can be credited with the significant progress made by Ukraine towards financial stabilization, despite fiscal budget issues. 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$1.1 billion. However, during the second half of 1998, foreign financing became unavailable to Ukraine. With international reserves declining rapidly, in September 1998, the NBU had to stop selling foreign exchange. The Hryvnia depreciated sharply from about 2.1 UAH/US$ in January 1998 to 3.5 UAH/US$ in September 1998. The NBU introduced administrative measures to reduce demand for foreign exchange.

30. During the first part 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 in late March 1999, the NBU started to remove the foreign exchange administrative controls imposed earlier. Foreign exchange was allowed to be 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. These foreign exchange liberalization measures have resulted in some depreciation of the currency. In addition, a crisis in August 1999, precipitated by fuel shortages, brought the exchange rate to a level of 4.5 UAH/US$ in the official market. It is also expected that, following the October 31 Presidential elections, there should be a further depreciation of the Hryvnia (since the National Bank had attempted to stabilize the market before the elections). In fact, on November 4th, the black market in Kiev was quoting an exchange

rate of 4.98 UHA/US$. Tight monetary policy, however, is likely to maintain the exchange rate from depreciating sharply, with a rate not exceeding 5.0-5.5 UAH/US$ expected by the end of this year.

31. The low Hryvnia liquidity of the last few months has allowed the National Bank of Ukraine to start purchases of foreign exchange in the inter-bank market. During the last few months, the NBU has bought US dollars in the open market, bringing its foreign exchange reserves to the level of US$ 1.3 billion by mid-October 1999.

(e) Balance of Payments Situation.

32. Due to the financial crisis, in 1998 merchandise exports and imports declined by about 18% from the levels achieved in 1997. 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.

33. During January-August 1999, foreign trade fell further by 23.8% to US$ 14.4 billion, compared to the same period last year. Exports fell by 16.7% to US$ 7.2 billion, whereas imports fell by 29.8% to US$ 7.1 billion. As a result, the foreign trade balance was positive at about US$ 100 million.

34. 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. These trends continued during 1999. 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.

35. 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.

(f) International Lending

36. Since September 1998 to September 1999, total loan disbursements from the International Monetary Fund and the World Bank, reached US$ 1.6 billion, or over 100% of current gross foreign exchange reserves. In early September 1999, the World Bank

disbursed US$ 100 million, within the framework of Financial Sector Adjustment Loan for budget deficit financing. At the same time, the IMF released another enhanced tranche (US$ 185 million) of its Extended Fund Facility.

37. However, in early October 1999, the IMF took the decision to postpone the release of the US$ 90 million tranche until after the Presidential elections, due to the decision by Ukraine to introduce certain export restrictions (including export taxes for sunflower seeds), and the lack of action on agreed upon price increases for utility and communal services.

38. During a recent mission to Ukraine, the IMF has said that it will revive its lending program to Ukraine only after it has agreed with the new Government on the Budget for the year 2000, the economic reforms to be undertaken by the new Government, and the implementation of price increases in utility and communal services. The Government and the IMF have stated that they will aim at achieving these conditions by the end of December 1999. However, a more likely scenario is that no IMF or World Bank disbursements would take place before the first quarter of year 2000.

39. In early September 1999, Ukraine announced its intention to seek consultations with the Paris Club of official bilateral creditors to discuss a possible debt rescheduling operation. While the share of such creditors in Ukraine's external debt is low accounting for less than 10% of debt service due in 2000-2001, an agreement with the Paris Club could facilitate Ukraine's debt discussions with private creditors of the London Club. It is unlikely, however, that such discussion would take place before the new Government has put in place a stronger economic reform program.

40. As noted earlier, in year 2000, the Government will need to serve significant amounts of foreign debt (about US$ 3.2 billion in principal and interest rates are due). Upon appointment, the new Government will need to take quick action to deal with these repayments and avoid international default. As mentioned earlier, the Government will need to accelerate privatization of state enterprises and deepen its economic reforms. These actions are needed, both, to bring resources and to increase international confidence. On this basis, the Government could attract the resources needed to serve its foreign debt, including from the international agencies and private foreign banks.

ATTACHMENT 1

Key Areas of Reform to Revive Growth.

1. Fiscal Reform

- Improve Government Revenues:
    - Improve Tax Structure
    - Increase the Tax Base
    - Improve Tax Administration
    - Eliminate Tax Exemptions
    - Improve Cost Recovery of Public Services

- Improve Management of Public Expenditures:
    - Improve Treasury Operations
    - Reform the Pension System
    - Reduce Current Expenditures of Government
    - Reduce Subsidies

2. Deregulation and Private Sector Development

- Issue transparent regulations for privatization
- Carry out case-by-case privatization based on majority private ownership
- Implement the Government's deregulation strategy and plan of action
- Enact a satisfactory bankruptcy law

3. Public Administration Reform

- Redefine the role of Government
- Reorganize the Cabinet of Ministers
- Consolidate Ministries and State Committees
- Carry out functional and operational reviews
- Reduce public employment

4. Financial Sector Reform

- Enact Law of the NBU that ensures autonomy
- Initiate restructuring of commercial banks
- Enforce new prudential regulations and loan loss provisioning
- Develop contingency plans to deal with possible troubled banks.

5. Agricultural Sector Reform

- Liberalize agricultural markets, eliminating Government interference with grain movements.
- Privatize agricultural silos
- ensure competitive procurement of Government grain purchases
- Remove export duties and other trade barriers
- Establish a single land registry.

6. Energy Sector Reform

- Implement the financial recovery plan for the sector, including tariff adjustments
- Eliminate constraints in the operations of the electricity markets.
- Carry out auction for gas for 20 billion m3
- Further privatize electricity companies.
- Continue with the restructuring of the coal sector.

ATTACHMENT 2

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 Creditors	1,650
Non-Resident T-Bills	117

TOTAL	US$11,500 million

ATTACHMENT 3

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 & Public Guarantees	311	302	271
EU/Japan	18	26	53
Gazprom	236	224	213
Eurobonds & Fiduciary Credits	379	1,323	667
TOTAL	1,995	3,237	2,364

ATTACHMENT 4

Key Economic Statistical Information

	1996	1997	1998	1999P
Real GDP (% change YOY)	-10	-3.0	-1.7	-0.5
GDP (UAH bn)	81	93	104	128
GDP per Capita (US$)	860	980	810	625
Fiscal Balance (% of GDP)	-3.2	-5.6	-2.7	-1.3
Fiscal Revenues (% of GDP)	36.7	38.4	36.1	36.3
Fiscal Expenditures (% of GDP)	39.9	44.0	38.8	37.6
Consumer Price Index (% change YOY)	40	10	20	15-20
Money Supply-M2 (% change YoY)	32	38	24	22
Exchange Rate (end of period, UAH/US$)	1.89	1.90	3.43	5.00
Merchandise Exports (US$bn)	15.5	15.4	13.5	12.9
Non-Factor Service Exports (US$bn)	4.8	4.9	4.7	3.7
Merchandise Imports (US$bn)	19.8	19.6	16.1	13.7
Non-Factor Service Imports (US$bn)	1.6	2.3	2.5	2.4
Trade Balance (US$bn)	-4.3	-4.2	-2.6	-0.8
Current Account Balance (US$bn)	-1.2	-1.3	-0.6	-0.9
Net Foreign Direct Investments (US$bn)	0.5	0.6	0.7	0.5
Gross International Reserves (US$bn)	1.9	2.3	0.7	1.2
External Public Debt (US$bn)	8.8	9.6	11.5	12.8
External Debt Service (US$bn)	1.2	1.2	1.8	2.0
Domestic Public Debt (US$bn equiv.)	1.3	4.6	3.7	2.2