UKRAINE - Economic Situation

Dr. E. Segura

June 1, 2000

The Ukrainian economy continued to show strong rates of growth during the first four months of 2000. During January-April, GDP and industrial output grew by 5.5% and 10.4% over the same period last year, respectively. Except for oil refining, positive rates of growth has been registered in virtually all major industries. The highest growth rates were registered in import-substituting (textiles and food) and export industries (metallurgy and chemicals).

This strong growth performance was due to the favorable effects of the real devaluation of the Hryvnia that took place since September 1998, by favorable world market prices for key Ukrainian exports, and by a strong recovery in trading partners, particularly Russia. These effects are likely to dissipate during the rest of the year, with a GDP growth for the entire year 2000 going down to about 2% pa. This would still be a significant achievement, and the first year since independence that Ukraine will have positive rates of growth. Over the medium term, in order to sustain economic growth, Ukraine will need to accelerate the pace of economic reforms to induce new investments.

During the first four months of 2000, fiscal policies have been tied. In fact, during January-April, the Government has been running small budget surpluses on a cash basis. At the end of April, the budget surplus stood at 0.1% of GDP. However, This fiscal surplus has now started to shrink and by the end of the year a deficit of 3.0% may be incurred, unless Parliament approves by July this year a package of 21 tax and budgetary laws submitted by the Government. The approval of this package of measures is a requirement of the IMF for the revival of the EFF Program.

In spite of tied fiscal policies, cumulative inflation for the first four months of year 2000 reached 12.1%. This high inflation rate was caused by a combination of cost-push and monetary factors. But by April, the monthly inflation rate had subsided to 1.7%. Although the Government still expects that inflation for the entire year will be limited to 19%, most analysts are now expecting that inflation for 2000 may reach 23%-25%.

In mid-April Ukraine completed a bond swap that reduce debt service due in 2000-2001 from about US$3.2 billion to US$2.2 billion. Of this amount, about US$930 million are due to the International Monetary Fund, and US$150 million to the World Bank. As part of the debt swap Ukraine issued US$2.6 billion in 7-year amortization bonds.

The Government is also planning to reschedule about US$500 million to US$800 million that Ukraine owes to the Paris Club creditors and Turkmenistan during 2000-2001. This Paris Club rescheduling, however, can only take place after the resumption of the IMF program. In anticipation, Paris Club creditors have agreed to a suspension of payments on their debts by Ukraine since January 2000.

The success of the bond swap was a necessary, but not sufficient condition to address the country's debt issues. It gave Ukraine some breathing space on its external financing issues. But current debt service obligations -- at US$2.2 billion for year 2000 -- are still large when compared to its international reserves of about US$930 million. The resumption of IMF lending is critical to serve large repayments due in the rest of the year.

Lack of IMF support will result in a major weakness of the Hryvnia, as international reserves would be used to serve debt. In fact, since the beginning of the year, the NBU had to purchase about US$250 million of foreign exchange in the open market to build up its reserves, which had declined to about US$930 million in May, after Ukraine paid US$260 million in accrued interest and commissions as part of the bond swap.

One major condition for the renewal of the IMF's EFF Program is a favorable outcome of the current independent investigation of the foreign exchange activities of the NBU during 1997-1998. The first stage of the audit of the reserve management practices during second half of 1997- early 1998 showed that NBU indeed overstated the size of its foreign exchange reserves, by as much as US$700 million at the end of 1997. This affected IMF decisions on disbursement of three Stand-by Arrangement tranches amounting to around US$200 million. During a recent visit to Washington by the Prime Minister, Ukrainian authorities have argued that the discrepancy is due to a difference in then prevailing accounting standards.

The visit by the Prime Minister to Washington helped in creating a more favorable attitude of the International Agencies towards Ukraine. An IMF mission will visit Ukraine in the second part of June to review the results of the expanded audit of reserves and fulfillment of other conditionalities. Following this mission, the IMF Board of Directors will decide on the reinitiation of disbursements under the EFF program. It is likely that some penalties, including a requirement to repay the three questionable stand-by tranches, and new safeguards, including keeping future EFF disbursements in a Fund account, may be imposed by the IMF to Ukraine.

If the reinitiation of the IMF program were to be delayed beyond mid-summer, this could lead to a significant reduction in NBU's usable reserves to below one week of imports and undermine macro stability, as the NBU may be forced to step up its purchases of foreign exchange, fuelling already rapid money supply growth.

The pro-Presidential majority in the Parliament has approved the Government's reform program for 2000-2004 and a series of reformist legislative acts submitted by the Government, including a privatization program designed to bring US$3 billion in privatization proceeds over 3 years. However, the President, concerned about the stability of the current Parliamentary majority, is seeking amendments to the Constitution that will give him the right to disband the Parliament if it fails to form a majority within one month or approve a budget within three months after the government submitted it. The amendments were overwhelmingly approved in an April 16 plebiscite.