Ukraine - Economic Situation

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Economic Growth.

During June 2000, the Ukrainian economy continued to growth, thought at a lower pace than in previous months. Real GDP grew by 3.4% in June 2000, compared to June 1999. During the first six months of the year, real GDP growth was 5.0%. This growth also represented a 2 percent real growth over the same period of 1998. The driving force for this GDP growth was the industrial sector, with industrial output increasing by 10.8% during the first six months of the year.

During the second half of 2000, GDP should continue to grow, but it is like to continue to desaccelerate as capacity utilization in key growth subsectors -- steel production and chemicals -- is reached in the absence of new investments. GDP growth for 2000 should be in the range of 2% to 3%. Future growth in year 2001 will depend on a revival of investments, which in turn will depend on an acceleration of economic reforms.

Fiscal Policies.

Thanks to a robust first-quarter fiscal budget surplus, during the first six months of the year, the fiscal budget was almost in balance (at 0.3% of GDP, compared to 1.5% of GDP -- IMF definition-- agreed at the beginning of the year.) However, in the second part of the year, the country may miss its fiscal balance targets due to shortfalls in the collection of fiscal revenues. To ensure that the fiscal budget will be under control, the Government has submitted to Parliament 21 laws that would expand the tax base and eliminate a number of exemptions, including laws on real estate taxes, income tax, and local taxes and duties. Although draft laws were submitted to Parliament early in the year, they have not yet been enacted. The approval of these fiscal measures is a condition for the renewal of lending by the IMF.

Monetary Policies.

During June 2000, Ukraine's consumer prices rose by 3.7%, compared with 2.1% in May. For the first six months of the year, inflation rose to a cumulative rate of 18.7%, almost hitting the Government's original inflation target of 19% for the entire year. Food prices and Paid Services led the increases in prices.

The high rate of inflation during the first half of the year was due principally to a high rate of monetary expansion (money supply increased by 22% during the period). This expansion was caused in part by the purchases by the NBU of US$710 million of foreign exchange in the open markets, in order to serve the country’s foreign debt. Other contributors to the high inflation rate were increased charges for housing, utility and communication services, and the introduction of market prices in the agricultural sector.

For the entire year, Ukraine's inflation rate is expected to be in the range of 25% to 30%. The lower rate is based on the assumption that the International Monetary Fund would restart the

US$2.6 billion EFF lending program. Ukrainian inflation was 19.2% in 1999, and 20.0% in 1998.

In spite of the above-mentioned increases in money supply and the relatively high inflation rate, during the first half of the year, the exchange rate for the Hryvnia has remained stable at around 5.4-5.5 Hryvnias/US$. This stability was due in part to the fact that, during the first half of the year, demand for foreign currency was significantly below predicted levels. This occurred because imported energy carriers did not pay for their imports of energy (the debt of the state company Naftogaz Ukrainy for imported natural gas grew by US$700 million during the first half of the year). If these payments were to be made in the second half of the year, the exchange rate would be under pressure. The stability of the Hryvnia may also be in jeopardy if the IMF/World Bank programs are not renewed before large debt service obligation are due in the last quarter of 2000. On the basis of this scenario, the exchange rate may reach 6.0 to 6.5 Hryvnya/US$ by the end of the year.

As of mid-July, the liquid gross international reserves of the NBU stood at US$890 million, down from US$950 million in mid-June 2000, and US$1.2 billion at the beginning of the year. The drop in reserves was due to payments by the Finance Ministry and the NBU on debts to the private sector and international financial organizations. Since the beginning of the year, Ukraine's external payments amounted to US$955 million, of which about US$450 million were for the IMF. In the second half-year, foreign debt service obligations are due to reach $750 million, excluding bilateral debt which is currently under suspension and is expected to be rescheduled following the renewal of the EFF Program.

International Trade.

In January-May 2000, the aggregate volume of foreign trade in goods grew by 24.7% compared to the same period last year, reaching US$11.1 billion. Exports reached US$5.3 billion (22.5% growth), while imports amounted to us$5.8 billion (26.7% growth). The trade balance showed a deficit of around US$500 million. This deficit was offset by a positive balance on “services”, which helped to maintain a positive current account balance. For the rest of year 2000, the ongoing recovery of exports to Russia and the strong growth in Asia and Europe should help in maintaining a positive balance in the country’s current accounts.

The IMF Program

Given the large foreign debt service obligations of the country in the second half of the year, financial stability will depend on the renewal of the IMF/World Bank lending operations.
An IMF mission visited Kiev from June 20-28, 2000 to review the possibility of reviving the EFF Program, which was suspended in September 1999. Although progress was made, the IMF mission did not recommend to its Board of Directors the revival of the EFF program, since there were still a number of conditions that needed to be carried out by the Government. The key conditions are (i) tax measures to balance the fiscal budget for year 2000; (ii) acceleration of privatization, including Ukrtelecom, to ensure fiscal receipts this year; (iii) further reform of the energy sector; (iv) lifting of current foreign trade restrictions, including the abolition of export duties on sunflower seeds, raw hides and metal scrap; (v) enactment of the Law of Banks and Banking Activities; and (v) phase out of free economic zones.

The Government believes that, except for the lifting of foreign trade restrictions, all other IMF conditions have been met. It believes that differences are only a matter of interpretation that could be explained successfully. To continue discussions with the IMF, a Government mission consisting of Deputy Prime Minister, Yuriy Yekhanurov, Finance Minister Ihor Mitiukov, and

Volodymyr Stelmakh, President of the NBU will visit Washington on July 28. However, given the recession in August of the IMF Board, it is unlikely that the EFF Program will be renewed before September 2000, even if the discussions are successful.

The IMF and the Government have stated that the renewal of the EFF program will not depend on the results of the ongoing audit of NBU activities by PricewaterhouseCoopers. The results of the second stage of the audit were released on July 11. It disclosed no transactions adversely affecting NBU gold reserve levels other than the transactions detailed in the first report. The third stage of the special examination, which is not expected to raise additional issues, will be completed in August 2000. After its recession in August, the IMF Board of Directors intends to decide whether Ukraine had violated the commitments it had given to the IMF when providing, as the first audit revealed, false data about the level of its gold reserves. Based on the conclusions to be made, the IMF leadership will decide what action it will take. Most likely, the IMF may require the Government to pay back the tranches (about US$200 million) it released based on the misrepresented information.

Following the renewal of the EFF program, the IMF may be able to disburse US$500 million by the end of the year. Furthermore, both the World Bank and the European Union may be able to renew disbursements under their current balance-of-payment loans. Revival of the EFF Program is also a condition for the restructuring of bilateral debt to the members of the Paris Club of creditors.