THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

Ukraine - Economic Situation

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November 1, 2000

Economic Growth.

During September 2000, the economy continued to show a growing trend, though at a slower pace than in previous months. GDP grew by 3.2% in September 2000, compared to September 1999. The rate of GDP growth in August 2000 had been 7.5% compared to the same month in 1999. From January to September 2000, the rate of growth of GDP reached 5.0%, compared to the same period in 1999.

A strong growth in industrial output continued to be the major factor supporting GDP growth. The rate of industrial growth during the period January-September was 11.6%, compared to the same period last year. Two main forces drove industrial growth. The first was a large increase in the output of consumer-oriented industries benefiting from reviving domestic demand. In fact, the highest rates of growth were achieved in the light industry (39%), the timber-processing and paper-making industries (36%), and the food industry (27%). The second driving force was expanding export sales in the basic industries, particularly metals (ferrous metallurgy). The fuel production industry was the only sector with negative growth. Agricultural production during January-September 2000 was also up by 1.3% from the same period last year. This was also the first time since independence that both Industry and Agriculture had increased from a previous year.

Based on these growth results, the Government is now forecasting GDP growth at 3.5% for 2000 (from an earlier forecast of 2%). For year 2001, the sustainability of GDP growth will depend on the resurgence of investments. There are indications that, indeed, investments may also be reviving. In fact, during the first half of 2000, fixed-capital investments were 21% above the levels achieved in past years. During the same period, direct foreign investments were 58% above 1999, amounting to US$420 million. The Government expects GDP to increase by 4% in 2001.

Fiscal Policies.

During the first eight months of 2000, Ukraine's consolidated fiscal budget was close to balance, thanks to tight fiscal discipline (the fiscal budget had a small deficit of UAH 200 million -- about 0.2% of GDP, using the IMF methodology). During this period, consolidated fiscal revenues amounted to UAH 27.1 billion, or about 10% below the target level of revenues for this period. But the Government was able to tap fiscal expenditures to the level of UAH 27.3 billion, by cutting expenditures by 10% from planned levels.

The level of fiscal collections is still an issue. In fact, during the last two months of August and September 2000, revenue collection worsened, with actual revenues at 82% of the month's target figure. But despite this issue, the Government is determined to maintain a balanced fiscal position. Accordingly, it has announced that if fiscal revenues are not increased, it will cut further budgetary expenditures during the rest of the year.

The draft fiscal budget for year 2001 is currently under discussions by Parliament. It is expected to be based on a new Tax Code, which is still under debate. The Government's draft proposes lowering the profit tax rate from its current 30% to 25-29%, halving the rate of taxation of dividends, lowering the rate of individual income tax from the current 10-40% to 10-20% , and lowering the value added tax from 20% to 15-17%. At the same time, the Government proposes to increase the tax base, suspending a number of tax exemptions, canceling the value-added tax breaks granted to several enterprises (agricultural, automobile and shipbuilding enterprises and enterprises operating with scrap metal), and raising the excise duty on gasoline. The Government is also proposing abolishing a number of special funds (including the Chornobyl Fund, the Innovation Fund, and the Fund for Development of Horticulture and Viniculture). These proposals are expected to enable the Government to preserve next year's tax revenues at the same level as this year's.

Another important issue with the draft budget for year 2001 is the adequacy of the projected level of revenues, particularly the projections for privatization revenues. These revenues are projected at a high level of UAH 9.0 billion (or 4.8% of GDP). There is also the concern of a possible sharp decline in budget revenues after the Tax Code, which significantly reduces tax rates, goes into effect. The Government has indicated that it will tackle these two issues in subsequent drafts of the budget. Privatization revenues will be reduced in parallel with reductions in expenditures. The Government has also indicated that it will reduce tax rates in accordance with the Tax Code, only if at the same time Parliament passes the draft laws to expand the tax base and eliminate tax exemptions.

Monetary Policies.

Inflation. In July, August and September 2000, inflation was brought under control, following accelerated inflation rates during the first half of the year. In fact, inflation rates in July, August and September 2000 were only -0.1%, 0%, and 2.6%, respectively. Given the high inflation rates during January-June, during the nine-month period form January to September 2000, inflation was 21.7%. For the entire year, Ukraine's inflation rate is expected to be in the range of 25% - 30%. A main factor behind the high inflation rate during January- June 2000 was a high monetary expansion of 30% during this period. This expansion in money supply was caused in part to finance the purchases by the NBU of US$1.2 billion of foreign exchange 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.

The Exchange Rate. During this year, the exchange rate for the Hryvnia has remained relatively stable at around 5.4-5.5 UAH/US$. However, during September, the Hryvnia was under pressure, reaching 5.7 in the cash market, due to increases in the import bill associated with higher oil prices, expansions in money supply to pay wage and pension arrears, and uncertainties regarding IMF financing. In order to defend the Hryvnia, the NBU is announced that it is prepared to spend 10% of its international reserves (about US$110 million). Since the beginning of September, about US$50 million have been spent for this purpose. On the other hand, at the end of September, the NBU purchased US$50 million of foreign exchange, without affecting the exchange rate. The exchange rate has remained more stable since then.

International Reserves. Since the beginning of the year, the level of international reserves has been relatively stable at about US$1.1 billion. This stability was achieved in spite of the fact that the country had to make significant repayments on its foreign debt from its own international reserves.

Government Debt.

International Debt. The Government has continued to serve promptly its international debt, which was reduced during 2000 from US$12.5 billion to US$10.5 billion. In the first half of the year, Ukraine's external payments amounted to US$955 million, of which about US$450 million were for the IMF. For the second half-year, foreign debt service obligation amount to $750 million, excluding bilateral debt, which is currently under suspension and is expected to be rescheduled following the renewal of the EFF Program. During the last quarter of 2000, the Government will have to make payments to the IMF of about US$210 million. As noted earlier, to serve its international debt, since the beginning of the year, the Government purchased about US$1.2 billion of foreign exchange in the open market. In the absence of international borrowings, the NBU may have to continue its purchase of foreign exchange in the open market, putting pressures on the inflation rate and on the Hryvnia exchange rate.

Domestic Debt. During the year, domestic debt increased from US$2.7 billion to US$4.8 billion US$ equivalent. About 90% of this debt is held by the NBU. In early October, the Ministry of Finance and the NBU have agreed on the restructuring of UAH 10.5 billion of Government debt maturing before 2004. This debt will be converted into bonds with maturities ranging up to 124 months. The first coupon payment would be due on January 25, 2001 at 18.9% rate, with later coupon rates to be adjusted for inflation (inflation rate plus 3%).

International Trade.

Ukraine’s international trade has continued to increase. During January to August 2000, the total volume of Ukraine's foreign trade in goods reached US$17.9 billion, an increase of 23% compared to the same period of 1999. Exports reached US$9.0 billion (an increase of 23.5%) while imports amounted to US$8.9 billion (a 23.2% increase). The country had a positive, though small trade surplus.

The biggest volumes of goods were exported to Russia (23% of the total), Turkey (6.3%), USA (6.0%), Germany (5.3%) and China (4.6%). The bulk of the imports came from Russia (43.5%, principally oil and gas), Germany (7.6%), Turkmenistan (5.5%), Belarus (4.7%), Italy (2.6%), and the USA (2.5%).

Multilateral Programs

Given the size of its foreign debt service obligations, future financial stability will depend on the renewal of the IMF lending operations, which was suspended in September 1999. Until September 2000, a major bottleneck was the investigation of the claim that the NBU provided false information and misused its international reserves. An international audit carried out by PricewaterhouseCoopers showed that there was not any evidence that Ukraine had misused the funds received from the IMF, but that, indeed, it had overstated the level of NBU currency reserves. This issue was closed in early September 2000, following an early refund by the NBU to the IMF of US$95 million.

An IMF mission visited Kiev from September 11 to 23 to discuss the possibility of reviving the EFF Program, which had been suspended in September 1999. The mission concluded that there had been a number of positive changes, including an improvement in the GDP rate of growth, lower barter transactions, improved collection in the energy sector, reduction of fiscal debts, raising of housing and communal tariffs, and the enactment of the privatization law. However, the IMF mission was unable to recommend the re-initiation of disbursements. The IMF was concerned with the Fiscal Budget for year 2001, lack of progress with privatization, inability to resolve the crisis of the Ukraina Bank.

A senior IMF mission will be visiting Kiev starting on November 2, 2000 to review progress made in the above issues. The Government is confident that it can address these issues to the satisfaction of the IMF. Accordingly, it expects that the IMF Board will make a favorable decision on the revival of the EFF Program around the end of November.

The World Bank has recently announced that it would be willing to resume loan disbursements, even before the EFF Program is revived. In particular, in early October 2000, Ukraine received the last US$70 million disbursement under the coal sector adjustment loan. Similarly, in early October, the European Bank agreed to lend US$100 million to the Government to finance fuel purchases.

Summary

Ukraine should be upbeat about its recent economic improvements, which include the revival of economic growth, the balance of its fiscal budget, the control of inflation, a stable foreign exchange rate, a 20% reduction in the size of external public debt, and growing revenues from exports. Furthermore, all this was achieved without any official external credits or aid. Future financial stability will depend on the country's ability to renew its international borrowings to permit servicing its foreign debt in a non-inflationary manner.