THE BLEYZER FOUNDATION

Turning Transitions Into Prosperity

Ukraine

Economic Situation

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Economic Growth

1. New figures released by the State Statistics Committee show that real GDP growth in year 2000 may have reached 6%, instead of the 5.4% previously reported. Even though there are some concerns about the accuracy of this estimate, it is clear that the year 2000 was the first year of positive economic growth in Ukraine since its independence.

2. In year 2000, industrial production increased by 12.9%. Production increased by 39% in the light industry, 37.1% in the wood processing and paper industry, 26.1% in the food industry, 20.7% for ferrous metals, 18.8% for non-ferrous metals, 16.8% in engineering and 5% in the chemical and petrochemicals industry. Output was down 4.1% in the fuel industry and 2.9% for electricity.

3. In year 2000, agricultural production also grew by a surprisingly high rate of 7.1%. Agricultural output had its first positive rate of growth thanks to individually-owned private farming in a few crops, particularly sunflower seeds, corn, and sugar beet, even though the traditional grain harvest actually declined to 24.4 million tons, the lowest level in Ukraine's history. According to a recent Government report, individually-owned private farms have now 15% of the country's agricultural land but account for as much as two-third of agricultural output.

4. During the month of January 2001, the economy continued to growth at an accelerated pace, with industrial output increasing by 19.5% compared to January 2000. The fastest growing sectors were the light industry, with a production growth of 40.5% year-to-year, the food industry — with a growth of 32.3%, the metallurgy sector – with 27.4% growth, machine building — with a 24.2% growth, and wood processing — 18.6% growth. Electricity production was the only industrial indicator to decline – by 0.2%.

5. For the rest of 2001, the rate of industrial and GDP growth should decline, since many sub-sectors are reaching full capacity utilization and export opportunities are becoming scarcer. Only a surge in fixed-capital investments would provide the basis for future economic growth. After several years in which fixed-capital investments were stagnant, in 2000 fixed-capital investments were 11% above the levels achieved in past years. Foreign direct investments also increased significantly, though from a low base, reaching US$750 million. These are positive signals that investments may be recovering, but may not be sufficient for sustainable growth. In order to maintain a growth momentum, the Government will need to accelerate the pace of economic reforms. For year 2001, the Government is forecasting a GDP growth rate of 4%.

Fiscal Policies.

6. Ukraine's fiscal situation continues to be stable. The consolidated Government fiscal budget in year 2000 was fully executed, for the first time since independence, at the level of UAH 42 billion (US$7.7 billion equivalent). The fiscal budget was in balance, partly because of strong fiscal revenues from a recovering economy and higher-than-projected inflation, which reduced real costs. The quality of budget resources also improved. In fact, after a ban on budget offsets introduced at the beginning of 2000, the share of cash revenues of the state budget increased to almost 100% from around 75% a year ago. On the other hand, privatization revenues did not materialized as expected.

7. On December 7, 2000, Parliament approved a fairly conservative 2001 fiscal budget, with revenues and expenditures set at UAH 52.0 billion (around US$8.5 billion, or 26% of GDP.) At the insistence of the IMF and a number of Members of Parliament, the level of privatization proceeds originally projected at UAH 9 billion (4.6% of GDP) was reduced in the final budget version to UAH 5.9 billion, still an ambitious target. The approved budget deficit accordingly was reduced to 3% (under the Ukrainian methodology, which puts privatization proceeds above the line, the approved budget has a zero deficit).

8. A major risk in the 2001 budget is the possibility of revenue shortfalls, given that the proposed Tax Code may lower tax rates (the income tax rate from 30% to 20% and the VAT from 20% to 15%). The Government has agreed with the International Monetary Fund to preserve stable tax revenues, with any cuts in tax rates matched by increases in the tax base and elimination of special privileges, so as to ensure revenue neutrality. Furthermore, in early February, the Government warned the heads of all ministries and departments about the possibility of cutting budget expenditures in 2001 by 10% on the average, to take into account the possibility that budget revenues this year, especially revenues from privatization, would not be sufficient. In fact, the privatization target in January was not achieved, although both the state and local budgets were fulfilled more than 100%.

Monetary Policies

9. The monthly inflation rates in December 2000 and January 2001, were 1.6% and 1.5% respectively. If these rates were to continue, the annual inflation rate in 2001 would be 20%, significantly above the Government's target inflation of 13.6% for 2001.

10. The high inflation rates in December and January were due principally to expansions in money supply associated to the continued interventions of the National Bank of Ukraine in the foreign exchange market to mop up excess foreign exchange supply. This excess foreign exchange supply came from a sharp improvement in the current account surplus -- to 5% of GDP -- during the last quarter of 2000 and the resumption of lending from multilateral agencies. Although the NBU interventions avoided a nominal appreciation of the Hryvnia, and contributed to the increase of foreign exchange reserves

to US$1.6 billion, they did increase money supply significantly. In fact, money supply increased by 8.8% in December 2000 alone. Money supply grew by 45% in year 2000. The target rate of growth in money supply for 2001 is 17-19%.

11. The recent IMF mission has required the NBU to conduct tighter monetary policy to restore monetary stability and control inflation. The NBU, in turn, has requested the Government to support these efforts by reducing the amount of money in circulation. In particular, it has proposed that the Government should purchase with cash the foreign exchange it requires to pay its external debts, instead of borrowing the money from the NBU. The request is now under consideration by the Government. If these measures are inadequate, in order to reduce Hryvnia excess liquidity, the NBU may raise its interest rates and reserve requirements for commercial banks.

Government Debt.

12. In year 2000, Ukraine’s external state debt declined by 17% (or US$ 2.1 billion,) to US$10.3 billion as of December 31. This foreign debt represents about 33% of GDP, a reasonable amount for a country like Ukraine. On the other hand, during the year, domestic internal debt rose by 38% (or UAH 5.7 billion,) to UAH 20.7 billion (US$3.7 billion equivalent).

13. Although the absolute size of Ukraine’s debt is reasonable, debt service in the next two years will be relatively high. In fact, Ukraine's annual debt-service is estimated at around US$1.8 billion in years 2001-02. This represents a high percentage (12%) of export revenues. The government expects to serve this debt from privatization revenues, multilateral lending, rescheduling of Paris Club debt, and current-account surpluses expected in both 2001 and 2002. If these sources were not to materialize, financial stability would be in jeopardy.

14. Following the resumption of lending by the IMF, in January 2001, the Government expects to submit a proposal to its bilateral creditors at the Paris Club for the restructuring of this debt. The Government is planning to restructure US$700 million of this debt due in 2000-2002. The Finance Ministry has hired Lazard Bank to advise it during negotiations on this debt restructuring. The initial discussions with the Paris Group are planned for March 2001, with expected agreement later in the year. However, the recent setback in the implementation of the IMF Program (see below) has put this plan in jeopardy. Normally the Paris Club would consider debt renegotiation only when an IMF Program is being implemented successfully. The Paris Club members will have to make their independent assessment as to whether debt renegotiation talks should now proceed.

International Trade and Capital.

15. In year 2000, Ukraine's foreign trade for goods and services totaled US$33.3 billion, an increase of 18.3% over 1999. The country's surplus in its foreign trade reached US$2.4 billion. During the year, Ukraine’s foreign trade turnaround with Russia increased 20%.

16. During 2000, exports of goods and services rose to US$17.9 billion, of which US$14.5 were goods (a 25% increase over 1999). The metallurgy sector accounted for 46% of overall exports, chemicals for 12%, machine building and metal processing for 12%, and agricultural products for 8%. During the same period, imports of goods rose to US$15.4 billion.

17. The Government forecasts a positive foreign trade balance of around US$2 billion in 2001. In fact, the growth of Ukrainian exports is expected to slow this year due to market limitations, especially in the metallurgy industry, and Ukraine's non-diversified export base. Furthermore, throughout 2000, the Hryvnia has appreciated substantially in real terms (by about 20%), which will gradually erode export growth and encourage imports, thus reducing the trade surplus.

Multilateral Programs

18. In December 2000, the International Monetary Fund agreed to re-initiate its lending to Ukraine after a 15-month suspension. Accordingly, in late December, it disbursed $248 million. It was also agreed that if economic performance were to progress according to the IMF Program, Ukraine will receive seven quarterly tranches of about $190 million each, after each successful IMF review mission, for a total of US$1.3 billion.

19. An IMF mission visited Ukraine in early February 2001 to review progress. The IMF noted that the Ukrainian economy is recovering with a positive GDP growth in 2000 and a positive balance in its current external accounts. The volume of barter trade was also greatly reduced at the state level. According to the IMF, these are the first steps to normalization of the economic situation. But the IMF mission felt that future recovery was in jeopardy due to the slow implementation in needed economic reforms. In particular, the IMF mission was concerned with the following:

- In December, the Government had agreed to further liberalize foreign trade and in particular to reduce the export duty on sunflower seeds from 23% to 10%. However, Parliament has not acted on this.
- In the energy sector, the Government should tighten the payment discipline of energy consumers. Cash payments had increased sizeably in 2000, rising from 10% to 50% but dropped drastically to 35% in January 2001. In addition, the Government should not proceed with the current proposal to allow direct settlement of payments between consumers and power generating companies, since this may decrease the level of cash payments for electricity.
- In the gas sector, the Government should speed up reforms.
- The Government should accelerate financial sector reforms and the restructuring the troubled banks (in particular, the Ukraina Bank and the Savings Bank.)
- The Government should enact adequate procedures to ensure transparency in privatization, in particular regarding the privatizations of Zaporizhia Aluminium, the oblenergos and Rivneazot.

- The Government should not proceed with current plans to reschedule and write off the tax debts of enterprises, since it would have fiscal budget implications.
- The Government should tighten monetary policy to control inflationary pressures, if necessary allowing exchange rate appreciation. The national currency should float freely.
- The Government should review fiscal loopholes related to Free Economic Zones.

20. On February 7, the IMF mission stated that before it releases its quarterly March tranche of US$187 million, the Government should take the above measures. Because of lack of progress so far, the IMF believes that it is unlikely that the March tranche would be released by the end of March. The Government, on the other hand, is more optimistic and has indicated that it will take the necessary measures within a month to comply with the IMF program and secure the tranche release.

21. The World Bank is continuing preparation of the $750 million Programmatic Adjustment Loan focusing on public administration and fiscal issues. Currently, this loan is scheduled to be submitted for Board consideration in May 2001, with a US$250 million tranche expected to be disbursed by June 2001. With the adoption of the Law on Banks and Banking Activity and efforts to address the situation at the troubled Ukraïna Bank, the authorities have also made some progress towards meeting the conditions of the other adjustment loan, Financial Sector Adjustment Loan. However, given the fact that some of the conditions are still outstanding – Law on Deposit Insurance has not yet been submitted to the Parliament and restructuring of the Savings Bank has been moving slowly – the World Bank is considering the restructuring of the last US$100 million tranche involving a cancellation of US$40 million and the disbursement of the balance, possibly during February 2001.

Political Situation

22. The economic outlook of Ukraine could be complicated by recent political uncertainties. President Kuchma has been accused by the Parliament's Socialist Party Leader, based on tape recording information provided by a former Presidential guard, of ordering subordinates to get rid of a local journalist. This journalist disappeared in September 2000 and his body was found in December 2000. No ironclad proof has emerged, but a large portion of Parliament has now turned against the President. The President has denied the charges and the Prosecutor General reported to Parliament that Ukrainian experts could not prove the authenticity of the tapes and therefore they could not be used in a criminal case as evidence. Nevertheless, some international organizations, including the Council of Europe, are going ahead with an independent expertise of the tapes. The extracts of the recordings made public to date, seem to be only a small portion of recordings made overall, some featuring prominent politicians. Further releases of the recordings are likely and a risk of political destabilization remains high. The outcome is uncertain and a political crises might bring not only political, but also economic instability to the country.