THE BLEYZER FOUNDATION

Turning Transitions Into Prosperity

Ukraine

Economic Situation

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Economic Growth

1. In February 2001, the real economy continued to perform very well, with industrial production growing by 12.6% compared to February 2000. This performance followed an impressive rate of industrial growth of 19.5% in January 2001, year-to-year. These figures give validity to the Government's forecast that year 2001 will be the second year since independence in which Ukraine will enjoy positive rates of economic growth.

2. Nevertheless, during the rest of 2001, the rate of economic growth is likely to decline, since some key sectors, such as steel and chemicals may face export difficulties. The expected reduction in the rate of growth of Russia, a major trading partner of Ukraine, from 7.6% in 2000 to 4% in 2001 will contribute to a desacceleration in the growth of the Ukrainian economy. Furthermore, Ukraine's overall business environment remains unfavorable, which will keep new investments under distress and growth rates at modest levels.

3. The Government forecast that industrial output for year 2001 would be 5.5% and that GDP will grow by 4%. These projections are plausible, given the rates of growth achieved in year 2000 (12.6% for industrial output and 6% for GDP). More impressive growth rates will depend on the rate of improvement in the business environment, particularly business liberalization, improvements in the legal framework and in public and corporate governance. The Government has expressed its intention to accelerate economic reforms in these areas, but it may find them hard to implement, given its poor implementation capacity and opposition by vested interests.

Fiscal Policies and Privatization Revenues.

4. In the first two months of 2001, Ukraine's fiscal situation continued to be sound. In fact, the good performance in industrial and GDP growth was complemented by adequate fiscal discipline. In January, revenue collections of the consolidated and state budgets were above the budget plan by 11.3% and 19.5%, respectively. In February, collections in the state budget were 10% above the plan.

5. Increases in tax revenues during January and February were accompanied by increases in privatization revenues, which reached UAH 614 million, or about UAH 124 million above the target figure of UAH 490 million for these two months. The largest amounts of funds were generated by the sale of 68% of the shares of the Zaporizhia Aluminum plant to the Russian AvtoVAZ Investment Company (UAH 380 million), the sale of a 25% of the equity of Tsentralnyi Iron Ore Plant to Detroit Cold Rolling (UAH 71.1 million), and part of the payment for the sale of 50% of the shares of the Ilich Metallurgical Plant.

6. For the future, the State Property Fund has already announced that the privatization target for March 2000 (UAH 600 million) will not be achieved, due to a one-month delay in the privatization of energy companies. It is also uncertain that the ambitious privatization target for the entire year 2001 (UAH 5.9 billion) would be achieved. The largest state enterprises intended for privatization this year are the Ukrtelecom telecommunications company and power supply companies, which may take longer to privatize.

7. In addition to potential shortfalls in privatization revenues, another major fiscal policy risk for the rest of the year 2001 is the possibility that the proposed Tax Code may lower tax rates without a corresponding increase in the tax base. The International Monetary Fund (IMF) has asked the Government to preserve a stable budget situation, with any cuts in tax rates matched by increases in the tax base and elimination of special privileges, so as to ensure revenue neutrality. The Government is also expected to maintain Government expenses under check, to ensure a balance budget situation.

Monetary Policies

8. Following relatively high monthly inflation rates of 1.6% and 1.5% in December 2000 and January 2001, respectively, the monthly inflation rate was brought down to 0.6% in February 2001. The Government has indicated its determination to achieve the targeted annual inflation of 13.6% for the entire year (equivalent to 1.1% per month). In order to reduce money supply -- and thus inflationary pressures, the National Bank of Ukraine and the Finance Ministry sold significant amount of Government obligations during the first two months of the year.

9. During 2001, it is expected that the monetary base will increase by 12% and money supply (M2) by 19%, consistent with an inflation rate of 13.6% for the year. By comparison, in 2000, Ukraine’s monetary base and money supply increased by 40% and 45% respectively, which generated an inflation rate of 25.8% for that year.

10. If the rate of inflation were to continue at about 1% in March, the National Bank of Ukraine might lower its interest rates in April, which had remained stable for over six months. The NBU had set its discount rate at 27% per annum and its Lombard rate at 30% per annum in August last year.

11. For over a year now, the inter-bank foreign exchange rate has remained relatively stable, standing at 5.43 UAH/US$ as of the beginning of March. For the entire year 2001, the Government expects that the average exchange rate of the Hryvnia will be 5.7 UAH/US$. Low inflation should maintain the exchange rate's stability. Although the recent issuance of Government obligations led to a tendency for currency appreciation, this tendency was neutralized by significant purchases of foreign exchange by the NBU. During the months of January and February, the NBU purchased US$300 million in foreign exchange, or about three times the amounts purchased during the same period last year. These purchases of foreign exchange also help in maintaining a steady level of

foreign exchange reserves. At the end February, liquid foreign exchange reserves of the NBU stood at US$1.7 billion.

International Debt and Lending Programs

12. Although the absolute size of Ukraine's foreign debt is not excessive (at US$10.3 billion or 33% of GDP), 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.

IMF Program

13. In 2001, Ukraine is due to pay to the IMF debt service obligations amounting to SDR 473 million (US$610 million). Following the resumption of lending by the IMF in December 2000, the Ukrainian government expected to receive the equivalent to US$190 million under the EFF Program at the end of March. This would have been used to service the IMF debt. However, IMF disbursements by the end of March are unlikely, given the negative outcome of the most recent IMF Mission to Ukraine. The IMF has indicated that the Government will need to comply with significant conditionality before it would disburse the March tranche. These conditions include:

- (i) The modification of the recent tax law that provides for tax amnesties and other privileges that would reduces the tax base.
- (ii) The enactment and announcement of adequate procedures to ensure transparency in the privatization of State enterprises.
- (iii) The acceleration of financial sector reforms and the restructuring the troubled banks (in particular, the Ukraina Bank and the Savings Bank.)
- (iv) The reduction of the sunflower export duty from the current level of 23%, leading to its eventual elimination.
- (v) Progress in the tightening of payment discipline in the energy sector by increasing cash collections. 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.

14. Although the March 31 tranche will not be disbursed on time, the IMF does not regard that the EFF Program is off-track since substantial discussions are ongoing. A Senior Government Official mission visited the IMF in Washington to discuss the above issues. Following this visit, an IMF Mission is now expected to visit Kiev in late March to review progress. The Government is aware of the need to maintain the IMF Program alive, given debt service obligations during the year, and has announced that it will be able to meet the IMF conditions by March 28. This may permit IMF disbursements in April 2001.

World Bank Programs

15. Following the enactment of the Banking Law, in February 2001, the World Bank made the final disbursement of US$60 million from a tranche of US$100 million under the Financial Sector Adjustment Loan (FSAL). The equivalent to US$40 million was cancelled since Ukraine did not meet other conditions, including the enactment of the Law on Deposit Insurance and the restructuring of the Savings Bank.

16. In May 2001, the World Bank expects to submit to its Board of Directors a Programmatic Adjustment Loan (PAL) for US$750 million. If successfully implemented, it would allow for US$250 million of Bank disbursements in June 2001. The World Bank is also considering three investment operations in year 2001, including a US$100 million loan to easy the social hardship caused by restructuring of the coal sector, US$24 million for a water utility projects in Lviv, and US$28 million for the modernization of the district heating system in Sevastopol.

European Bank Programs

17. In early March, the Government held discussions with EBRD management on a proposed loan of US$243 million to complete the construction of two nuclear power plants. The discussions were successful and Ukraine will be able to receive these funds once it has created an independent regulatory body for the nuclear sector and has successfully negotiated the restructuring of its bilateral debt with the Paris Club.

18. EBRD has also agreed to permit Ukraine to utilize the US$100 million balance-of-payment loan for fuel imports, which was not used during the current winter. This loan was extended until next year. In addition, Ukraine is expected to receive from EBRD a US$100 million loan to upgrade its power plants, and a US$65 million loan to construct a gas pipeline in the Odessa region.

Bilateral Debt

19. On March 6, 2001 Ukraine started negotiations with the Paris Club of bilateral creditors to reschedule US$1.0 billion of bilateral debt due in 2000-2002. Ukraine had suspended payments to the Paris Club in early 2000, in conjunction with the rescheduling of US$2.7 billion of foreign private debt. Ukraine submitted its official proposal for Paris Club restructuring in December 2000, following the resumption of IMF disbursements. Although there has been no announcement of the outcome of the negotiations, it is likely that negotiations will continue only after the IMF has made further disbursements under its EFF Program. A final agreement with the Paris Club is not expected until later in the year.