Ukraine - Economic Situation and Reforms

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Economic Growth

In May 2001, economic growth continued at an accelerated pace, with real GDP increasing by 10.9% and industrial output by 20.4%, compared to May 2000. These were among the highest rates of growth in the world. For the five-month period from January to May, real GDP grew by 9%, year-on-year, and industrial output by 18.8%, year-on-year. Industrial growth was broad-based with major increases in non-traditional sectors, such as food and machinery. In the same five-month period, agricultural production also grew at a high rate of 6.1%, compared to the same period last year.

Given this performance, the Government has increased its forecast for GDP growth in 2001 to 6.2%, compared to an earlier forecast of 4%. Industrial output should increase by about 9% in the year. The agricultural sector is expected to have a major revival, with grain output increasing from 24 million in 2000 to 30-35 million in 2001, depending on weather conditions. Sugar beet, the second most important crop, should grow from 13 million tons in 2000 to 18 million tons in 2001.

For 2002, given the depth of the past recession, the high level of unutilized capacity, and the resources of the country, economic growth should be able to continue at a good pace.

Beyond 2002, growth based on existing capacity should slow down. Therefore, the continuation of a high pace of growth beyond 2002 will require additional investments, particularly foreign investments, since domestic savings are low. Foreign investments, however, remain low.

A recent study carried out the International Private Capital Task Force (IPCTF) has outlined nine policy measures to attract more foreign investment into Ukraine. It contains specific measures to: (i) liberalize and deregulate business activities; (ii) provide a stable and predictable legal environment; (iii) enhance governance and reform public administration; (iv) remove international capital and foreign trade restrictions; (v) facilitate financing of businesses by the financial sector; (vi) deal with corruption; (vii) minimize political risks; (viii) expand government business promotion; and (ix) rationalize investment incentives.

The IPCTF is chaired by SigmaBleyzer and consists of representatives of private sector companies and international institutions operating in Ukraine. The IPCTF report was recently presented to the President and state authorities. Following the presentation, the President and the new Prime Minister have stated their strong commitment to increase foreign investments and have. Accordingly, the President has instructed the Government to prepare a “Long-Term Program to Accelerate Investments”, following the recommendations of the International Private Capital Task Force (IPCTF) Report.

Implementation of the IPCTF measures will provide the basis to put the economy on a sustainable path of growth.

Fiscal Policies

The Government has continued to implement sound fiscal policies. During January - May 2001, the consolidated budget showed a fiscal surplus of $110 million. For the rest of the year, tax revenues should be at target levels. Although some tax collections would decline due to recent tax amnesties and write-offs, other tax collections would increase due to the cancellation of the Kartoteka (the right of tax authorities to access taxpayers bank accounts unilaterally), which is bringing shadow enterprises to the official economy. In fact, the compliance rate has increased from 40% of potential revenues in 1998 to 60%.

Privatisation revenues are likely to be below the plan: they should reach $700 million, a shortfall of $400 million from the plan of $1.1 billion. To deal with this shortfall, the Government plans to cut fiscal expenditures during the rest of the year.

For 2002, the President has approved fiscal budget guidelines that call for a surplus of 1% of GDP (including privatization receipts of 2.5% of GDP). The President believes that the 2002 budget should be based on the draft Tax Code which is in Parliament. After enactment, the Tax Code would reduce taxes, while increasing the tax base to maintain revenues. Tax rates would be reduced as follows: the corporate profit tax from 30% to 20%, the valued-added tax from 20% to 17%, and personal income tax from 5 rates (with maximum 40%) to 2 rates, 20% and 10%. The number of taxes would be reduced from 39 taxes to 23. The new Tax Code would also facilitate tax “interpretations”, declarations, dispute resolution, and classification of chargeable expenses. There is the risk, however, that Parliament may approved a reduced variant of the Tax Code, which may reduce tax rates somewhat, but without a corresponding reduction in expenditures or increase in the tax base.

Monetary Policies

During this year, inflation has remained under control: from January to May 2001 inflation was 4.7% (or 12% on an annual basis), consistent with the planned inflation for 2001 of 13.6%. Monetary policies are about right: from Jan to May 2001 money supply increased by 9.6%, compared to planned expansion of 19% for all 2001 (in 2000 monetary expansion was 45%).

The local currency has remained at the level of 5.42 UAH/$ as demand for money increased with GDP growth. International reserves have increased from $1.6 billion at the beginning of the year to $1.8 billion currently.

Government Debt

Due to net repayments during Jan-May 2001, Ukraine's external debt was reduced by $200 million to a level of $10.1 billion. This debt level is not excessive, representing 30% of GDP. But external debt service in 2001 would be quite large, at about $1.8 billion ($800 million due to the IMF.) Of this amount $700 million were due and paid in Jan-May; the remaining $1.1 billion are due in June-December 2001. This debt service represents a significant load, compared to the level of international reserves and exports. The only foreign balance-of-payment loan received by Ukraine this year has been a $60 million tranche from the World Bank.

Monetary and Debt Policy Risks

Monetary expansion so far has been induced by the purchases by NBU of foreign exchange in the inter-bank market. From January to May, the NBU purchased $730 million of foreign exchange. These funds were utilised to serve foreign debt, which amounted to $700 million during this period. This monetary expansion has not resulted so far in inflation and depreciation due to increases in money demand associated with GDP growth and foreign exchange availability from exports.

During the rest of 2001, foreign debt service will be $1.1 billion. Part of this external debt service can be financed by additional purchases of foreign exchange by the NBU and by a reduction in international reserves. This strategy would be successful if GDP and exports continue to growth at a good pace. But to avoid inflationary pressures, a part of the foreign debt service during the rest of the year should be met from new lending from international institutions.

If the IMF Program were not to be renewed, the level of international reserves would fall from the current level of $1.8 billion to about $1.0 billion by the end of the year. Under this worse case scenario, inflation would increase to around 20%. These parameters would still be reasonable, but would cast doubts on the future ability of the country to maintain macroeconomic stability over the medium term.

International Trade and Capital

Ukraine has a favourable balance-of-payment, with a surplus of $816 million in its foreign trade and services balance during the first quarter of 2001. Trade figures for May are also positive. In this period, exports of goods and services increased by 5.8%, while imports of goods and services declined by 5.4%.

There were major reductions of barter in favor of cash payments: Exports via barter declined by 70% while imports via barter declined by 81%.

In spite of export difficulties to Russia (due to its economic slowdown and some trade disputes), and anti-dumping impositions elsewhere, Ukraine has developed new markets to maintain export growth: CIS now represents 30% of exports, compared to 57% in 1996.   A positive current account balance for 2001 is expected.

The IMF and World Bank Program

The IMF visited Ukraine from June 11 to 22, 2001 to review progress in meeting loan conditionality under the EFF Program. This conditionality was as follows:

1. Adjust fiscal policies by reducing Government expenditures, and by passing a Tax Code that would reduce tax rates only if there are increases in the tax base.
2. Acceleration of privatisation under transparent procedures.
3. Increased cash collections in the power and gas sectors,
4. Reduction in the number of free-trade zones,
5. Reduction of the sunflower export tax to10%.
6. Closure of the Ukraina Bank.

The mission noted progress on privatisation, trade policies and energy cash collections. Furthermore, on July,1, the NBU withdrew the banking license of the Ukraina Bank, thus meeting this IMF condition. But the issue on fiscal policies remained (i.e., the possibility that the Tax Code may not expand the tax base.

To discuss the Tax Code, an IMF mission is now planned for August 2001. The expectation is that this mission will be able to reach agreement on this issue. Between $570 million to $760 million could be disbursed by the end of 2001.

The World Bank has also completed a mission to Ukraine to negotiate the disbursements of $250 million under its proposed $750 million Programmatic Adjustment Loan. This World Bank loan would also proceed in August after the IMF's renewal of its program.

The Government has expressed its commitment to renew its lending from the International Agencies and is confident that it will be able to renew lending in September 2001.

Conclusion

The extraordinary economic performance of Ukraine in the 18 months has given the country a unique opportunity to break through its past economic difficulties and sustain growth. The new Prime Minister, with the support of the President, is fully aware of the need to take advantage of this window of opportunity and accelerate the implementation of reforms. With the likely renewal of international financing from the IMF/World Bank, the country will be able to ensure economic stability over the medium term.