

## **Ukraine - Economic Situation**

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### **Economic Growth.**

Despite expectations that Ukraine's GDP growth would lessen its pace during the second half of the year, in August GDP showed an unexpectedly high growth rate of 7.5% compared to August 1999. From January to August 2000, the rate of growth of GDP reached 5.3% compared to the same period in 1999.

The strong growth in industry has continued to be the major factor contributing to GDP growth. Industrial output rose by 13.7% in August, in comparison with August last year. The rate of industrial growth during the period January-August was 12%, compared to the same period last year. Industrial growth was driven by two forces: first, expanding export sales by the basic industries, particularly metals; and second, increases in the output of consumer-oriented industries benefiting from reviving domestic demand associated with the payment by the government of wage and pension arrears.

During January-August 2000, the highest rates of industrial growth were achieved in the light industry (46%), the timber-processing and paper-making industries (36%); the food industry (30%); and the ferrous metallurgy industry (20%). Output fell in the electric power and fuel industries. During August, the agricultural sector recovered somewhat, with agricultural production during January-August 2000 matching the level of output reached during the same period last year.

Given these positive growth results, the Ministry of Economy revised upward its GDP growth forecast for the year 2000 to 3.5% from the previous 2%. Future growth in 2001 will depend on the resurgence of investments, since key sectors are reaching their full capacity utilization. There are some signs that fixed-capital investments are indeed reviving. After several years in which fixed-capital investments were stagnant, during the first half of 2000 fixed-capital investments were 21% above the levels achieved in past years during the same period. To maintain this 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.**

Tight fiscal discipline assured that, during the first eight months of the year, Ukraine's consolidated fiscal budget was close to balance, with a small deficit of UAH 200 million (about 0.2% of GDP, using the IMF methodology that excludes privatization revenues). During January-August 2000, consolidated fiscal revenues amounted to UAH 27.1 billion, or about 10% below the target level of revenues for this period. Expenditures were kept at UAH 27.3 billion, thanks to cuts in expenditures, particularly by the non-payment of domestic government debt due to the NBU, which now holds 90% of the domestic government debt.

During August 2000, revenue collection worsened, with actual revenue at 85% of the month's target figure. The Government has announced that, if fiscal revenues are not increased, and if external credits are not revived, it will cut Government budgetary expenditures during the rest of the year. The measures basically envisage a proportionate 5% reduction of expenditures across all ministries and departments, with the exception of protected social areas.

Parliament has not yet enacted a number of fiscal budget laws submitted by Government, including the proposed Tax Code. The Tax Code would expand the tax base and eliminate a number of tax exemptions, including laws on real estate taxes, income tax, and local taxes and duties.

A realistic budget for 2001 has become one of the main issues in the most recent discussions with the IMF. In particular, IMF experts are concerned that the projections for privatization revenues for 2001 are unrealistically high at UAH 9.0 billion (compared to only UAH 1.3 billion obtained in January-September 2000). The IMF is also concerned about the possibility of a sharp decline in budget revenues after the Tax Code, which significantly reduces tax rates (including the VAT and the profit tax), goes into effect. The Government has indicated that it will agree to significantly reduce tax rates in line with the Tax Code only if Parliament passes the package of draft laws expanding the tax base simultaneously with the Tax Code.

### **Monetary Policies.**

In August 2000, inflationary pressures continued to be controlled, following accelerated inflation rates during the first half of the year. In fact, in August 2000, the inflation rate was 0%, following a July drop in the consumer price index of 0.1%. Over January-August 2000, inflation reached 18.6%. For the entire year, Ukraine's inflation rate is expected to be in the range of 25% to 30%.

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 almost 30% from January to August). This expansion in money supply was caused in part to finance the purchases by the NBU of US\$1.2 billion 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.

During the first half of the year, the exchange rate for the Hryvnia remained stable at around 5.4-5.5 UAH/US\$. However, during September 2000, the Hryvnia has been under pressure 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. Although the official rate has remained at about 5.45 UAH/US\$, in the retail cash market the exchange rate reached 5.7 UAH/US\$ during the second half of September. In order to defend the Hryvnia, the NBU has indicated that it is prepared to spend as much as 10% of its international reserves (about US\$110 million) to prevent further depreciation of the currency. Since the beginning of September, about US\$35 million have been spent to defend the Hryvnia.

Given increases in imports associated with higher oil prices, and the large debt service obligations of the Government during the last quarter of 2000, the Hryvnia may depreciate sharply during the rest of the year, unless international borrowings, particularly from IMF -- is re-established.

Since the beginning of the year, the NBU has also managed to maintain relative stability in the level of international reserves. As of September 25, the liquid gross international reserves of the

NBU stood at 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 resources, including its international reserves.

### **Government Debt**

The Government has continued to serve promptly its international debt. 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 months of October, November and December, the Government will have to make payments to the IMF of about US\$210 million.

To serve its international debt, during the course 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 to the Hryvnia.

During this year, domestic debt increased from UAH 15 billion to UAH 26 billion at the end of September (or from US\$ 2.7 billion to US\$ 4.8 billion, equivalent). About 90% of this debt is held by the NBU. At the beginning of 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 from 16 to 124 months, and with monthly coupon payments. 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 plus 3%).

### **International Trade.**

During January to July 2000, the total volume of Ukraine's foreign trade in goods reached US\$15.6 billion, an increase of 23.5% compared to the same period of 1999. Exports reached US\$7.7 billion (an increase of 21.6%) while imports amounted to US\$7.9 billion (a 25.4% increase). The trade deficit was only US\$161.7 million.

The biggest volumes of goods were exported to the Russian Federation (22.8% of the total), Turkey (6.2%), USA (6%), Germany (5.4%) and China (4.8%). The bulk of the imports came from the Russian Federation (45.1%, principally oil and gas), Germany (7.3%), Turkmenistan (5.4%), Belarus (4.4%), Italy (2.6%), and the USA (2.5%).

### **The IMF Program**

Given the size of its foreign debt service obligations in the second half of the year, financial stability will depend in part on the renewal of the IMF lending operations. A major bottleneck had been the investigation of the claim that the NBU had provided false information on its international reserves to the IMF and that this misleading information led to IMF disbursements that would have not been made otherwise. The audits showed that Ukraine had not misused the funds received from international financial organizations, but had indeed overstated the level of NBU currency reserves. This issue was closed in early September, 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 improvement in the rate of growth of the economy, lower barter transactions, lower tax exemptions, 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 mission left without clarifying the prospects for reinitiating disbursements. It was concerned with deficiencies in the Budget for year 2001, lack of progress in abrogating custom tariffs on exports of some agricultural goods, slow structural reforms in the banking and energy sectors, and inability to resolve the crisis of the Ukraina Bank. It is expected that the IMF Board will make final decision on the revival of the EFF Program in November. At the end of the year, the current EFF Program would terminate. Additional funds from the IMF after that closing date would require the negotiation of a new EFF Program.

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