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UKRAINE - Status of Economic Situation and Reforms

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The economic situation in Ukraine remains stable but fragile. During January and February, due to lack of external financing, the Government used NBU's International Reserves to serve foreign debt obligations. These foreign obligations included US$155 million due on February 5 on a eurobond issue and 160 million deutsche-marks (US$97 million) interest payment due on February 26 on a DM 1 billion eurobond issue. An additional 74 million euros (US$92 million) of interest payments are due on March 17 on an Euro 500 million eurobond. Altogether, it is expected that Ukraine should be able to serve this additional payment from its international reserves.

However, the level of international reserves at the NBU is already low. The NBU has reported that, as of December 31, 1998, the level of international reserves was US$685 million, excluding gold and other non-liquid items, but including gold held at foreign banks (including these assets, the NBU reported that international reserves were US$1,049 million, as previously reported). Nevertheless, payments in January and February should have reduced this level further. Although the NBU has not reported more recent numbers, the level of reserves may have gone down to US$500 million by mid-February. Given current uncertainties, in the un-official market, currency dealers are buying dollars at a rate of 4 Hr/US$, compared to rates of 3.8 Hr/US$ in January.

Given the low level of international reserves, the country will require IMF/World Bank financing to cover other debt service obligations due in 1999, which include US$182 million in principal and interests on a bond maturing in June, US$700 million due to the IMF, US$185 million due to the World Bank. As noted in earlier reports, including debt service to multilateral institutions, bilateral agencies, Russia, Turkmenistan, and others, total debt service in 1999 would amount to US$2.4 billion. The debt service of the Ministry of Finance alone is US$1.2 billion.

A tight fiscal situation has also forced the Government to convert domestic debt held by domestic commercial banks due in February. About Hr 173 million of T-bills due on February 5, were re-scheduled for payment in the second half of 1999. Although eight banks had agreed to the conversion, other banks are currently challenging this decision, calling it a *de facto* default by the Government. Nevertheless, the NBU has indicated that if the T-bill conversion were to be reversed, the financing will need to be provided by the NBU. To avoid excess liquidity, the NBU would need to increase reserve requirements from 15% to 18%. For many banks, this may be a less favorable situation. Negotiations on the conversion of domestic T-bill are ongoing.

Around March 10, the Board of Director of the IMF is expected to consider the possibility of re-establishing disbursements under the Extended Fund Facility (EFF) for Ukraine. The IMF had disbursed US$230 million under the EFF in 1998, before suspending further disbursements in November 1998 due to lack of progress on fiscal and structural reforms.

During negotiations in January and early February, the IMF had set a number of actions that the Government had to take before the March 10 meeting of its Board. As noted in the previous economic report, the key IMF conditions include:

- Although the fiscal deficit of 1% of GDP will remain as a target, the IMF is seeking more realistic projected revenues and expenditures. A reduction in the absolute level of both, revenues and expenditures for 1999 is sought.

- Further progress in strengthening the operations of the Treasury is required, particularly regarding the extension of Treasury's control on extra-budgetary funds.

- Further tightening of monetary policies, including foreign exchange policy – particularly the establishment of an exchange rate corridor with a wide band and removal of constraints in the foreign exchange market.

- Further acceleration in the pace of structural reforms in the agricultural sector. In order to reduce the level of control and interference by the Government in the grain markets, agricultural credit should be reformed and privatization of agricultural silos accelerated.

- Further structural reforms in the gas sector, particularly by implementation of the agreed upon auction of natural gas.

- Reversal of the current law that prohibits increases in utility tariffs for community services, to improve cost recovery for these services.

- Further acceleration of the pace of reforms on Public Administration.

- Passage of the agreed upon draft of the Law of the National Bank, which would grant autonomy to this institution.

At a February 17 Press Conference, the Government stated that by February 19, it will fulfill all the conditions stipulated by the IMF. In fact, good progress has been made in most areas, but not in all of them. In particular, the Ministry of Finance has recently reported that it has not been able to obtain a decision of the Constitutional Court to reverse a Parliament decree that block increases in utility prices. Second, in addition to the recent setting of the foreign exchange rate corridor at Hr 3.4-4.6/US$, further action is needed to remove some of the constraints in the foreign exchange regime (which the NBU promised to do by the end of March). Third, the Law of the NBU has not been enacted yet. Since it is likely that some of the IMF conditions will not be met by March 10, the IMF will need to make a judgement as to whether the reforms taken so far are sufficient to justify the continuation of the EFF. Most likely, the IMF would make a favorable decision, since it should be concerned with the serious deterioration in the economy that could occur if the EFF is not renewed. Although it is likely to opt for a favorable decision, the IMF may institute further future conditions and more stringent monitoring of developments in the reform agenda in Ukraine.

If approved, on March 10, the IMF would disburse two tranches of its US$2.2 billion Extended Fund Facility for Ukraine, or US$158 million. The World Bank should be able to disburse about US$150 million by the end of March. In addition, by the end of March, the EBRD may also be able to disburse US$56 million under the first tranche of a balance of payment loan. If all these disbursements were to take place, the NBU expects that by April 1, the level of international reserves would suffer only a minor decline of US$90 million from the December 31, 1998 level.

On the above basis – and a fiscal deficit of no more than 1% of GDP -- the NBU expects that money supply during 1999 would increase by only 10%. It believes that inflation could be controlled to 19% in 1999. It also forecast that, by the end of 1999, the exchange rate could be maintained within the ceiling of the band at 4.6 Hr/US$. Although this is a possible scenario, a most likely result for 1999 – assuming continuation of the EFF reform program -- would be a higher growth in money supply, (around 15-20%), higher inflation (25-35%), an exchange rate of 4.6-5.5 Hr/US$ by the end of the year, and a decline in GDP of 1-2%. With a significant drop in imports, for the first time since independence, in 1999, Ukraine could show a positive current account balance in 1999.