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UKRAINE: READY FOR A BREAKTHROUGH[1]

by
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SUMMARY

Unexpectedly, Ukraine is now poised for its first serious attempt at economic reform. The government has signed an agreement with the International Monetary Fund (IMF) to receive a $360 mn loan under the Systemic Transformation Facility (STF), and will now negotiate for a larger stand-by loan.

President Leonid Kuchma has announced a far-reaching economic reform program, to include essential measures of stabilization, liberalization and privatization. The government is finalizing a package similar to Poland's, which was implemented at the start of 1990.

The decision to launch serious reform comes against a background of deep economic crisis. The budget deficit is huge, and the country cannot pay for vital energy imports. Inflation has been brought down dramatically in 1994, but is now accelerating. Unless strong reform measures are effected at once, high inflation is likely to reemerge.

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POLITICS

The new president is clearly determined to press ahead with radical economic reform and has sufficient authority to implement a coherent reform package. The response of the recently elected parliament is not yet clear.

Presidential Election

The Ukrainian political scene changed altogether when, in a surprise result, Leonid Kuchma was elected President on July 10. The first-round election on June 26 had reduced the field to two candidates, Kuchma and incumbent president Leonid Kravchuk. In the second, run-off round Kuchma won a narrow majority, just over 52 percent of the vote, with much stronger support in eastern Ukraine than in western areas. Voter turnout was quite high at 71.7 percent.

A key election issue was the state of the economy, which almost all candidates acknowledged as parlous. However, the campaign featured little serious debate of economic policy alternatives.

Kuchma, previously prime minister in 1992-93, took power easily, at once initiating positive steps such as an invitation to IMF Managing Director Michel Camdessus. Both President Kuchma's first two important foreign visitors, Camdessus and U.S. Vice President Albert Gore, emphasized the need for Ukraine to press ahead with serious reforms and the availability of supportive western financial assistance.

An IMF mission arrived in mid-August and, with Kuchma's full support, began negotiations on the form and conditionality of that assistance. These talks led directly to the

signing of the STF agreement in late September, which will take effect upon the approval of the IMF's board at the end of October.

President and Government Work Together

By late summer, Minister of Economics Roman Shpek had established himself as the key government minister with regard to economic reform. Shpek was in charge of the recent IMF negotiations and has a reputation as an effective administrator.

Also clearly on the side of economic reform is the National Bank chairman, Viktor Yushchenko, who fought hard against inflation this year. Other key reformers are three new appointees: Deputy Prime Minister Igor Mitiukov, Chairman of the State Property Fund Yuri Ekhanurov, and Minister of External Economic Relations Sergei Osyka. A reform team has emerged and is gradually being reinforced.

Less enthusiastic about reform is Prime Minister Vitali Masol, the former head of Gosplan in Ukraine. Although he signed the letter of intent with the IMF, Masol was quoted as saying that the reform package would not exactly mirror IMF requests.

However, economic policy-making remains firmly controlled by the new president. Kuchma has his own staff, headed by Dmytro Tabachnyk, but works closely with the government. There are no signs of the conflicts between presidential and governmental apparatus which marked Russian politics in the past year.

Parliament: An Uncertain Quantity

Parliamentary elections were held on March 27, 1994. Due to low turnouts in some districts, some seats were not filled. A number of by-elections have been held, and more are to come.

By early autumn, there were 393 deputies (out of 450 total seats in the single-house parliament), of which 219 were officially independent of any party. Still, the deputies have formed eleven factions, of which three, the communists, socialists and agrarians (all former communists) vote as a block with 171 deputies.

Socialist Party leader Oleksandr Moroz is particularly important as chairman of the parliament. Moroz is on the record as a strong opponent to privatizing land; even so, Moroz's position on reform appears flexible. During his U.S. trip in early October, for instance, Moroz made statements both for and against economic reform.

Crimea

The political situation in Crimea remains unresolved. However, the conflict over whether Crimea, which is ethnically predominantly Russian, should belong to Russia or Ukraine, has been transformed into an internal Crimean struggle between its President Yuri Meshkov and its parliament. The conflict seems to owe primarily to personalities and personal power, and as Crimea is generally lagging behind in reforms and economic development, the Crimean problem appears de-dramatized.

Kuchma Declares Radical Economic Reform

On October 11, President Kuchma made an hour-long programmatic speech entitled "On the Road of Radical Economic Reform," which stunned Parliament. Few expected such a radical reform speech. First, Kuchma analyzed Ukraine's extraordinary economic failures -including those during his own term as Prime Minister. Ukrainians had learned that slow economic reforms do not work, he declared, and their failure had put Ukraine's survival as a nation into question. Accelerated reforms, then, were required to secure Ukraine's sovereignty.

Kuchma went on to describe a radical reform package. Prices, domestic trade, and foreign trade should be liberalized. Sustainable stabilization should not rely only on monetary policy but increasingly on fiscal restraint. Next year, the Ukrainian national currency hryvnia should be introduced and its exchange rate pegged. Most state property should be privatized, and a mass privatization launched soon. Private ownership of land should be recognized and private farming should dominate agriculture. Ukraine should open up to the outside world.

Parliament was too amazed to offer any organized resistance. A week later, it voted overwhelmingly in support of Kuchma's reform speech. The President stated his intention to work with Parliament, but made clear that it should stick to legislative duties, leaving executive tasks to him.

The reform program is supposed to start with two steps, the first connected with implementation of the STF agreement with the IMF. The exchange rate will be unified, which will eliminate import subsidies, and substantial price rises and price liberalization will

take effect before November. As an effect, the budget deficit will be reduced to 10 percent of GDP for the whole of 1994. Moreover, Ukraine will hopefully get almost $1 bn in international financing for the last quarter of 1994.

The second step will combine with a stand-by agreement with the IMF. Negotiations to start in November are intended to conclude the agreement before the end of 1994, so that Ukraine can undertake the remaining liberalization in early 1995. The budget deficit should then be reduced to some 5 percent of GDP for 1995. The exchange rate should be pegged and the hryvnia introduced, to symbolize the stabilization of Ukraine's own national currency without the need for confiscatory measures. Still, Ukraine, suffering a severe structural deficit, will need at least $5.5 bn in international financing in 1995, apart from debt rescheduling.

The combination of Ukraine's previous dismal performance and the last two months of exemplary reformism has transformed it from a disregarded basket case into the darling of the IMF, World Bank, and U.S. Ukraine's relations with Russia have also improved dramatically. Except for Germany and Holland, however, Europe is remarkably disinterested. Suddenly Ukraine seems to have a chance at success, but as President Kuchma stresses, it may be Ukraine's last chance.

LIBERALIZATION

Post-communist Ukraine inherited an over-industrialized economy with a great deal of military production and few small enterprises. However, the seriousness of Ukraine's

problems can be attributed largely to the failure to introduce real economic reform since independence in 1991.

State Controls

Under President Kravchuk and three prime ministers, the government tried gradual and partial reform policies. The state tried to retain control of most aspects of economic activity, while its effective ability to organize production and distribution collapsed. Ukraine's GDP in dollars, measured at the market exchange rate, has fallen to around $33 bn or about $600 per capita.

Direct retail price controls continue on only a few goods, such as bread and energy, but there is much bureaucratic intervention in the economy. While there are no generalized shortages, the selection of goods in state stores remains poor and regional price regulation prevents the development of a fully national market. In particular, there are effective limits on price mark-ups and profits at intermediate stages of production.

The old system of subsidies to state enterprises was curtailed at the start of 1994. No official announcement was made, but the central bank stopped giving very cheap credits. However, the lack of full liberalization and the system of dual exchange rates pursued under the Zviahilsky government (autumn 1993 to summer 94), gave enterprises little incentive to restructure or export. As a result, industrial output is lower, but there is not much evidence yet of real change at the enterprise level.

STABILIZATION

Inflation was brought down sharply in the first half of 1994 through tight monetary policy. However, the government maintained a large budget deficit and inflation is now rising.

Hyperinflation Halted

At the end of 1993 Ukraine was undeniably in a hyperinflation. Consumer prices increased by 80 percent in September, 66 percent in October, 45 percent in November and 91 percent in December 1993. This situation led Ukraine's national bank (or NBU) president to single-mindedly tighten monetary policy.

Hyperinflation was ended at least temporarily, and inflation fell from 19 percent in January and 13 percent in February to 2.1 percent in July. The NBU kept inflation low by halting new credit issue to commercial banks and raising the refinance rate.

Real interest rates rose sharply. In 1993 real interest rates were consistently negative, so that any credit was effectively a gift. By spring 1994, in real inflation-adjusted terms the NBU's refinance rate was over 200 percent a year and commercial banks' loan rates over 300 percent a year, amounting to an effective elimination of subsidies to the state sector, particularly to industry. Immediate results were evident in a sharp fall in previously subsidized activities. Industrial output dropped by 36 percent during the first half of 1994, down to about 50 percent of its 1990 level.

Money demand rose in the first half year in response to falling inflation. The amount of real currency in circulation (nominal currency divided by the CPI) rose 50 percent from January to May, although it still reached only 30 percent of its June 1992 level.

The NBU was therefore able to issue some money to finance the government's budget deficit without re-igniting inflation. In the first six months of 1994, net NBU credit to the government was 44 trn krbs, at 8 to 10 percent of GDP. In contrast, the outstanding stock of NBU credit to commercial banks - previously a major channel of subsidies - rose slightly in nominal terms, so in fact was halved in real terms.

Budget Deficit Is Unsustainable

From January to July, state revenue was 42.1 percent of GDP and executed expenditure 47.4 percent, giving a deficit of 5.2 percent of GDP. However, spending was only held so low because the government did not pay its bills. There were also growing and unsustainable arrears on budget expenditures (at least 12 percent of GDP on an annual basis).

For August to December, expenditure was forecast to rise to nearly 75 percent of GDP, and the budget deficit for the whole of 1994 was projected at 19.5 percent of GDP. International experience shows that hyperinflations generally occur when the monetary financing of the budget deficit rises above 12 percent of GDP. Such budgetary outcomes would require credit emissions to probably triple the nominal money supply and lead directly to a new hyperinflation.

There are three large categories of government subsidies which can be cut most easily. First, there are communal services, meaning gas, heating and electricity for

households. In January - July 1994, the government spent 3.1 percent of GDP on these items. Second, the total cost of the coal industry to the budget is approximately 4 percent of GDP including direct subsidies equal to 3 percent of GDP and an exemption from VAT costing near 1 percent of GDP. Third, budget spending on agriculture was officially 3.8 percent of GDP. However, accounting for various forms of indirect subsidy raises this to 5 percent. Total government support to agriculture, including cheap credits and tax exemptions, is much larger; informed estimates put it at around 10 percent of GDP. Implicit subsidies in cheap energy used by rural areas should be added, for a total agricultural subsidy of around 15 percent of GDP.

In addition, Ukraine maintains large import subsidies primarily for imports of natural gas and oil from Russia and Turkmenistan through a lower exchange rate for energy imports. These subsidies exceed one tenth of GDP, but do not show in the budget as they are financed by Ukrainian arrears on payments to Russia and Turkmenistan.

These four groups of subsidies will be targeted for budget cuts. Unification of the exchange rate will abolish the import subsidies. The coal industry is actually pushing for its complete liberalization as the only means to revive the viable coal mines. There is a broad agreement on a gradual and limited reduction of coal subsidies for communal services. President Kuchma and his reform team call for far-reaching liberalization of agriculture, but the agricultural lobby offers hard resistance.

Inflation Accelerates

In August the agricultural lobby convinced Parliament to decide on huge agricultural credits for the harvest, against the will of the NBU and the reform ministers. Approximately 50 trn krbs of credits were issued to agriculture, the equivalent of 5 percent of GDP and 40 percent of the money supply. This huge emission directly effected both inflation and the exchange rate.

After an official inflation rate of only 2.6 percent during the month of August, monthly inflation rose officially to 7 percent in September, and a further acceleration of inflation is to come, as there is a lag between monetary expansion and actual inflation. Moreover, the expected price liberalization and price increases around the beginning of November are projected to cause a price rise in the order of 50 percent.

Exchange Rate Collapses

The Ukrainian currency, the karbovanets (popularly known as the coupon), slowly appreciated from early June to early August, as the falling inflation boosted the minimal demand for karbovantsy. The free market rate moved from 52,000 per dollar up to 43,000. However, from August 22 there was a steady depreciation, and the street rate exceeded 100,000 by October 13, after which it has receded a bit.

The main explanation for this collapse is the issuing of huge agricultural credits. In reality, they benefit middlemen. With no possibility to use such large credits domestically, the beneficiaries rush to purchase hard currency. The situation might be aggravated by expectations of an imminent unification of the exchange rate, which should convince

exporters to delay payments to Ukraine to avoid an unfavorable surrender rate. Also, credit expansion and imminent price liberalization have raised inflationary expectations.

To permanently end this vicious circle of accelerating inflation, subsidies, and fiscal deficit, which can quickly explode into hyperinflation as enterprises and households lose confidence in the domestic currency, the government's only alternative is to quickly unify the exchange rate and to liberalize prices and reduce subsidies to sustainable levels. By raising energy prices, it can directly reduce subsidies, while at the same time increasing non-inflationary budget financing through receipts from sales of energy provided with external credits.

LIVING STANDARDS

The state sector is no longer the largest provider of people's incomes. However, the private sector activity which has flourished is small-scale and not registered. In the current regulatory environment, this private sector offers a way to survive rather than the prospect of rising living standards.

Punitive taxation

Tax rates remain extremely high, hence a large part of the private sector is unregistered. A significant amount of business which would otherwise occur in the state sector is probably also diverted into unregistered activity.

The top marginal rate of personal income tax is 90 percent, which explains why it generated only 3 percent of GDP in state revenue in the first half of 1994. The effective

payroll tax (including all contributions) is 52 percent, there is a 22 percent tax on value added (known as the enterprise income tax) and the state also collects 1.4 percent of the total value of sales. In addition, there is a type of turnover tax (known as the value added tax) which is 28 percent for most goods.

The government intends to reduce the personal income tax to a maximum of 50 percent next year and sharply raise thresholds, leaving most employees with a tax of 12 percent. The enterprise income tax will be replaced with an ordinary profit tax of 30 percent, and the value added tax will be cut from 28 percent to 20 percent. However, many technical problems will inevitably remain.

State Sector Wages

Wages in the state sector are very low. A minimum consumption basket, with enough food to survive but little meat, cost $30-35 per person per month in summer 1994 (at the free market exchange rate). In dollar terms, the average state sector wage has stayed in the $20-22 range in 1994. The purchasing power of average wages fell by 40 percent from December 1992 until spring 1994.

The state sector still accounts for 90 percent of official employment, but these jobs do not generate enough income for people to survive. Wages in Ukraine remain considerably lower than for similar jobs in Russia, both measured in purchasing power and dollars.

Survival Strategies

As a result, the informal, small-scale private sector is growing very fast. One estimate for eastern Ukraine is that over 40 percent of all state sector employees are earning more than their official income through parallel, unregistered activities, such as trade with Russia, private farming, and services. These people keep their state jobs but survive through various types of private sector work.

A substantial amount of income-earning assets such as real estate, light vehicles, and some agricultural land are already controlled by private individuals, if not formally privatized. State assets such as trucks, trains, and industrial premises can be accessed easily through informal markets.

Surveys in Kiev and Dnepropetrovsk find that few of the supposedly unemployed are doing no work at all. As the unemployment benefit is worth just a few dollars per month (and falls as inflation accelerates), this is hardly surprising. Although they work in the informal private sector and earn enough to survive for the time being, this form of private sector activity can in no way lead to a sustained increase in the standard of living.

PRIVATIZATION

Progress in privatization has been meager. The State Privatization Program for 1994 had drawbacks, but could have led to a reasonable amount of small, medium and large-scale privatization. Instead, privatization of all kinds has been blocked by Parliament, most notably when it voted 180 to 62 on July 29 to suspend implementation of the program until autumn.

After independence in 1991 the number of leased enterprises rose sharply, accounting for 1,928 of the 7,756 industrial enterprises in Ukraine by the end of the third quarter 1993. However, a political backlash against leasing, which functions as a form of insider privatization, has stalled the process.

In the 1993 small-scale privatization plans, the State Property Fund estimated that there were 60,000 "small" enterprises (those with less than 250 employees). In Russia and Poland, this form of privatization has proceeded rapidly, but in Ukraine through June 1994, only 2,000 units - mostly shops and restaurants - had been privatized.

BALANCE OF PAYMENTS

Ukraine's second major crisis, besides a massive budget deficit, is a severe problem in the balance of payments. In 1992 and 1993 Ukraine received substantial financing from Russia. From the end of 1993 these loans were no longer available, but both Russia and Turkmenistan have allowed Ukraine to run up large arrears.

A sharp decline in exports and the reduction in balance of payments financing caused import volumes to fall enormously - by 35 percent in 1992, 21 percent in 1993, and perhaps another 8 percent in 1994. Despite this large drop in imports, Ukraine cannot currently pay for essential energy imports.

Energy Imports

Ukraine remains heavily dependent on imported energy, particularly from Russia, and its overall energy balance causes great concern. After independence in 1991, Ukraine faced

the need to reduce these imports to affordable levels. It has made considerable progress mainly by reducing energy consumption.

However, the most critical energy issue is natural gas from Russia and Turkmenistan, which Ukraine receives from the pipeline to western Europe. In 1993 Ukraine imported for its own use 79.8 bn m3 of gas, 68 percent from Russia and the rest from Turkmenistan, while the total flow of gas through the pipeline (transit plus imports) was 205 bn m3.

In contrast to the positive adjustments seen for all other types of energy, the consumption and import of natural gas remains almost unchanged, down only slightly from the 85 to 90 bn m3 of 1990-92. Imports in the first 6 months of 1994 were 38.3 bn m3. Imported natural gas provided a worryingly high 44 percent of Ukraine's total primary energy consumption in 1993.

In the first half of 1994, industry accounted for about 62 percent of natural gas consumption. However, natural gas remains vital for heating apartments. A big part of the problem is that Ukraine charges users from 1 to 30 percent of actual cost for both gas and oil, so that domestic sales revenues cover only a fraction of costs.

Ukraine still receives the gas, but continues to run up payment arrears with Russia and Turkmenistan. During the first three quarters of 1994, the net increase in external arrears is estimated just under $1 bn per quarter. Total new arrears in 1994 totaled $2.8 bn by September.

Even if domestic prices are raised to equal costs, Ukraine cannot afford to reduce annual energy and other imports by $4 bn to avoid arrears on these imports. This would

require a reduction in total imports of approximately 27 percent in 1995, following severe energy and other import cuts in 1992 and 1993.

The table below shows an estimate of the balance of payments for 1993 and 1994. The 1994 numbers assume that Ukraine implements its recently signed agreement with the IMF. The estimates here show a financing gap of $1 bn in the fourth quarter 1994, when the IMF program begins.

Foreign Debt

The precise level of Ukraine's foreign debt is unknown. The best estimate is around $7 bn, most of which is unregulated arrears. More than $5 bn is owed to Russia, over $1 bn to Turkmenistan, and less than $1 bn to all other creditors. Russia, Turkmenistan, and Ukraine have declared their intention to reach an agreement on debt rescheduling by the end of 1994 in collaboration with the IMF.

OUTLOOK

Ukraine now has a real chance to implement a major breakthrough reform. Its program is similar to Poland's in 1990 and Russia's in 1992. The package to be implemented this fall includes these key short-term measures:

1. Abolition of most export quotas and licenses by November 1, and the rest by early 1995 (except those required by international agreements, or pertaining to arms, narcotics, etc.).

2. Abolition of all state orders and full liberalization of domestic trade.

3. Liberalization of all prices except those on natural monopolies and some services (gas, electricity, railroad, coal) in two steps, first by early November and second by early 1995. All forms of profit restrictions on enterprises should be lifted.

4. The government will unify the exchange rate by the end of October.

5. The government will raise the domestic price of energy for enterprises to fully reflect the higher energy prices caused by unification of the exchange rate (because energy was previously priced by multiplying the import price in dollars by the official exchange rate.)

6. The budget deficit should be reduced to around 10 percent of GDP in 1994, and approximately halved in 1995.

Fiscal and tax reform measures are needed to reduce the monetary financing of the budget deficit. This financing should not exceed 1 percent of GDP in 1995. In addition, taxes should be reformed to provide greater incentives to business and reduce tax fraud.

In response to all these measures, the international community, primarily the IMF and World Bank, should provide substantial financing. Bilateral donors will be requested to offer about $2 bn.

As a consequence of all these measures, Ukraine should have inflation fully under control by spring, and a foundation for economic recovery will have been laid.

The most obvious threat is posed by the parliament. Privatization appears particularly complicated in Ukraine, and there is always a risk that a reform will run out of momentum.

Ukraine's Balance of Payments
(bn USD)

	1993	1994 proj.
Exports	12.8	12.5
Imports	-15.3	-15.7
Energy	-6.2	-6.3
Other	-9.1	-9.4
Net services	1.5	0.7
Official transfers	0.1	0.2
Current account	-0.9	-2.3
Medium and long term	0.7	-1.1
Disbursements	0.8	0.4
Amortization	-0.1	-1.5
Commercial banks	0.0	0.6
Foreign direct investment	0.1	0.1
Errors and omissions	-1.2	-0.6
Monetary liabilities	-1.3	n.a.
Capital account	-1.7	-1.0
Overall balance	-2.6	-3.3
Financing required	2.6	3.3
Sources of financing		
Change in gross reserves	-0.1	-0.3
Credits from former Soviet Union	2.5	0.0
Payment arrears	0.3	2.6
Financing gap	0.0	1.0

Note: Export and import numbers are IMF preliminary estimates on the basis of partner country statistics. About 30 percent of exports and 19 percent of imports are with non-former Soviet Union countries.

The Ukrainian Economy
(percent change over corresponding period preceding year unless otherwise noted)

	1992	1993	1994 1st half
GDP in current prices, in Ukr. coupons	5,127 bn	153 trn	1,055 trn[1]
Real GDP	-14	-14.2	-23
Industrial production	-9	-7.4	-36
Agricultural production	-11.1	-6.7	n.a.
Unemployment, Dec. (%)	0.27	0.33	0.39[2]
Inflation, Dec.-Dec. (%)	2,920	10,199	64[3]
Budget balance[4] (% of GDP)	-17	-9.7	-8.1
Exports (non-FSU), bn USD		3.8	
Imports (non-FSU), bn USD		2.9	
Balance, bn USD		0.9	
Exports (FSU), bn USD		9.0	
Imports (FSU), bn USD		12.4	
Balance, bn USD		-3.4	

Notes:
1. Whole year, projected
2. March
3. December to June
4. General government (cash basis)

Sources: *Ukrainian Economic Trends*
Ukraine in Numbers
IMF