November 2005
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Ukraine: 2005 Article IV Consultation and Ex Post Assessment of Longer-Term Program Engagement—Staff Reports; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 2, 2005, with the officials of Ukraine on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 18, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of November 4, 2005 updating information on recent developments.
- a staff report on ex post assessment of longer-term program engagement, which was completed October 18, 2005.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 9, 2005 discussion of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Selected Issues Paper
Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2005 Article IV Consultation

Prepared by the European Department
(In consultation with other departments)

Approved by Reza Moghadam and Michael T. Hadjimichael

October 18, 2005

- Article IV consultation discussions were held in Kyiv during July 25-August 2, and were continued at the Annual Meetings in Washington, D.C. on September 22-26, 2005. The Ex Post Assessment (EPA) of Ukraine's longer-term program engagement with the Fund was also discussed at the Annual Meetings. The mission met with NBU Governor Stelmakh, Minister of Finance Pynzenyk, other senior officials, and representatives of the diplomatic community, financial institutions, think tanks, and entrepreneurs' associations.

- The mission comprised Mr. Jaeger (Head), Mr. Rossi, Ms. Schaechter, Mr. Tiffin (all EUR), Mr. Flanagan (FAD), Mr. Halikias (PDR), and Ms. Ong (MFD), and was assisted by Mr. Franks, Senior Resident Representative. Mr. Yakusha (OED) participated in the discussions.

- A 12-month Stand-By Arrangement treated as precautionary by the authorities expired in March 2005.

- Ukraine has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system that is free of restrictions on the making of payments and transfers for current international transactions. The country has subscribed to the Fund's Special Data Dissemination Standard (SDDS) since 2003, and its data provision to the Fund is broadly adequate for surveillance, albeit with some shortcomings (Appendix IV).

- The authorities published the mission's concluding statement on August 24, 2005.

- The previous consultation was concluded on October 25, 2004. The conclusions of the Executive Board's discussions and country documents were made available at www.imf.org on January 24, 2005.

Contents Page

Tables

Appendices

Appendix Table

EXECUTIVE SUMMARY

Background. GDP growth this year has slowed sharply from 8½ percent during 2000–04 to about 3 percent for January-August 2005. Export growth has decelerated, investment has slumped, but private consumption has been fuelled by rising wages and social transfers. Inflation has been on an upward trend since early-2003, and has been hovering around 15 percent for most of this year. Fiscal policy has been tightened, compared with 2004, but massive hikes in public pensions and wages—financed by a concomitant increase in the tax burden—have fuelled inflation pressures. Despite some attempted tightening by the NBU, monetary conditions remain loose. The Ukraine-EU Action Plan contains a sweeping agenda for structural reforms, but, aside from the trade policy area, progress has been limited.

Outlook. In the short term, GDP growth is projected to slow to 4 percent in 2005, before picking up somewhat to 5½ percent in 2006. On the one hand, the projection assumes a rebound of investment but, on the other hand it also assumes stronger external headwinds, particularly lower terms of trade. The downside risks stem from the external sector as well as a generally difficult investment climate. Inflation is likely to exceed the authorities' end-2005 objective, and tighter and more coordinated fiscal and monetary policies will be needed to bring inflation back into single digits during 2006. Under a strong reform scenario, Ukraine's medium-term growth outlook should be bright.

Policy discussions. The discussions focused on the following issues:

- Staff argued that the authorities' 2005 deficit target (2½ percent) needs to be met, while the 2006 budget needs to be tight (deficit target of 2¼ percent of GDP) to support disinflation. A key measure would be to ensure that wage and pension increases do not exceed projected inflation in 2006. Staff also urged the authorities to base their 2006 budget on a realistic and consistent macroeconomic framework. The authorities' draft 2006 budget aims at a slightly higher deficit target (2½ percent of GDP), but the macroeconomic framework also seems optimistic. The budget could be significantly changed in parliament.

- Staff argued that monetary policy needs to be tightened and that the NBU should adopt a more flexible exchange rate regime to allow better control of inflation. The authorities have made some steps in this direction, but seem bent on moving slow and gradually, particularly in the present political context.

- The financial sector's vulnerabilities and capacity to manage shocks were a concern to both sides. Progress has been made on the regulatory and supervisory side, but key legislation remains stuck in parliament and much remains to be done.

- There was agreement that reforms that foster more market-friendly institutions are key to sustaining Ukraine's catchup growth and that the investment climate was of particular concern. But the key bottleneck remains reaching political consensus.

Glossary

CAR	Capital adequacy ratio
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPI	Consumer price index
EMBI	Emerging Market Bond Index
EPA	Ex Post Assessment
EUR	IMF European Department
EU	European Union
FAD	IMF Fiscal Affairs Department
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
HRV	Hryvnia
IFI	International Financial Institutions
LEG	IMF Legal Department
MFD	IMF Monetary and Financial Systems Department
NBU	National Bank of Ukraine
NDA	Net domestic assets
NIR	Net international reserves
NPLs	Non-performing loans
PDR	IMF Policy Development and Review Department
PPI	Producers price index
PPP	Purchasing power parity
SBA	Stand-By Arrangement
SDDS	Special Data Dissemination Standard
SDR	Special drawing right
SOE	State-owned enterprise
STA	IMF Statistics Department
VAT	Value added tax
WEO	World Economic Outlook
WTO	World Trade Organization

I. Introduction

1. **The consultation discussions focused on the policy requirements for restoring and maintaining macroeconomic stability, as well as improving medium-term growth prospects.** Following a generally strong macroeconomic performance during 2000–04, recent inflation rates have persistently exceeded their target, while GDP growth has slackened. And, notwithstanding the remarkable growth spurt during 2000–04, Ukraine's economy remains highly inefficient in using its available human and physical resources. This mainly reflects slow progress in building more market-friendly institutions, and it also highlights the significant scope for accelerated growth once a political consensus on the necessity of reforms is established.

2. **Discussions took place against a fluid political background, and significant uncertainties remain.** Following last year's tumultuous elections, President Yushchenko was inaugurated in January 2005 on a reform platform that pledged to tackle pervasive corruption and rent seeking. Following a close policy dialogue during the first half of 2005 (Box 1), the Article IV discussions in Kyiv were held during July 25–August 2, but shortly thereafter, on September 8, the president dismissed the government led by then-Prime Minister Tymoshenko. Prime Minister Yekhanurov was confirmed by parliament in a second-round vote, and a new cabinet has taken office. Constitutional amendments that will shift power from the president to the prime minister and parliament are scheduled to take effect early next year, giving the March 2006 parliamentary elections added importance.

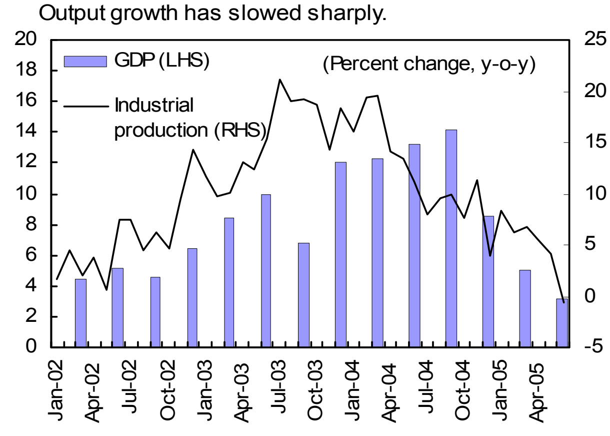
II. Background

A. Recent Growth and Inflation Developments

The short-term macroeconomic situation has deteriorated.

3. **GDP growth has slowed significantly**. During 2000-04, real GDP growth averaged 8½ percent, peaking at about 12 percent in 2004 (Table 1). However, during the course of this year, growth has progressively decelerated. Externally, the combination of a slowing a global economy, an appreciating real exchange rate, and flat terms of trade has abruptly reversed the impetus behind the recent boom. As for domestic demand, monetary policy has remained loose, while massive hikes in public pensions and wages have provided an expansionary boost to consumer demand. Moreover, by raising the tax burden to pay for these social payments, the 2005 budget has effectively re-allocated income from the (higher-saving) corporate sector to the (lower-saving)

Output growth has slowed sharply.



Sources: Ukrainian authorities; and staff estimates.

Box 1. Impact of Recent Staff Advice

A 12-month Stand-By Arrangement, treated as precautionary by the authorities, expired in March 2005. Relations with the Fund through March 2005, including the effectiveness of policy advice, are discussed in the Ex Post Assessment (EPA) of long-term use of Fund resources. This box covers the impact of more recent staff advice since President Yushchenko took office, a period characterized by close policy dialogue and extensive provision of technical assistance.

On **fiscal policy**, staff argued for a significant tightening of the stance in 2005, cautioning in particular against going ahead with already-approved large hikes in public pensions, and recommending overall restraint on recurrent spending combined with broadening of tax bases. In the event, the 2005 supplementary budget adopted in March 2006 targeted a deficit in line with staff recommendations (2½ percent of GDP). In addition, tax loopholes were closed and pension hikes were partly rolled back. Nevertheless, the remaining increase in pensions has left the pension fund in a precarious financial imbalance. And, against staff's advice, nominal public wages were raised by more than 50 percent, providing a strong additional impetus to inflation.

On **monetary and exchange rate policy**, staff noted that monetary conditions are loose and recommended tightening while also advocating a shift to more exchange rate flexibility. In this context, the NBU welcomed staff's attempt to provide detailed analysis of policy options and risks. The NBU argued that it has taken adequate steps to control inflation, including by stepping up sterilization operations, tightening reserve requirements, and allowing some nominal appreciation of the hryvnia. Although agreeing in principle with the need for more exchange rate flexibility, the NBU prefers a very gradual approach, which it considers to be more in tune with Ukraine's specific economic and political circumstances.

On **structural reforms**, the Ukraine-EU Action Plan provides a sweeping blueprint for structural reforms, many of them long advocated by the Fund. Staff also called for a speedy resolution of the debate on past privatizations of state-owned enterprises that started in February 2005, which, however, continued to linger, aggravating an already difficult investment climate.

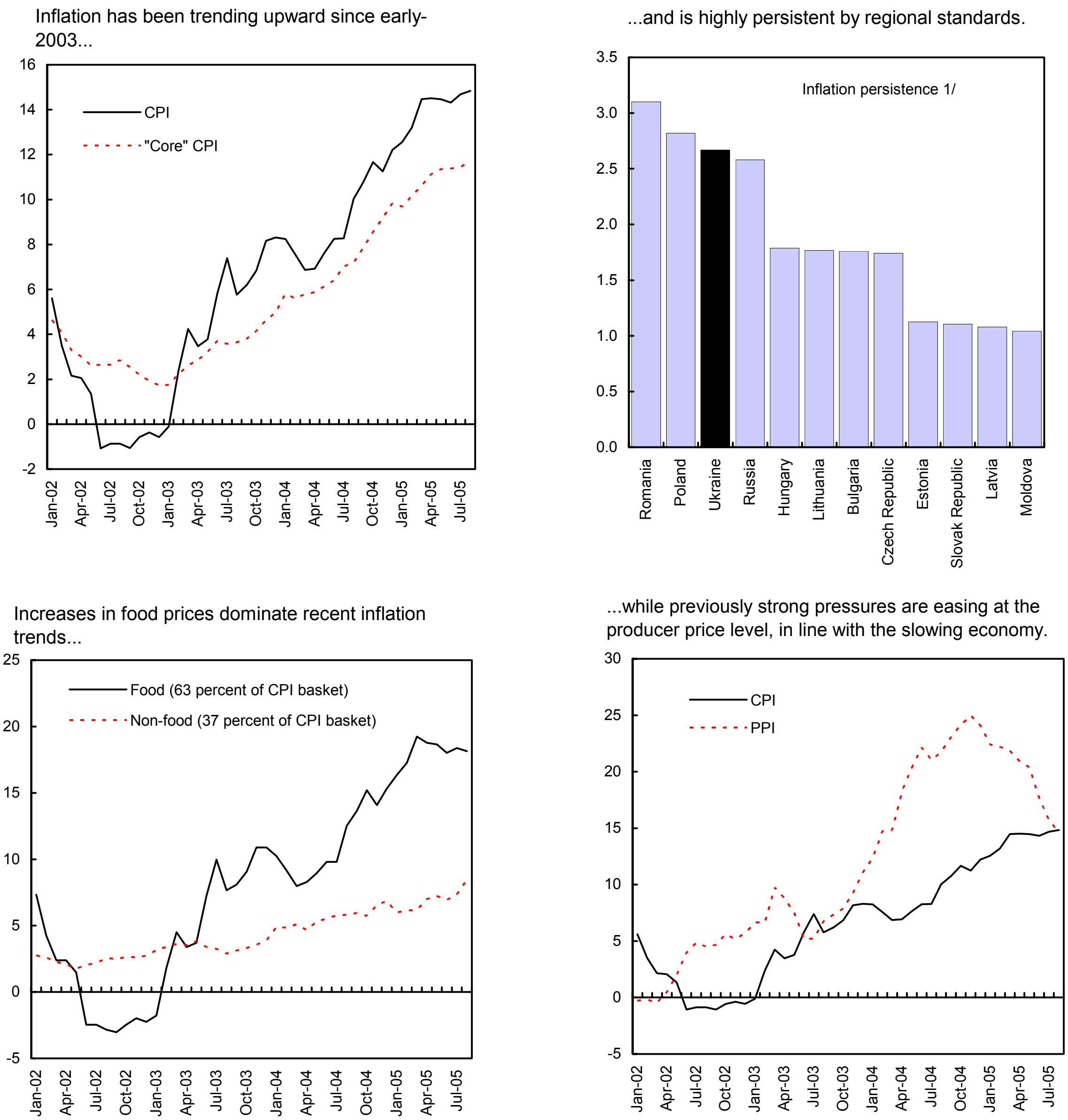
The recent policy dialogue, combined with intensive technical assistance, seems to have fostered internal debate and reflection, even when the authorities and staff have disagreed.

household sector. And, at the same time, drifting structural policies and the budget's sharp hike in the tax burden have dampened private investment demand.

4. **Inflation has risen well into double digits**. Since 2000, with the monetary policy framework centered on defending the de facto peg to the U.S. dollar, inflation has remained unanchored, decelerating initially when growth took off, but trending upward again since early-2003. The lack of an effective anchor is indicated by the high persistence of inflation in Ukraine (Figure 1).[1] Recent inflationary pressures are mainly rooted in strong domestic demand, particularly consumer demand for food items, fuelled by large increases in social spending and wages. At the same time, pressures on producer prices have been receding somewhat, mainly owing to a slowing economy. Efforts to fight inflation by narrowly targeted administrative measures, such as price caps in the food and energy markets, may have contained some pressures on the headline rate, at least temporarily.

[1] See the *Selected Issues* paper on inflation persistence in Ukraine.

Figure 1. Ukraine: Inflation, 2002–05
(Year-on-year change in percent, unless otherwise indicated)



Sources: Ukrainian authorities; and staff estimates.
1/ This measure of persistence quantifies the long-term impact on the price level of a 1 percent shock to inflation, during January 2000 to June 2005, assuming that central banks' targeted inflation rate remained constant.

B. External Sector Developments

The impetus from favorable external demand and prices is fading.

5. **Export growth, vibrant during 2000-04, has lost momentum.** Ukraine's economy is highly open, with exports heavily concentrated in metals (Figure 2). Several factors combined to underpin booming exports during 2000-04: strong price and cost competitiveness; significant idle capacities; and strong external demand for Ukraine's main export items. More recently, however, exports have slowed markedly, reflecting an appreciating real exchange rate and slowing global demand, including for metals.

6. **Ukraine has benefited from favorable terms of trade, but this external impulse leveled off in 2005.** Metal prices in particular have skyrocketed since 2003, and are presently about 50 percent above their long-term trend (Figure 2). While energy prices have also increased substantially, the overall movement in the terms of trade during 2003-04 has been strongly in Ukraine's favor, boosting corporate profits and accounting for most of the increase in the current account surplus during 2003-04 (Table 2). But, in 2005 the upward trend in the terms of trade came to an abrupt halt, as metal-price increases leveled off and energy prices soared.[2]

7. **Capital inflows have been subdued since 2000, and foreign investor interest, while picking up, remains cautious.** The persistence of market-unfriendly institutions has weighed heavily against capital inflows, notwithstanding booming growth and reasonable prospects of macroeconomic stability. In particular, per capita FDI inflows during 1998-2004 remained very low; among transition economies, only the Kyrgyz Republic, Turkmenistan, and Uzbekistan have fared worse (Figure 2). But foreign interest is rising: rating agencies have upgraded Ukraine, noting its low external public debt (19 percent of GDP in 2004) and promising growth prospects; and sovereign spreads have narrowed significantly. Foreign portfolio investors, also attracted by a perceived undervaluation of the hryvnia, have returned for the first time since 1998 to purchase most of the government's T-bills. But uncertainty about the direction of policies, combined with a dearth of attractive financial assets, continues to constrain inflows.

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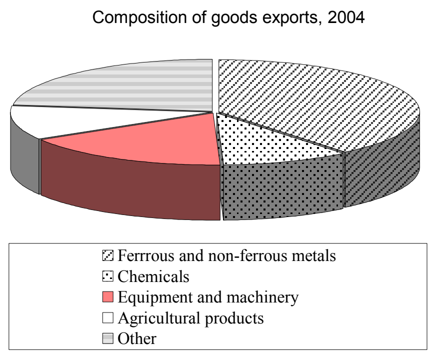
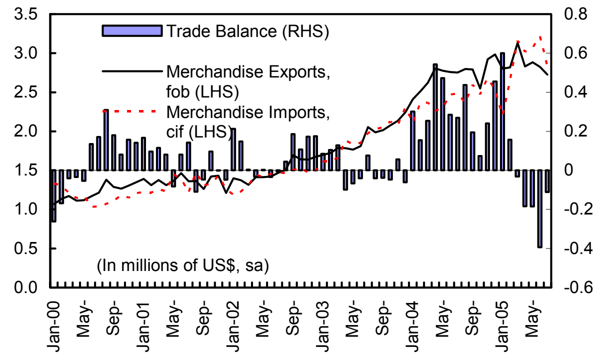
[2] Ukraine, while a net energy importer, is well hedged against rising oil prices, as transit fees for oil, along with higher Russian demand for Ukraine's exports, act as significant offsets. At the same time, prices for imported natural gas remain well below international levels, and the potential convergence of natural gas prices to world prices constitutes a significant external downside risk. See the *Selected Issues* paper "Ukraine: External Risks and Opportunities."

Figure 2. Ukraine: External Sector Developments, 2000–05

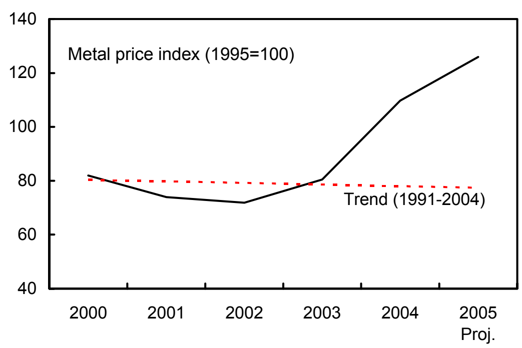
Metals account for a large share of exports.



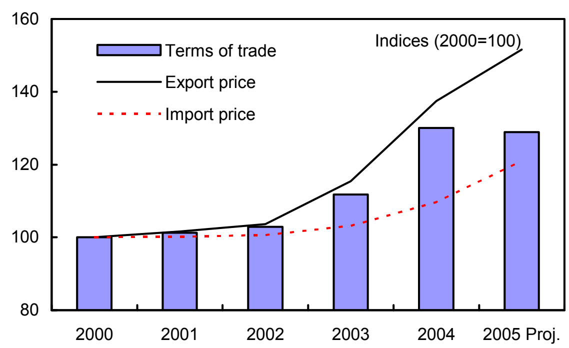
Exports have peaked while the trade balance has turned negative.



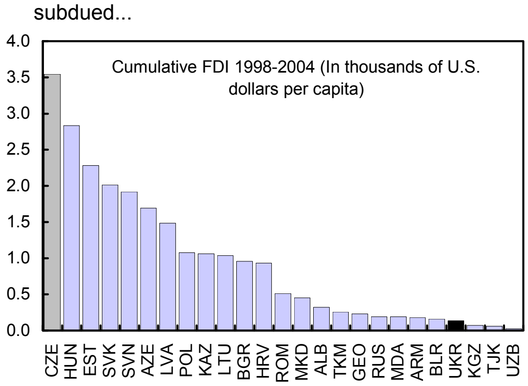
Metal prices are presently well above their longer term trend...



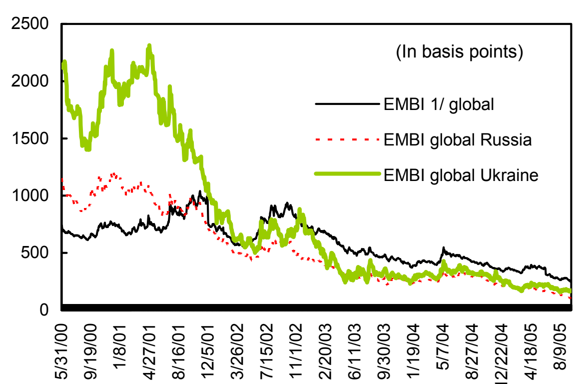
...and the recent surge in the terms of trade came to a halt in 2005.



Capital inflows, particularly FDI flows, have been subdued...



...but sovereign spreads have narrowed drastically.



Sources: Ukrainian authorities; Bloomberg; and staff estimates and projections.
1/ Emerging Market Bond Index (EMBI).

C. Macroeconomic Policies

Recent policies have lacked consistency.

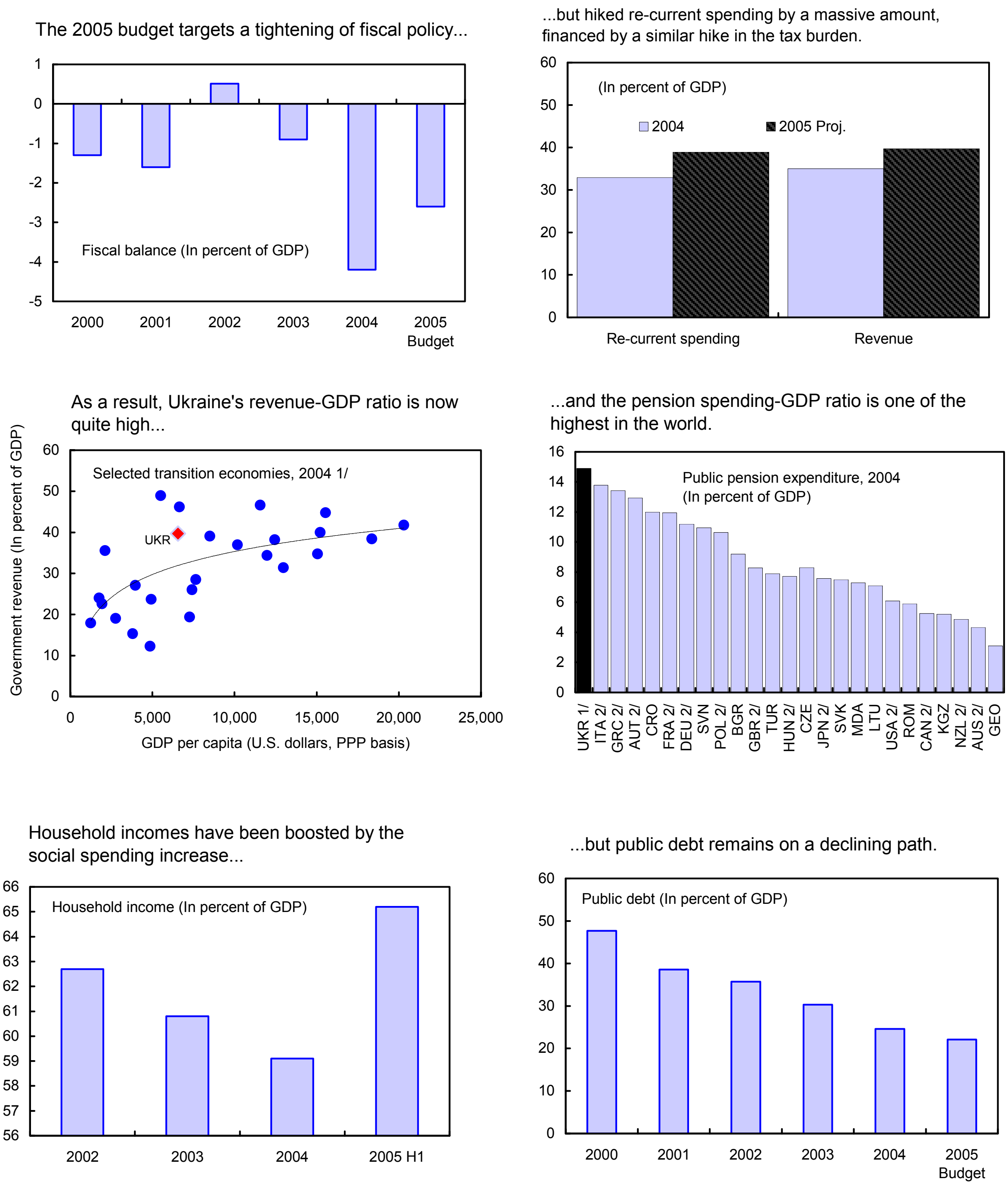
8. **The 2005 budget, while aiming at a significant fiscal tightening, massively raised public pensions and wages, offsetting the spending hike by a similarly large increase in the tax burden**. The 2005 supplementary budget targets a state budget deficit of 1¾ percent of GDP (Table 3). This is equivalent to a general government deficit of 2½ percent of GDP, well below the 4½ percent realized during 2004, and the 6-7 percent implicit in the original budget for 2005. The targeted fiscal tightening reflects a series of measures, including the closure of tax loopholes, improved tax administration, higher state-enterprise dividends, and steep cuts in capital spending. However, the supplementary budget largely accommodated the previous government's pension increases, and boosted the public wage bill, raising average public pensions and wages by over 50 percent (against an inflation target of just under 10 percent). Public pension spending in 2005 is projected to approach 15 percent of GDP, up by 3½ percent of GDP compared with 2004—one of the world's highest ratios (Figure 3).

9. **Budget implementation during the first half of 2005, however, was on track**. Through end-June, the general government deficit, including VAT refund arrears, was 1 percent of annual GDP (the total stock of VAT refund arrears at end-June amounted to about Hrv 3 billion, or ¾ percent of GDP). In the same period, expenditures were broadly in line with targets. Apart from increased VAT refund arrears, buoyant cash revenue collections mainly reflect the tax measures introduced in the 2005 budget. Corporate tax receipts have been particularly buoyant (but may also reflect the lagged impact of last year's boom), as have customs revenues (reflecting an anti-smuggling program, and the shift of energy-related tax collections to the border).

10. **Monetary conditions have remained loose**. Apart from a short-lived episode during last year's financial near-crisis, the NBU has continued to purchase foreign exchange, while sterilization efforts remained limited. The largest liquidity-absorbing support for monetary policy has come from the government, which has issued new T-bills to buy back higher-yield restructured securities held by the NBU, and which has built up deposits by maintaining a tight fiscal stance (Table 4). The NBU's own liquidity-absorbing operations, on the other hand, were relatively limited, even when accounting for an increase in reserve requirements effective September 1. As a result, there is high excess liquidity in the banking system, and all interest rates, including banks' lending rates, are now negative in real terms (Figure 4). Monetary aggregates have expanded more slowly than in 2004, but this comes against a backdrop of sharply decelerating money demand as inflation has risen into double digits.

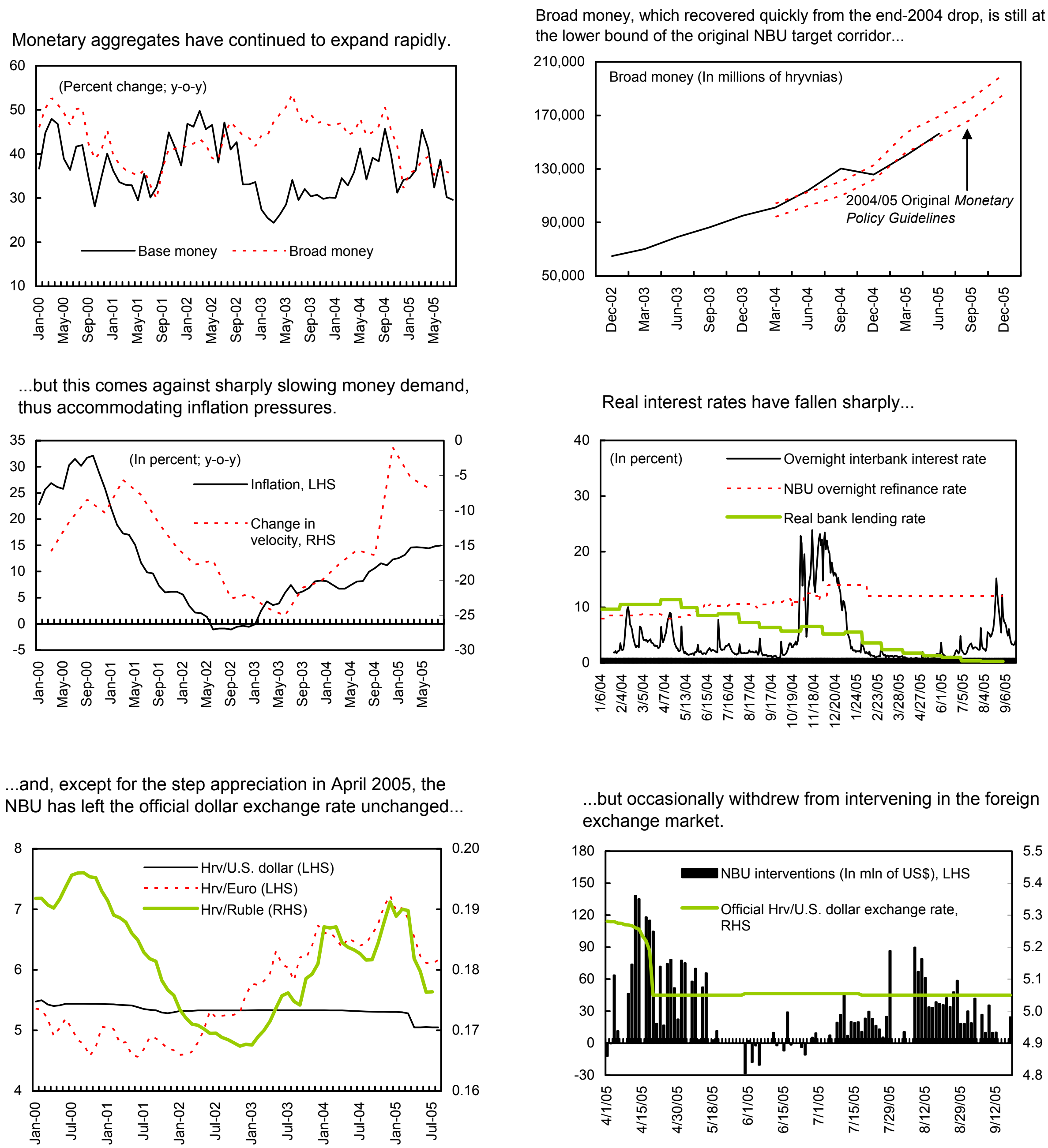
11. **But the NBU has taken first steps toward greater exchange rate flexibility**. The first of these was a relaxation of foreign exchange control measures, including export surrender requirements and the provision that non-residents predeposit the full amount of their T-bill auction bids. In August, the NBU lifted the ban that required banks to operate only on one side (buy/sell) of the foreign exchange market within the same day, and also allowed forward operations. Together with the 1.5 percent foreign exchange transaction tax,

Figure 3. Ukraine: Fiscal Policy, 2000–05



Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates and projections.
1/ Projection for Ukraine for 2005.
2/ Data are for 2001.

Figure 4. Ukraine: Monetary Indicators, 2000–05



Sources: Ukrainian authorities; and staff estimates and projections.

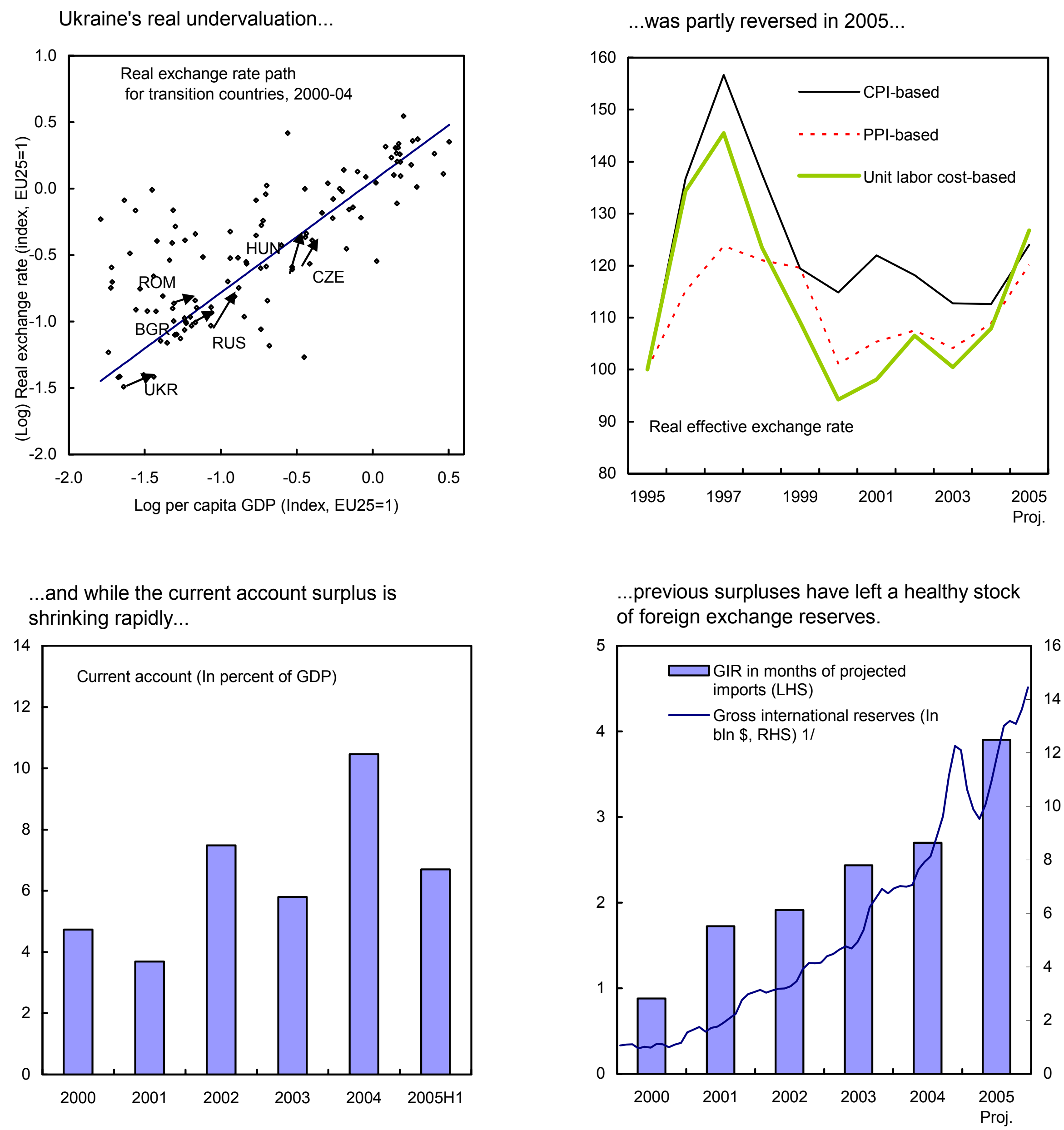
which the draft 2006 budget proposes to halve, these were the main impediments for developing Ukraine's foreign exchange markets and instruments. At the same time, the NBU has introduced a new restriction on purchases by non-residents of government securities with original maturities of less than one year, but which is likely to be non-binding (government securities generally have original maturities that exceed one year). The NBU also introduced a 20 percent reserve requirement on foreign currency loans with a maturity of up to 180 days from non-residents. On April 20, in a surprise move, the NBU also allowed the hryvnia to appreciate by almost 3 percent, and has since occasionally withdrawn from the market (Figure 4).

12. **Reflecting high domestic inflation, the real exchange rate has appreciated markedly**. The real exchange rate fell sharply in the aftermath of the 1998 financial collapse, and remained steadily undervalued after 2000, owing to the hryvnia's de facto peg to a weakening U.S. dollar and relatively high inflation in Russia. This undervaluation was evident in PPP-based comparisons, large and growing current account surpluses, and the significant buildup of foreign exchange reserves (Figure 5). Since August 2004, however, a surge in domestic inflation and a modest nominal re-valuation against the U.S. dollar has appreciated the real exchange rate by about 11 percent. In addition, U.S. dollar wages in manufacturing have increased by almost 40 percent, and the current account surplus declined considerably during the first half of 2005.

13. **Nevertheless, the real exchange rate remains competitive**. Updated indicators of price and cost competitiveness—including PPP-based measures, staff estimates of the real equilibrium exchange rate, and international wage comparisons—suggest that Ukraine's real exchange rate remains below its equilibrium level, although quantitative estimates vary considerably. Wages, in particular, are still about half the level prevailing in Russia.

14. **A lack of clear and market-friendly structural policies has dampened an already difficult investment climate, weighing on the economy's supply side**. A protracted debate on the scope and modus of reconsidering past privatizations of state-owned enterprises has aggravated uncertainties about property rights—domestic and foreign investors have responded by adopting a wait-and-see approach. Heavy-handed interventions to contain price pressures in the fuel, meat, and sugar markets further added to a perceived drift in the government's policies. Finally, while there was tangible progress in certain areas, particularly WTO accession, lack of political consensus has continued to hinder progress on long-delayed structural measures, including the adoption of a joint stock company law.

Figure 5. Ukraine: Indicators of Competitiveness, 1995–2005



Sources: Ukrainian authorities; and staff estimates and projections.
1/ Monthly data until August 2005.

D. Financial Sector Developments

15. **The banking system weathered last year's political shocks well, but the near-crisis also revealed prudential and supervisory shortcomings**. The events surrounding the presidential election triggered a shift into foreign-currency denominated cash holdings as well as capital flight, resulting in a sharp decline in foreign reserves. The NBU responded with a well-orchestrated package of liquidity support for banks, combined with administrative measures aimed at slowing the hemorrhaging of reserves and deposits. Once the political crisis dissipated, reserves and deposits quickly recovered previous losses. However, the near-crisis has exposed several weaknesses, including: a legislative framework that makes it difficult to prevent panic-driven withdrawals of time- and savings deposits; the indirect exchange-rate risk resulting from lending in foreign currency to unhedged borrowers; inadequate liquidity management by many banks; and a lack of administrative preparedness by the NBU to handle a full-blown financial crisis.

16. **The banking system continues to be plagued by structural weaknesses**.[3] The largest vulnerability of the banking sector is the potential impact of a disappointing macroeconomic performance on the repayment ability of borrowers, particularly given the sharp increase in banks' loan portfolios over past years. Credit growth in August remained high at 42 percent, after some deceleration in late 2004 and early 2005 (Figure 6). Banks are refocusing on household-sector loans (their share in total loans has increased from 5 percent at end-2001 to 19 percent by end-August 2005), including mortgage lending to a booming housing market. These vulnerabilities are exacerbated in some banks by concerns about capitalization, risk management practices, related-party lending, widening maturity mismatches, and the still-high, albeit declining, non-performing loans ratio (Table 5). In particular, low profitability—though also a reflection of tax avoidance—restricts banks' ability to replenish capital from own resources. Competition, risk management practices, and efficiency are expected to increase as more foreign banks enter the market, which has so far been dominated by domestic banks.[4]

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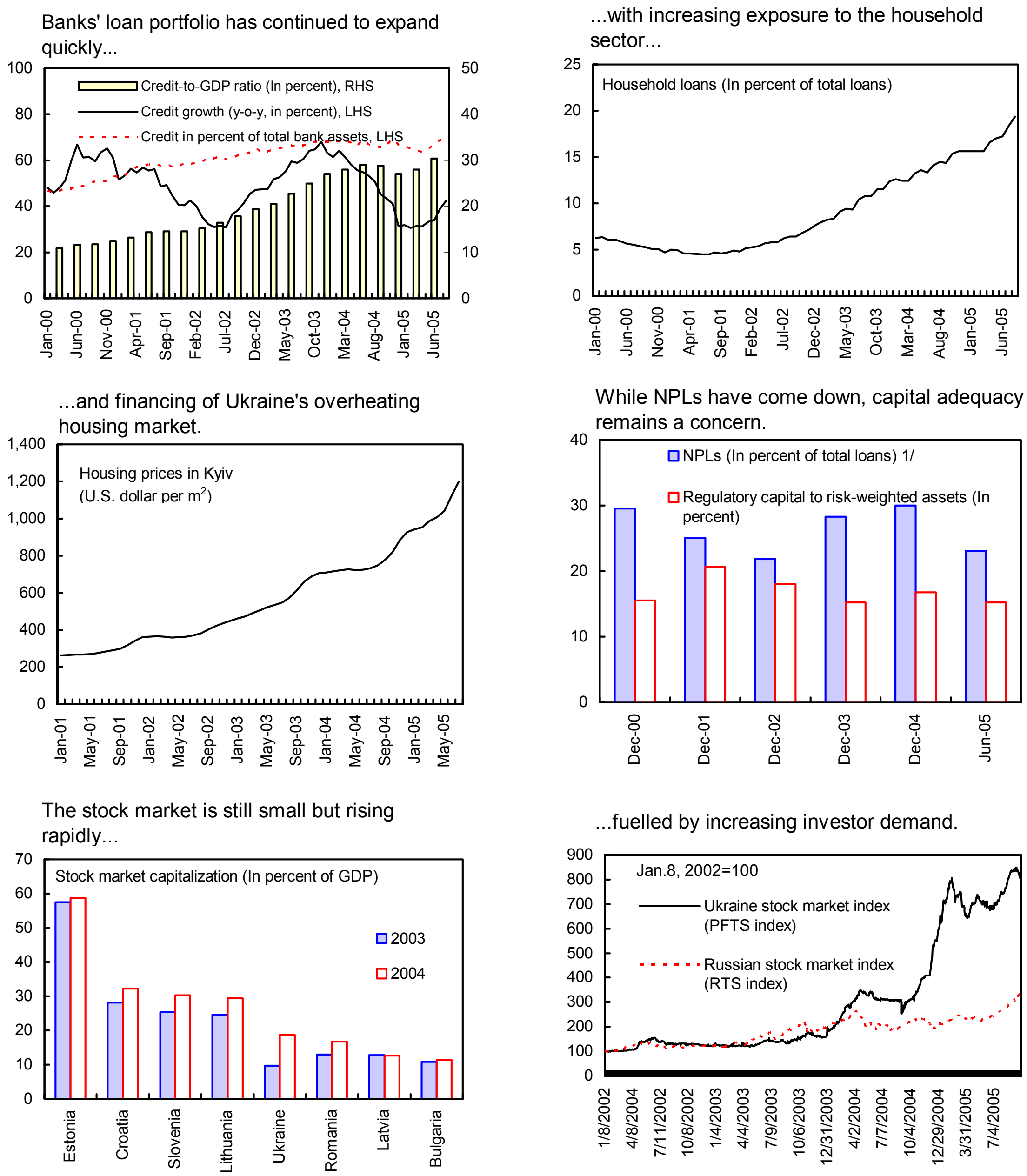
[3] See the *Selected Issues* paper "Developments in Ukraine's Financial Sector—FSAP Follow-Up Report."

[4] In August 2005, Raiffeisen bank (the largest foreign bank) announced an agreement to buy Aval bank (the second largest bank).

Figure 6. Ukraine: Financial Sector Developments, 2000–05



Sources: Ukrainian authorities; and staff estimates.
1/ Nonperforming loans (NPLs) comprise those classified as substandard, doubtful, and loss. The increase in NPLs in 2003 is largely due to a change in loan classification rules. The NBU estimates that at end-March 2004 about 94 percent of substandard loans were serviced timely. Excluding these timely serviced loans from the NPL definition would reduce the ratio to about 8 percent (see Table 6).

III. Report on the Discussions

A. Key Issues

17. **Ukraine faces several economic challenges and vulnerabilities, but also opportunities**:

- Restoring macroeconomic stability is the immediate policy challenge. In particular, what is the appropriate mix of fiscal and monetary policies to restore low and stable inflation?
- Ukraine is a potentially rich country, but slow institution building has resulted in a highly inefficient economy. How can Ukraine achieve a path of sustained, rapid catchup growth that brings it closer to its long-term potential?
- While Ukraine has strong macroeconomic fundamentals in many areas, particularly as regards public debt and external competitiveness, there are also significant financial vulnerabilities. How could policies and reforms help minimize them?

B. Fiscal Policy

Present plans are tentative.

18. **There was agreement that reaching the 2005 general government deficit target of 2½ percent of GDP was important**. In staff's view, while meeting the target would support the authorities' disinflation effort, the composition of the budget itself was a key driving force behind inflationary pressures. The authorities viewed the target as important in enhancing their fiscal management credibility, and were confident that they could reach it while fully repaying the accumulated stock of VAT arrears. Financing the deficit—even a higher deficit—will not be difficult, despite a potential shortfall in privatization proceeds, given World Bank loan disbursements and good prospects for issuing a eurobond. Recent preliminary data hint at buoyant income- and VAT collections through August, suggesting that, with maintained spending discipline, the deficit target would be missed by only a small margin, up to ½ percent of GDP (Table 3).

19. **The mission called for targeting a general government deficit of 2¼ percent of GDP in 2006, underpinned by a freeze of real recurrent spending**. While the deficit target implies only a mild fiscal tightening, the recurrent spending freeze would help contain domestic demand pressures by restraining nominal growth in social spending and public wages—a key factor behind currently high CPI inflation. As part of an overall strategy, the recommended fiscal policy stance would be consistent with single-digit inflation, without overburdening monetary policy. It would also leave the general government debt ratio on a gently declining trend (the level would fall by over 4 percent to 18½ percent of GDP).

20. **The authorities' draft 2006 budget targets a general government deficit equivalent to 2½ percent of GDP, broadly in line with staff recommendations, but the actual outcome could be higher**. As a general point, the authorities noted that the large hikes in social spending in the 2005 budget need to be viewed as a one-time adjustment, and that future budgets will have to focus on the country's development and investment needs. The draft 2006 budget was prepared by the recently-dismissed government and might still be revised significantly, including in response to amendment requests by parliament.[5] The draft budget projects a strong rebound of real growth in 2006, 1½ percentage points higher than in the staff's baseline, and continued revenue buoyancy. As for revenue measures, the budget includes a 2 percentage point reduction in the payroll tax rate, a halving of the foreign exchange transaction tax, and an increase in the basic personal income tax allowance. On the expenditure side, average public wages and pensions are envisaged to increase by some 18 percent and 13½ percent—both increases somewhat above projected inflation. Staff's preliminary estimates suggest that, based on a more realistic macroeconomic framework and somewhat more conservative revenue estimates, the general government deficit could approach 3¼ percent of GDP (Table 3). To achieve the staff's recommended deficit target under an adjustment scenario would require measures of up to 1½ percent of GDP, as lower nominal GDP growth would cut into nominal revenue while nominal spending would remain roughly unchanged. A fiscal package to achieve this target could include: expenditure cuts, including to subsidies, net lending, and goods and services; a lower minimum wage increase in line with inflation; and further reduction of tax expenditures. In addition, to reduce the risk of a discretionary loosening of the fiscal stance in 2006, the staff urged the authorities to eliminate the provision that allows spending of excess privatization receipts without previous parliamentary approval.

Ukraine: Options for Fiscal Measures in 2006

	2006	
	In Hrv million	In percent of GDP
Sum of fiscal measures (1+2+3)	**7,804**	**1.6**
1. Expenditure cuts	3,580	0.7
Align public wage increase to inflation	674	0.1
Reduce subsidies and net lending	1,316	0.4
Reduce state payroll by 2 percent and cuts on goods and services	1,490	0.2
2. Tax preferences	3,024	0.6
VAT exemptions and zero ratings on transport and cars	516	0.1
VAT, elimination of special agriculture regimes	1,968	0.4
Excise	540	0.1
3. Pension fund	1,200	0.2
Lower net spending due to smaller minimum wage increase	1,200	0.2

21. **The authorities aim at resolving the VAT refund arrears problem, but some steps may not be effective**. They have abandoned a recently-introduced risk-oriented audit scheme, owing to its heavy information requirements. Instead, they intend to legalize their practice of denying refunds to any claimant who sources from a chain where VAT was not paid. On the positive side, they are strengthening their reporting systems to identify fraud at

[5] Furthermore, the next parliament elected in March 2006 could also revisit the 2006 budget.

an earlier stage. The mission urged the authorities to reconsider risk-based audits, but based on a simpler approach.

22. **Regarding the medium-term fiscal policy agenda, the staff suggested that many needed reforms could be implemented over time in a self-financing manner**. For instance, raising low civil servant wages could be addressed by cutting excessive employment over time; tax-rate cuts could be offset by broadening the tax base (including through reform of the simplified taxation regimes and improvement in tax administration); and additional social spending on health and education could be financed by better targeting of benefits. Increased reliance on public private partnerships to finance public investment would be another option to help bridge resource gaps, but the staff strongly cautioned against such an approach, at least until a capacity to monitor and assess related risks can be built up.

23. **The mission also argued that decisive pension reforms will have to be a key part of the medium-term fiscal policy agenda**. The recent pension hikes have effectively dismantled the multi-pillar system envisaged by the 2003 reform.[6] Ukraine's pension system is now one of the most expensive in the world, and massive budget transfers are needed to cover contribution shortfalls. Furthermore, each contributor to the pension fund is already effectively supporting one pensioner, suggesting that higher labor taxation will not be a feasible solution. Ukraine's difficult demographic outlook also points to a need for early action. The mission suggested that the focus should be on better targeting the minimum pension subsidy, lifting retirement ages, and pruning privileged pension regimes. To build support for the reform, the mission suggested that the authorities strengthen transparency regarding the cost of the privileged pension regimes. The authorities saw little scope for discussing such reforms prior to parliamentary elections.

C. Monetary and Exchange Rate Policy

The monetary framework is evolving slowly.

24. **The roots of Ukraine's high and persistent inflation rate were subject to different interpretations**:

- Staff took the view that the present monetary framework is unlikely to anchor inflation around a low and stable rate. External and internal shocks have provided inflationary impulses, but these impulses have faced little resistance from monetary policy—as higher net international reserves under the de facto peg have translated directly into higher monetary aggregates.

- The NBU, while agreeing that inflation was ultimately a monetary phenomenon, argued that the sharp increases in social spending and public wages, as well as some supply side shocks, have been the main driving forces. In their view, the contribution

[6] See *Selected Issues* paper "Rebalancing Ukraine's Public Pension Finances."

of monetary policy was relatively minor. Moreover, the NBU stressed that last year's near-financial crisis had distorted monetary and credit aggregates, and that it was broadly on track toward achieving the monetary targets outlined in the NBU's 2005 *Monetary Policy Guidelines*.

25. **Staff argued that the monetary stance needs to be tightened to bring inflation back to single digits**. The NBU should more actively absorb excess liquidity and limit monetary growth to a rate consistent with an end-2006 inflation goal of about 9 percent. The mission stressed that the effectiveness of monetary policy would be limited by maintaining the de facto peg. At the time of the mission, staff viewed the NBU's envisaged base money growth target of 38-43 percent for end-2005 as too expansionary to achieve the recommended end-2006 inflation target of about 7 percent. Money demand had slowed faster than projected, reflecting rising inflation and the cooling of the real economy (Figure 3). Staff therefore at the time of the mission recommended a slowdown in base money growth during the remainder of the year (to about 32 percent) and a significant deceleration in 2006 (to about 22 percent) as the decline in velocity was projected to slow further in line with experiences in more advanced transition economies. However, as monetary conditions have not been tightened in the interim, money growth and inflation during the remainder of 2005 are now likely to exceed staff's earlier recommendations.

26. **The NBU, while stressing policy uncertainties, argued that its planned monetary stance for 2006 is adequate to reduce inflation to single-digits**. The NBU did not view monetary policy by itself as sufficient to address current imbalances, and called also for tighter fiscal policy and accelerated structural reforms to increase aggregate supply. Moreover, the NBU was concerned that a tighter monetary policy could worsen the growth outlook. In its *2006 Monetary Policy Guidelines*, the NBU envisages a sharp deceleration of monetary aggregates—the lower bounds of the targeted corridors for base and broad money growth are broadly in line with staff recommendations. The NBU's inflation objective of 8.5-9.5 percent for end-2006 is in line with staff's current suggested disinflation path for 2006, but only because the 2005 inflation outturn is now expected to be higher than if policy had been tightened from mid-2005. The NBU underscored that the *Guidelines* are preliminary and may have to be adjusted in response to other policy developments, particularly in fiscal policy, and to changes in the Cabinet of Ministers macroeconomic forecasts.

27. **Staff argued that the NBU can attain lower and more stable inflation by adopting a monetary framework that allows for more exchange rate flexibility**. The current peg has served Ukraine well in the past but seems no longer to be compatible with the objective of low and stable inflation. Staff also stressed that, as Ukraine successfully implements institutional reforms, attracts large capital inflows, and secures sustained growth, it should expect its real exchange rate to appreciate. In this context, the choice facing the authorities was whether real adjustment would take place via nominal appreciation or higher inflation, with staff arguing in favor of lower inflation.

28. **In addition, a more flexible exchange rate would have other advantages**. It could function as a shock-absorber for Ukraine's highly open economy, stem speculative capital inflows, and discipline unwarranted risk-taking by the private sector.

29. **The mission recommended that the authorities move gradually to a managed float, and ultimately to inflation targeting**. The mission urged the authorities to swiftly proceed with their preparations for the new regime, in line with recommendations provided by various MFD technical assistance missions (Box 2). If sufficient progress is made in 2006, the NBU could introduce implicit inflation targeting in 2007, using, for example, its 2006 Monetary Policy Guidelines to communicate the characteristics of the new regime.

30. **While the NBU reiterated its commitment to move to an inflation targeting framework, it favored a gradual approach not bound by a specific timeframe**. The NBU stressed that more exchange-rate flexibility would eliminate a key anchor of stability while also negatively impacting competitiveness; a concern in light of the shrinking trade surplus and the slowing economy. The NBU also emphasized the need to find a shared view on exchange rate policy among the main government agencies.

Box 2. Preparing Inflation Targeting

MFD has provided substantial technical assistance to support preparations for more exchange rate flexibility, as well as in support of an ultimate move to inflation targeting. The focus was on developing Ukraine's financial infrastructure and strengthening the monetary transmission mechanism. Both are important preconditions for effective monetary policy, but even more so under inflation targeting. The main recommendations included:

Develop foreign exchange markets by: (i) allowing banks to conduct forward operations and to trade in both directions within the same day; (ii) eliminating the current limited trading session; (iii) reconsidering the 1.5 percent tax on foreign exchange operations; and (iv) making the NBU reference exchange rate more transparent. Most recommendations were implemented in August 2005.

Improve banks' risk-management capabilities by: (i) allowing the use of hedging instruments; (ii) encouraging banks to extend loans in foreign currency to borrowers who have foreign exchange income and who are appropriately hedged against foreign exchange risks; and (iii) conducting a survey on banks' direct and indirect foreign exchange rate exposures, and closely monitoring banks' ability to manage these exposures.

Strengthen monetary policy operations by: (i) communicating more clearly the NBU's main policy rate; (ii) engaging in more active liquidity management through open market operations; (iii) securitizing the NBU loan to the government, which could then be used for open market operations; (iv) improving coordination between monetary and fiscal policy; and (v) promoting development of interbank and government securities markets to provide benchmark interest rates.

Dealing with volatile capital inflows by: (i) reducing incentives for short-term inflows, including by increasing the flexibility of the exchange rate and maintaining a consistent monetary-exchange rate-fiscal policy mix; (ii) carefully sequencing capital control liberalization, including by liberalizing some controls on capital outflows; (iii) avoiding new capital controls; and (iv) better monitoring and analyzing the nature of capital flows.

31. **The NBU has plans to revitalize a long-term lending facility for banks, which staff has opposed firmly on earlier occasions**. The NBU argued that such a facility would allow it to expand its monetary policy tool kit and improve credit intermediation in the economy. Staff noted that a similar facility, operated by the NBU during 2003–04, was eliminated since it was viewed as interfering with the monetary policy function of the central bank, exposing the NBU to considerable credit risk, and distorting market-determined financial intermediation.

D. Near-Term Outlook

Given policy and other uncertainties, the near-term outlook is clouded.

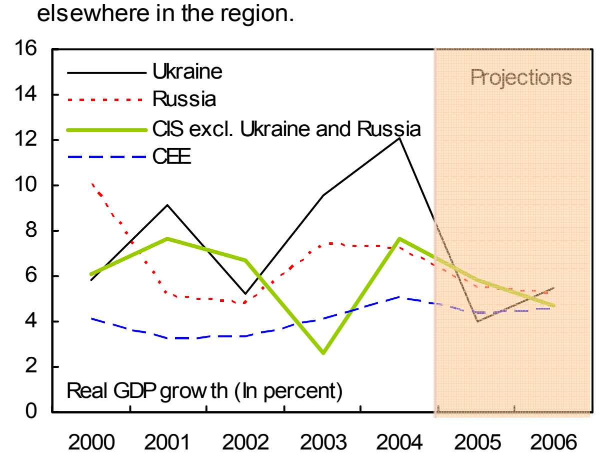
32. **Compared with both official and staff forecasts, growth in 2005 has been disappointing**. With preliminary data suggesting that GDP growth over January–August 2005 has declined to about 3 percent (relative to the same period last year), and with a strong rebound in investment unlikely before next year, growth in 2005 is projected to slow to 4 percent. From a regional perspective, Ukraine's growth slowdown stands out and seems mostly driven by factors specific to Ukraine. Staff project a modest recovery in investor confidence after the March 2006 elections, but this will likely be offset by a further deterioration in Ukraine's external environment. Easing demand for Ukraine's exports, combined with significantly higher energy import prices, will result in a decline in Ukraine's terms of trade—which are assumed to drop by about 6 percent in 2006. The net impact is an expected 2006 growth rate of about 5½ percent, underpinned in large part by continued strong consumer demand.

Contributions to Growth
(In percent)

	2003	2004	2005	2006
		Prel.	Baseline scenario	
Total domestic demand	11.4	9.7	6.9	7.2
Private consumption	5.5	9.6	5.9	5.8
Public consumption	1.2	0.8	0.1	0.2
Gross fixed investment	4.2	2.1	-0.4	1.2
Changes in inventories	0.6	-2.8	1.3	0.0
Net exports	-1.8	2.4	-2.9	-1.7
Exports of GNFS	4.5	8.0	2.0	2.9
Imports of GNFS	-6.4	-5.6	-5.0	-4.6
Real GDP growth	**9.6**	**12.1**	**4.0**	**5.5**

Sources: Ukrainian authorities; and staff estimates and projections.

Output growth in Ukraine is slowing faster than elsewhere in the region.

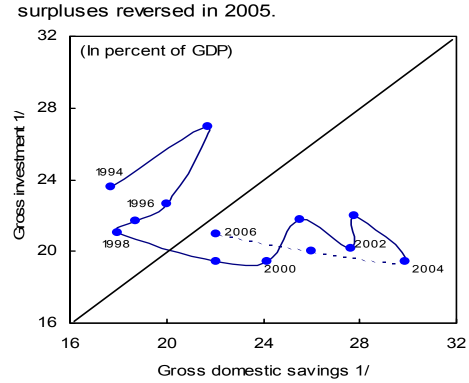


Sources: IMF *World Economic Outlook;* and staff estimates and projections.

33. **Present policies are unlikely to bring 2006 inflation back into single digits**. The current budget envisages further social payments in the final quarter of 2005, adding to upward pressure on household demand and consumer prices. Moreover, sharply increased gasoline prices this year have raised transport and business costs and will continue to impact the general price level. In sum, staff project that CPI inflation will remain firmly in the double digits in 2005, with an end-year outcome of around 14 percent. Looking forward into 2006, the baseline scenario assumes that long-anticipated increases in utility prices and tariffs will be delayed until after the March 2006 elections, complicating efforts to bring inflation down in 2006. On the basis of the authorities' announced policy intentions—with continued monetary accommodation and no fiscal tightening—staff project that inflation will likely remain in double digits.

34. **Reflecting a significant downward shift in savings, Ukraine's current account surplus is projected to shrink rapidly in the near term**. As noted above, fiscal policy over 2004-05 has effected a sizeable reallocation of resources from the high-savings corporate sector to the low-savings household sector. So, while investment has remained subdued, savings have fallen significantly—the counterpart to this fall has been a decline in the current account balance, with buoyant household demand prompting a surge in import volumes.

Ukraine's trend of expanding current account surpluses reversed in 2005.



Source: IMF *International Financial Statistics; and staff projections* .
1/ 2005-06 are staff projections.

35. **Staff outlined to the authorities an adjustment scenario that would bring 2006 inflation back below 10 percent**. Fiscal policy would need to play a key part in this effort, with a general government deficit of 2¼ percent of GDP and a real freeze on recurrent spending. On monetary policy, staff recommended a significant slowdown in the rate of money growth in 2006. Staff also recommended that the NBU move to a more flexible exchange rate—which would provide the autonomy needed to focus on inflation, and would ease the burden on other policy measures if foreign exchange inflows were to persist. Under the adjustment scenario, staff projected that inflation could be reduced to 9 percent in 2006, with little impact on growth (the combined impact of tighter policy and a possible nominal appreciation was unlikely to exceed half a percentage point).

36. **Looking ahead, macroeconomic policies should be implemented in a more coordinated fashion**. Over the past year, policies were not well coordinated; with procyclical fiscal spending policies fuelling inflation, monetary policy putting up insufficient resistance against inflationary pressures, and structural policies undermining the economy's supply side and growth momentum. Moreover, communication on policies has sometimes left the public confused about policy objectives and responsibilities. The NBU noted that efforts are underway to address these problems, including by reaching a formal coordination agreement among key policy makers.

E. Institutional Reforms and Medium-Term Framework

Medium-term growth opportunities are considerable.

37. **The crux of Ukraine's growth problem is low production efficiency, which in turn is rooted in market-unfriendly institutions**. Cross-country data suggest that Ukraine uses its physical and human resources poorly, even when compared with other transition economies. Furthermore, staff's analysis suggests that this stems from weakness, in Ukraine, of those institutions needed to create and regulate markets—proxied by indicators that capture the security of property rights, degree of corruption, competence of civil servants, and regulatory quality (Figure 7).[7]

38. **But reform of market-enhancing institutions seems to have essentially stalled since 1998**. The investment and business climate in Ukraine remains daunting—confronting entrepreneurs with complex regulations, bureaucratic discretion, and corruption. Ukraine continues to perform poorly according to Transparency International's corruption perception index, ranking 122 out of 146 countries in 2004. And broad governance indicators suggest that this state of affairs seems to have changed little since the 1998 crisis (Figure 7). Moreover, the strength of market-friendly institutions in Ukraine continues to lag behind the more successful transition countries.

39. **Against this backdrop, the authorities have placed institutional reforms at the top of their policy agenda**. The president in particular has stressed the key role of market-enhancing institutional reforms in improving the living standards of Ukraine's citizens. As a strategic choice, the authorities have also emphasized the benefits of anchoring Ukraine's reform drive within a program of closer integration with the European Union and global markets. To this end, the authorities have sought to transpose the Ukraine-EU Action Plan into specific reforms and measures, including many that have long been advocated by the Fund and other IFIs (Table 10).

40. **The authorities pointed to several achievements and reform plans**. Notable achievements included: (i) adoption of legislation to simplify the permit system, and to mutually offset and restructure the debts of the energy sector; (ii) considerable reduction of import tariffs on food products, appliances, and some groups of industrial equipment; and (iii) establishment of a telecommunications regulatory agency. Noteworthy plans include: (i) presidential decree on eliminating corruption and reforming customs administration and procedures; (ii) adoption of a Cabinet of Ministers concept for comprehensive reform of the internal financial control and auditing system; and (iii) legislation on regulating the scope and modus of reviewing past privatizations, which was pending before the dismissal of the previous government. The previous government also announced a large number (about 3000) of targeted cuts in red tape and regulations, and the first steps have already been taken to establish a new agency to assist foreign investors.

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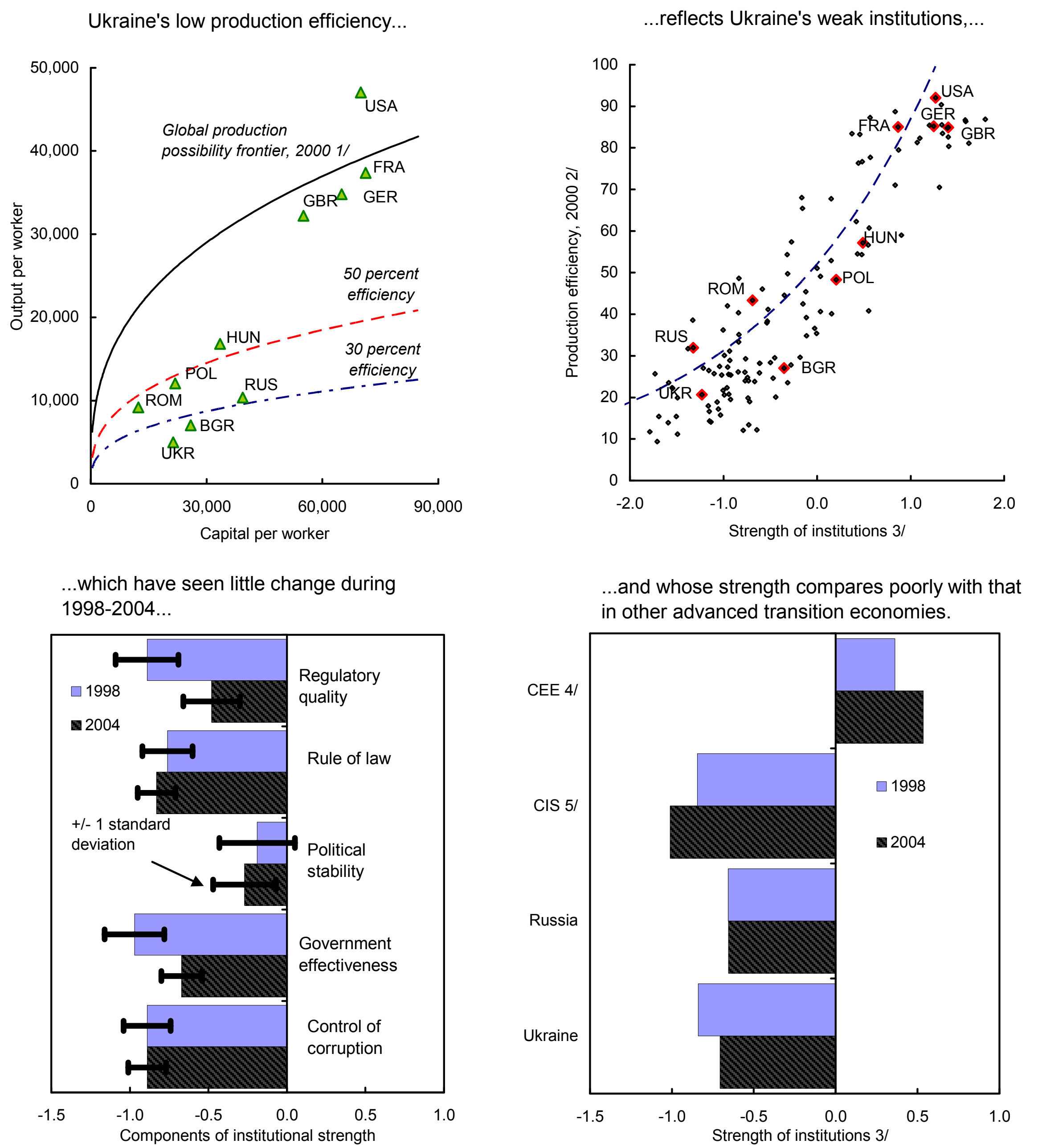
[7] See the *Selected Issues* paper "The Efficiency Cost of Market-Unfriendly Institutions."

Figure 7. Ukraine: Institutions and Production Efficiency, 1998–2004



Sources: World Bank Governance Database; and staff estimates.
1/ The frontier represents the implicit output that could be obtained if a country were to employ all its resources efficiently, using global best practices.
2/ Measures how closely (in percent) a country operates to the global production possibility frontier.
3/ Measured using the principal component of indices compiled in the World Bank Governance Database (ranging from -2.5 to +2.5) comprising rule of law, political stability, control of corruption, government effectiveness, and regulatory quality.
4/ Including: Hungary, Poland, Czech Republic, Slovak Republic, Estonia, Croatia, Latvia, Lithuania, Romania, Bulgaria, Slovenia.
5/ Excluding Ukraine and Russia.

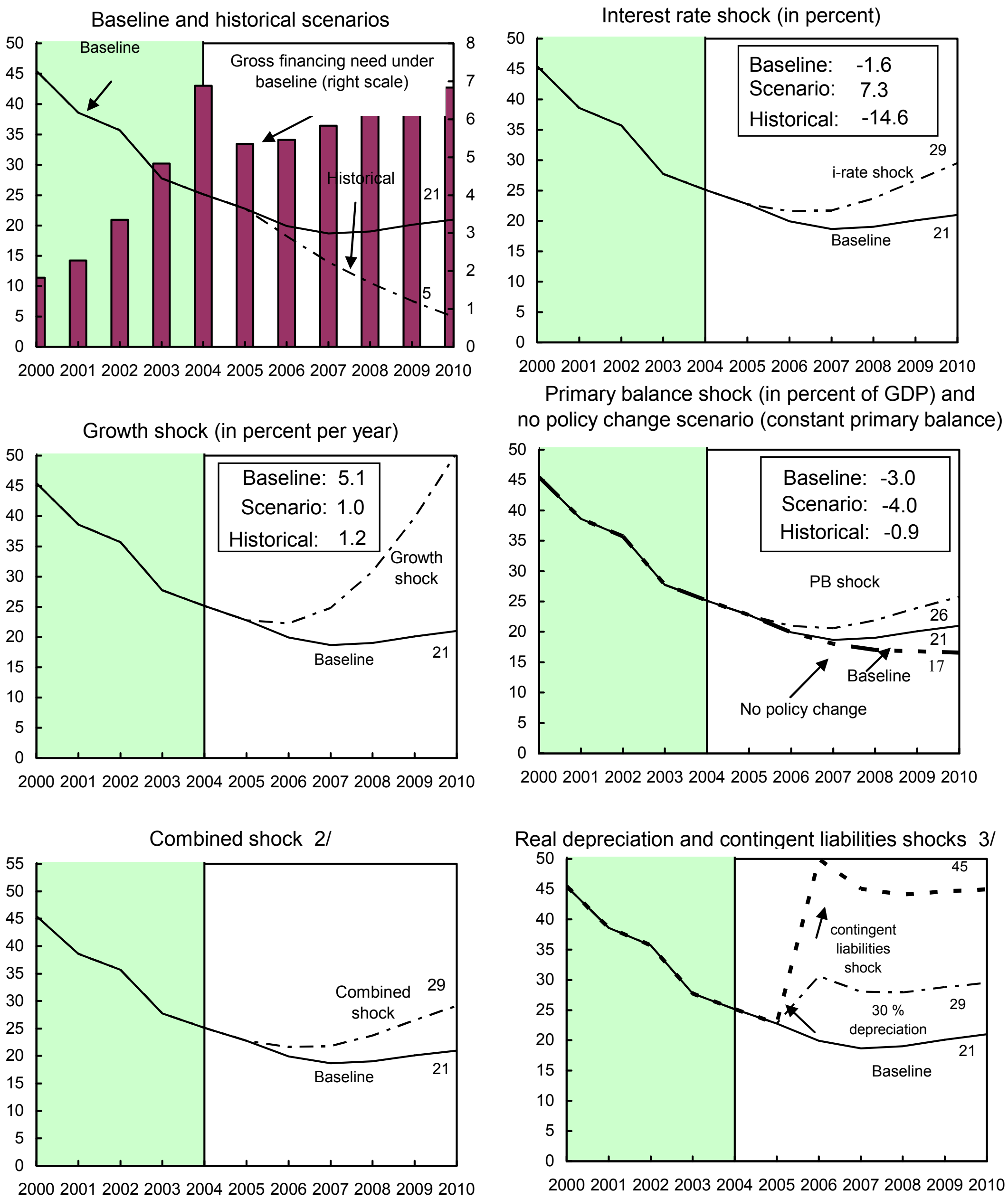
41. **The staff's medium-term baseline scenario assumes a sustained structural reform effort, but allows for delays or slippages**. Stalled or unsuccessful institutional reforms would sharply limit Ukraine's longer-term growth potential, and might conceivably be associated with increased macroeconomic instability, as implied by Ukraine's own experience during the 1990s. On the other hand, under the staff's cautiously optimistic baseline, a moderately successful reform effort would help boost productivity and support a trend growth rate of about 5 percent. At the same time, if the authorities were to implement their reform agenda in full, the experience of other transition economies suggests that productivity can be increased significantly, consistent with a medium-term growth rate as high as 8-9 percent (Table 6).[8] With higher growth relative to the baseline, and assuming the debt-GDP ratio is kept constant at about 16 percent of GDP over the medium term, this could free up budgetary resources of about 2 percent of GDP annually, which could be used to foster additional fiscal reforms. On inflation, the baseline scenario assumes that, as part of a move to inflation targeting, the authorities will succeed in bringing average inflation down into single digits in 2007; a similar monetary policy regime is assumed in the higher-growth scenario, but this scenario also includes front-loaded policy adjustments in 2006, consistent with a lower inflation path in 2006-08. This would then place Ukraine within range of a feasible longer-term inflation target (4-5 percent) by 2009.

42. **Public debt is low and sustainable, assuming that risks from the savings lost during the 1990s hyperinflation are contained**. Sensitivity analysis suggests that only a collapse in medium-term growth or the recognition of lost savings as public debt would pose a serious threat (Table 8 and Figure 8). In particular, recognition of the lost savings as debt (up to 30 percent of GDP) could more than double the current level of public debt. The parliament and president have both made proposals in 2005 to repay this debt over extended periods of time, and without awarding interest. In staff's view, any settlement would need to be sustainable and final, and carefully designed in view of financing, macroeconomic, and budget impacts. Certain means of settlement, for instance mutual debt cancellation (which has been utilized in 2005), should not be considered in view of adverse incentive effects.

43. **Externally, the baseline assumes continuing healthy export growth, but the economy is also projected to return to an external deficit**. The current account is forecast to switch to moderate deficits by the end of the projection period. These deficits should be comfortably financed by capital inflows, especially foreign direct investment and private long-term borrowing. In this setting, gross international reserves should remain at adequate levels, both in terms of import coverage and in relation to short-term debt. The changing

[8] The higher-growth scenario is based on the assumption that the authorities implement their ambitious reform agenda in full: i.e. the scenario assumes that, over the next decade, Ukraine will have successfully met all the requirements for EU membership. A precise policy roadmap is difficult to outline at this stage, and will likely evolve over time.

Figure 8. Ukraine: Public Debt Sustainability: Bound Tests[1/]
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 30 percent of GDP shock to contingent liabilities occur in 2006 (to simulate recognition of "lost savings"), with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

structure of the balance of payments is appropriate for an emerging market economy like Ukraine, but also opens up new financial vulnerabilities—vulnerabilities that have been largely avoided so far, owing to Ukraine's recent relatively high-savings, low-investment path. Key factors underpinning the medium-term switch in the current account position include: an increase in investment; more rapid productivity growth relative to Ukraine's main trading partners; and real appreciation (mainly through nominal exchange rate flexibility rather than high inflation).

44. **The medium-term outlook is subject to a number of external risks and opportunities**.[9] On the current account, external risks include a much sharper-than-projected reduction in world metal prices, a slowdown in metal export markets, or a rapid convergence of Ukraine's energy import prices, particularly for natural gas, to world levels. These risks could entail a much sharper deterioration of the current account and an adverse impact on growth. In this context, Ukraine's relatively high external debt, which is significant by the standards of most transition countries, suggests that, without substantial FDI inflows, Ukraine could have difficulties running large and sustained current account deficits in the future (Figure 9, Table 9).[10] By contrast, there are significant opportunities on the capital account. In particular, deep institutional reforms could result in FDI and other long-term inflows that are higher than envisaged in the baseline, mirroring the experience of the more successful transition economies. At the same time, the economy could also be faced with more volatile short-term capital flows.

F. Financial Sector Issues and Vulnerabilities

45. **There was broad agreement that bank credit risks need to be monitored most closely**. Staff highlighted the banking system's large exposure to credit risk, especially against a deteriorating macroeconomic outlook, opaque ownership structures, and concerns about capitalization. The increasing exposure to the real estate market, either through mortgage and construction lending or through collateral, could become a major vulnerability over the medium term if recent real-estate price increases were to reverse (housing prices have quadrupled over the past 3½ years). Such risks could be exacerbated by populist government policies aimed at boosting mortgage lending at below markets rates, as envisaged in a recent plan for the State Mortgage Corporation, which, however, has not found majority support in parliament. The NBU broadly agreed with the assessment and stressed the need to improve the quality of bank capital to provide appropriate buffers against shocks. In that vein, it plans to further tighten asset revaluations, has increased the minimum core capital adequacy ratio from 4 percent to 5 percent, and has reduced the ceiling on related-party lending. It also plans to strengthen banks' reporting requirements on mortgage lending.

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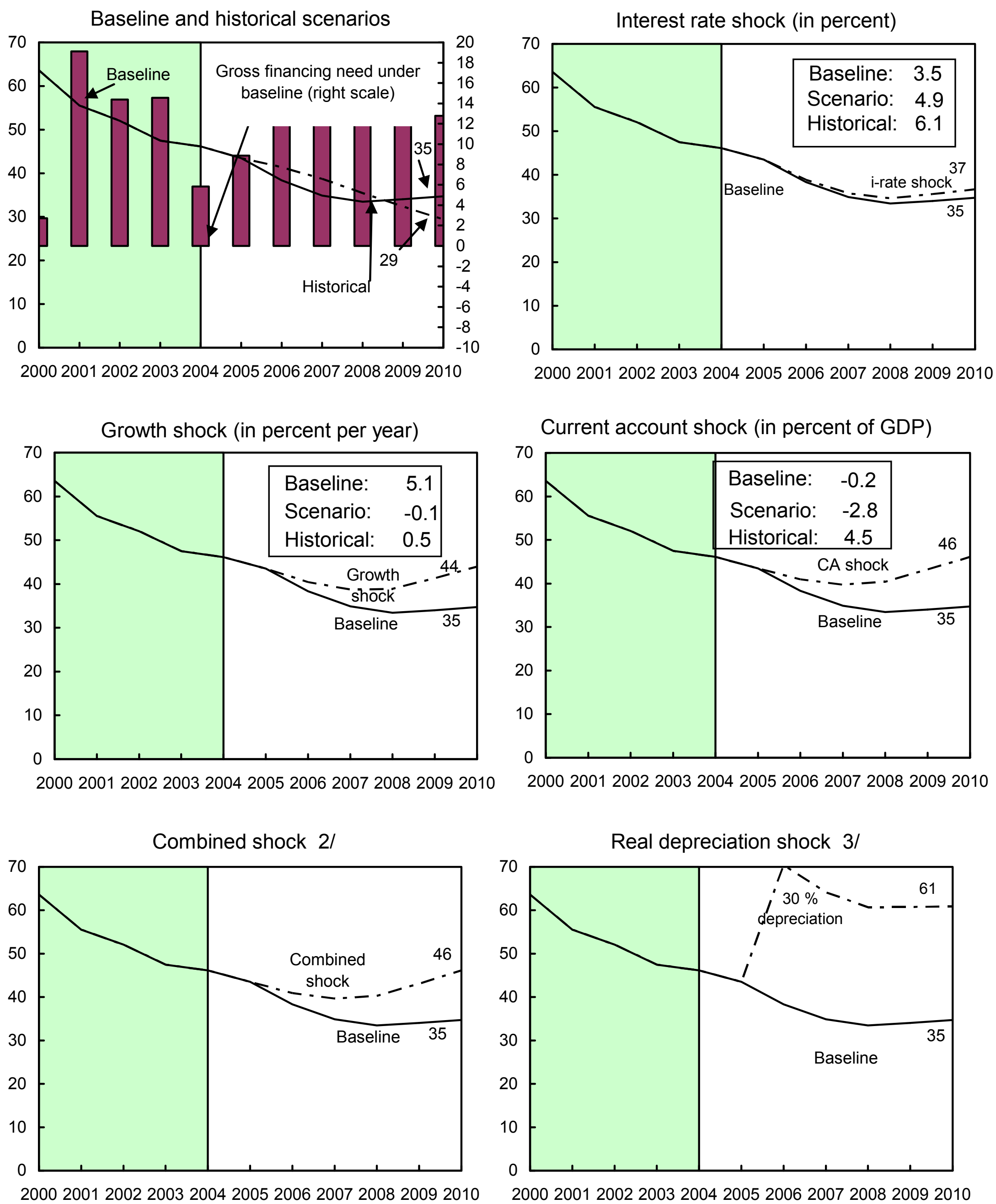
[9] See the *Selected Issues* paper "Ukraine: External Risks and Opportunities."

[10] But external private debt, at some 25 percent of GDP in 2004, may include extensive on-lending by residents to their own corporations through off-shore accounts.

Figure 9. Ukraine: External Debt Sustainability: Bound Tests[1/]
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

The mission applauded these steps but reiterated that an increase in the minimum capital adequacy ratio from 10 percent to 12 percent would serve as a further safeguard until risk-management practices and the quality of capital improve.

46. **But other risks also warrant attention**. The mission argued that proper foreign-exchange risk management will be key if banks are to adjust to an environment of more exchange rate flexibility. In light of Ukraine's political uncertainties, liquidity risk also remains a concern and has prompted the NBU to submit draft amendments to legislation that would limit early withdrawal of deposits. To address other risk-related concerns, the NBU has reduced limits on open foreign exchange positions and tightened loan-loss provisioning requirements. While the NBU has strengthened regulatory requirements, its supervisory practices remain rigidly procedural rather than risk-based, as observed by representatives of private banks. The mission also encouraged implementation of MFD recommendations on strengthening the process of bank resolution.

G. Trade Policy

47. **The authorities have made progress in implementing their ambitious trade policy agenda**. The government has set itself two key trade policy objectives for 2005: (i) acceding to the WTO; and (ii) receiving market economy status from the EU. To ensure WTO-conformity of Ukrainian laws, parliament has adopted a number of key bills, including on intellectual property rights. Moreover, significant tariff cuts have been enacted; and parliament has also adopted legislation to lower the 17 percent export tax on sunflower seeds by 1 percentage point per year upon WTO accession. But several WTO bills, particularly on agricultural issues, have faced strong parliamentary opposition. Ukraine also still needs to complete bilateral negotiations with a number of countries, including the United States. While Ukraine seems close to being granted EU market economy status, recent issues raised included bankruptcy laws, price controls, and the re-surgence of VAT refund arrears.

H. Statistics

48. **There seem to be no compelling reasons to doubt the broad integrity of the 2004 national accounts data**. Several senior government officials have noted that export and GDP statistics for 2004 might have been significantly overstated, reflecting fraudulent VAT refund claims, and that this could explain part of the growth slowdown in 2005. The Statistical Office took the view that, while investigation of the issue is pending, there are no strong reasons to adjust the national accounts data before 2005. Staff's own preliminary analysis suggests that Ukraine's export data seem to be broadly consistent with direction-of-trade statistics, as well as the import growth of Ukraine's trading partners, and dollar-price trends of Ukraine's main exports.

IV. RELATIONS WITH THE FUND

49. **The EPA attributes Ukraine's disappointing transition experience mainly to a lack of political consensus, particularly on building more market-friendly institutions**. Following a very difficult start (1992-94), Ukraine made gradual progress on macroeconomic stabilization, but output kept tumbling owing to the slow pace of structural reforms (1995-99). In the aftermath of the 1998 financial crisis, the economy rebounded strongly (2000-04), supported by a favorable external environment, a highly competitive real exchange rate, the authorities' limited but focused structural reform efforts, and maintained fiscal discipline—the latter partly necessitated by financing constraints. But indicators of the institutions needed to create and regulate markets, which are vital in raising production efficiency and sustaining long-term growth, have improved little since 1998. Tackling long-delayed institutional reforms should therefore be at the top of the authorities' policy agenda, as indeed recognized by the Ukraine-EU Action Plan.

50. **Based on this broad assessment, the EPA concludes that better program ownership, rooted in stronger political consensus, would be key in improving the chances of success for a potential future program-based engagement**. The EPA notes that Fund-supported programs were quite effective in supporting macroeconomic stability, but did not help much in accelerating market-friendly institutional reforms, explaining Ukraine' poor program compliance. The EPA also finds that transfer of macroeconomic knowledge through continuous policy dialogue was a crucial pay-off from longer-term Fund engagement. The success of a potential future program, if considered as an alternative to continued surveillance, would depend critically on program ownership, including whether structural reforms can be anchored externally, for example by the Ukraine-EU Action Plan. In this vein, prior actions should focus on demonstrating that the authorities command sufficient political and social consensus to assure program success.

51. **The authorities felt that the EPA put too much stress on the role of lagging institutions in accounting for Ukraine's transition experience, while shortcomings in the Fund's past advice received too little attention**. They highlighted in particular the significant progress on building fiscal and monetary policy institutions since 1998, with key support from the Fund. As regards accounting for the 2000-04 growth rebound, they thought too much weight was given to favorable external conditions, while the contribution of the government's structural reforms was underplayed. They also felt that the EPA should have refrained from discussing the link between market institutions, which were seen as outside the Fund's competence, and Ukraine's longer-term growth experience. Instead, the EPA should have focused only on fiscal, monetary, and financial sector issues.[11] Finally, they also noted that past Fund advice has often been provided without outlining alternative policy options, and that it insufficiently reflected Ukraine's specific conditions. The authorities did not express a view on the desirability of a near-term IMF-supported program engagement.

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[11] In response, the discussion in the EPA was adjusted by adding Box 3, which draws a distinction between market-stabilizing institutions and market-enhancing institutions.

V. Staff Appraisal

52. **While Ukraine faces considerable challenges, a focused improvement in policies would help unleash the economy's significant untapped potential.** Ukraine's highly open economy, undiversified export structure, and terms-of-trade gains expose it to considerable external risks. However, with more coherent policies and a focused effort at restoring and maintaining macroeconomic stability—combined with sustained implementation of the authorities' structural reform agenda—Ukraine's inefficient economy should respond strongly, allowing catchup growth to resume.

53. **Over the last year, GDP growth has slowed sharply, while inflation has surged into double digits**. Over 2000–04, Ukraine's economic performance has been impressive; reflecting in part a favorable combination of external factors, but also reflecting a generally prudent set of macroeconomic policies, especially fiscal policy. But, during the run-up to the 2004 presidential elections, fiscal policy shifted abruptly to a procyclical stance. And while the supplementary 2005 budget targeted an appropriately lower deficit, it nevertheless added to inflationary pressures by raising public pensions and wages, while increasing an already-heavy tax burden. Monetary policy has remained largely focused on defending the peg against the U.S. dollar, and has for the most part accommodated excess demand pressures. Finally, progress on structural policies has remained limited, while a protracted debate on past privatizations of state-owned enterprises has raised concerns as to the security of property rights, further clouding an already difficult investment climate.

54. **Tighter monetary conditions are needed to contain inflation**. The NBU should actively reduce excess liquidity in the banking sector, by constraining money growth to rates consistent with the goal of single-digit inflation. This will most likely require a significant deceleration in money growth in 2006, especially in light of the current liquidity overhang. The lower bound of the NBU's currently envisaged monetary growth corridors for 2006, when combined with appropriate other macroeconomic policies, would be broadly in line with bringing inflation below 10 percent by end-2006.

55. **The introduction of more exchange rate flexibility and an inflation targeting framework would provide better leverage for achieving low and stable inflation.** The peg served Ukraine well in stabilizing inflation following the Russian crisis, but it now fails to provide a firm nominal anchor. Looking forward, current-account related inflows will continue to result in reserve accumulation under a maintained peg, given that the real exchange rate still appears undervalued, notwithstanding the recent real appreciation. Moreover, and in line with Ukraine's substantial investment needs, sound macroeconomic policies and institutional reforms could attract significant capital inflows.

56. **Tentative steps toward a more flexible exchange rate regime are welcome, but the NBU should also communicate its policies more consistently**. While the shift to a more flexible exchange rate is neither simple nor risk free, Ukraine would still move from a position of relative strength and could proceed gradually. But the modalities of the new regime would need to be explained transparently to avoid market confusion. In this vein, the NBU should build on its recent efforts—which have included significant deregulation of the

exchange rate market—and continue to strengthen its operational framework and the development of financial markets. The NBU's tentative plans to expand its tools and support bank intermediation by a long-term credit facility should be re-considered. The NBU should see its main role in providing liquidity, rather than longer-term credit, to the banking system.

57. **Fiscal policy needs to support disinflation in 2006**. For 2005, the authorities should seek to achieve the budget deficit target of 2½ percent of GDP, while clearing all legitimate VAT refund arrears. For 2006, the draft budget submitted to parliament in mid-September, while targeting a general government deficit of 2½ percent of GDP, appears to be based on unrealistic macroeconomic assumptions. Moreover, it contains policies that might be revisited. Staff recommends maintaining a tight fiscal stance in 2006, including by targeting a general government deficit of 2¼ percent of GDP and freezing re-current expenditures in real terms. If new initiatives in the draft budget are upheld, they should be financed through spending cuts or measures to broaden the tax base.

58. **There is also a strong case for improving policy coordination between the government and the NBU**. International experience shows that assigning clear objectives and roles to policy makers is key for ensuring macroeconomic stability and sustained growth. Staff therefore welcomes a recent NBU initiative to reach a more formal understanding on policy coordination between the NBU and the government.

59. **Restoring a viable public pension fund would open significant room for higher public investment and lower taxes in the medium-term**. The recent pension hikes have put the pension fund in a precarious financial position, requiring large budget transfers to cover contribution shortfalls and constraining the room for reducing the high tax burden on labor. The authorities' focus should be on better targeting the minimum pension subsidy, lifting retirement ages, and pruning privileged pension regimes.

60. **The main impetus for sustained growth will have to come from the new administration's welcome vision of sweeping structural reforms**. Even accounting for the growth rates of 2000-2004, Ukraine's performance has lagged significantly behind that of most other transition economies; and this shortfall ultimately reflects a failure to agree upon and build the market-enhancing institutions that would allow Ukraine to use its resources more efficiently. An ambitious reform agenda is both timely and appropriate, and the new administration's goals in this regard are promising—the Ukraine-EU Action Plan commits the authorities to a wide range of actions, anchoring the institutional reform drive within closer integration with the EU and global markets.

61. **A rapid resolution of the debate on past privatizations is needed**. The recent presidential memorandum guaranteeing property rights, as well as the government's efforts to clearly and quickly identify those state enterprises to be privatized, along with the official commitment to fully comply with privatization legislation is welcome. However, a credible legislative proposal is needed that outlines the full scope of possible challenges to past privatizations. Such a proposal would help eliminate investor uncertainty and strengthen the prospects for successful new privatizations. More broadly, the authorities should give priority to improving the investment climate. Entrepreneurs and investors currently have to negotiate

a daunting array of excessive, opaque, and discretionary regulations, so the authorities' goal of targeting some 3,000 unhelpful regulations for elimination is a welcome first step.

62. **The ambitious trade-policy agenda is also highly welcome**. Trade will be key in improving overall productivity, leading to the creation of new and better-paid jobs, and also helping improve corporate transparency. The liberalization achieved so far this year constitutes an important step, but early implementation of the pending measures needed for WTO membership should remain a priority.

63. **Development of domestic capital markets is important**. In line with earlier Fund and World Bank recommendations, the authorities should focus on establishing benchmark issues for government securities, setting up a coherent debt management strategy, and swiftly adopting a Joint Stock Company Law. In addition to their role in risk management and financial intermediation, more developed capital markets will facilitate the shift to inflation targeting by strengthening the transmission mechanism.

64. **The financial sector's supervisory framework should be strengthened further**. Regulatory changes to tighten requirements have been positive, including: foreign-currency loan-loss provisioning; open foreign currency positions; limits for related-party lending; and the definition of capital. But it is essential to approve the long-delayed amendments to the Banking Act, which would require identification of bank owners. Revisions to the Civil Code and the Banking Act to limit early withdrawal of deposits should also be a priority to safeguard against a future liquidity crisis. Moreover, the authorities should move from their current, highly-procedural supervision methods to a more risk-based framework, and they should strengthen their bank resolution process. Also, improving the quality of capital is key, so until this is achieved and the structural weaknesses of the banking system have been overcome, the authorities should consider raising the minimum capital adequacy ratio to 12 percent.

65. **There has been tangible progress on statistics, which are broadly adequate for surveillance, but shortcomings remain**. The recent controversy about the integrity of the 2004 export and GDP statistics should be resolved speedily, based on impartial assessments. Further improvements of statistical data should focus on reconciling stock data on sectoral financial assets and liabilities with flow data, particularly on the external side. Also, the quality of labor market data, particularly on wages and employment, could be improved.

66. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Ukraine: Selected Economic and Social Indicators, 2001–06 1/

	2001	2002	2003	2004	2005	2006	
				Prel.	Proj.	Baseline scenario 2/	Adjustment scenario
Real economy (percent change unless indicated otherwise)							
Real GDP	9.2	5.2	9.6	12.1	4.0	5.5	5.0
Nominal GDP (in billions of hryvnias)	204.2	225.8	267.3	345.9	415.5	499.8	486.5
Unemployment rate (ILO definition; percent)	11.8	10.1	9.1	6.1	...	...	...
Consumer prices, period average	12.0	0.8	5.2	9.0	14.2	14.4	12.1
Consumer prices, end of period	6.1	-0.6	8.2	12.3	14.0	13.0	9.0
Average monthly wages, annual average	34.9	20.7	23.0	27.7	...	...	...
Public finance (in percent of GDP)							
Cash balance	-1.6	0.5	-0.9	-4.4	-2.9	-3.2	-2.3
Revenue 3/	33.5	36.0	35.9	35.0	39.7	38.4	38.4
Expenditure (cash basis)	35.1	35.5	36.8	39.4	42.7	41.5	40.7
Primary balance (cash basis)	0.4	1.8	0.1	-3.5	-2.1	-2.1	-1.2
Commitments balance 4/	-1.5	0.2	-0.1	-3.6	-2.8	-3.1	-2.2
Privatization proceeds	1.3	0.5	1.1	3.1	0.8	1.8	1.8
Net domestic financing	-0.1	-0.3	-1.2	-0.1	1.4	0.8	-0.1
Net external financing 3/	0.4	-0.7	1.0	1.5	0.7	0.5	0.6
Public debt and arrears 5/	38.6	35.7	27.7	25.1	22.8	19.9	18.5
o.w. external debt	26.6	24.0	21.6	19.2	15.6	12.5	12.3
Money and credit (end of period, percent change)							
Base money	37.4	33.6	30.1	34.1	42.1	24.5	21.8
Broad money	41.9	41.8	46.5	32.3	41.0	27.9	25.1
Credit to nongovernment	40.5	47.3	63.4	31.2	29.5	33.9	30.3
Velocity 6/	4.46	3.48	2.78	2.75	2.34	2.20	2.19
Balance of payments (in percent of GDP)							
Current account balance	3.7	7.5	5.8	10.5	6.0	1.2	1.1
Foreign direct investment	2.0	1.7	2.8	2.7	1.6	2.4	2.6
Gross reserves (end of period, in billions of U.S. dollars)	3.1	4.4	6.9	9.5	16.0	18.2	18.8
In months of next year's imports of goods and services	1.7	1.9	2.4	2.7	3.9	4.1	4.1
Debt service (in percent of exports of goods and services) 5/	6.7	5.4	6.2	4.8	4.8	5.1	5.1
Merchandise exports (annual volume change in percent)	7.0	7.1	14.1	16.5	3.2	6.9	6.4
Merchandise imports (annual volume change in percent)	12.8	5.9	30.4	15.7	13.8	10.9	10.3
Merchandise exports	45.0	44.0	47.4	51.4	46.8	40.7	38.9
Merchandise imports	44.4	42.4	47.9	46.3	45.4	43.3	42.2
Share of metals in merchandise exports (in percent)	39.3	38.2	35.8	39.1	...	...	...
Net imports of energy (in billions of U.S. dollars)	5.0	4.9	5.1	6.6	...	...	...
Savings and investment (in percent of GDP)							
Foreign savings	-3.7	-7.5	-5.8	-10.5	-6.0	-1.2	-1.1
Gross national savings	25.5	27.7	27.8	29.9	25.4	21.9	22.2
Nongovernment	24.0	24.2	24.2	28.0	24.7	21.4	20.8
Government	1.5	3.5	3.6	1.9	0.7	0.5	1.3
Gross investment	21.8	20.2	22.0	19.4	19.4	20.7	21.1
Nongovernment	18.7	17.2	17.7	13.1	15.8	17.1	17.5
Government	3.1	3.0	4.3	6.3	3.6	3.6	3.6
Exchange rate							
Exchange rate regime		*de facto* peg to U.S. dollar					
Hryvnia per U.S. dollar, end of period	5.3	5.3	5.3	5.3	...	...	...
Hryvnia per U.S. dollar, period average	5.4	5.3	5.3	5.3	...	...	...
Real effective rate, (percent change) 7/	6.0	-4.1	-6.3	-0.9	...	...	...

Social indicators

Per capita GDP: US$ 1,311 (2004); **Poverty** (percent of population): 31.7 (2001; national headcount index);
Life expectancy at birth: 68.2 years (2002); **Infant mortality** (per 1,000): 16.0 (2002); **Child malnutrition** (percent of children under 5): 3.0 (2001);
Income/consumption distribution (Gini index): 29.0 (1999); **Gross primary enrollment** (percent of school-age group): 90.5 (2001)

Sources: Ukrainian authorities; and Fund staff estimates and projections.

1/ An updated version of this table can be found in the Staff Supplement.
2/ Based on policy intentions by the authorities and staff's real GDP projections.
3/ From 2003 onwards, based on an accounting treatment that excludes offset-based amortization to Russia, which decreases revenues and increases net external financing (and the budget deficit) by 0.2 percent of GDP relative to previous years.
4/ Cash balance adjusted for the net accumulation of expenditure and VAT refund arrears, as well as for non-cash property income.
5/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
6/ Annual GDP divided by end-period broad money (M3).
7/ Period averages; (+) represents real appreciation; based on CPI and average trade weights for 1996-2002.

Table 2. Ukraine: Medium-Term Balance of Payments, 2001–10
(In millions of U.S. dollars; unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Prel.	Proj.	Baseline scenario				
Current account balance	1,402	3,173	2,891	6,804	4,837	1,186	-941	-2,707	-3,385	-4,278
Merchandise trade balance	198	710	-269	3,741	1,094	-2,602	-5,088	-7,202	-8,279	-9,542
Exports	17,091	18,669	23,739	33,432	37,933	40,237	42,147	44,042	47,623	51,755
Imports	-16,893	-17,959	-24,008	-29,691	-36,839	-42,839	-47,235	-51,244	-55,902	-61,297
Services (net)	415	1,147	1,557	1,132	1,949	2,052	2,208	2,453	2,741	3,047
Receipts 1/	3,995	4,682	5,214	6,287	7,268	8,012	8,754	9,476	10,059	10,672
Payments	-3,580	-3,535	-3,657	-5,155	-5,319	-5,960	-6,546	-7,023	-7,318	-7,625
Income (net)	-667	-606	-581	-645	-848	-1,079	-1,061	-1,154	-1,248	-1,399
Of which: Interest on public debt 2/	-529	-475	-477	-485	-659	-753	-709	-739	-779	-838
Current transfers (net)	1,456	1,922	2,184	2,576	2,642	2,815	3,000	3,195	3,400	3,616
Financial and capital account	122	-1,050	322	-4,227	1,951	1,536	2,509	3,852	4,893	5,711
Direct investment and capital transfers (net)	772	713	1,394	1,718	1,279	2,379	2,672	2,934	3,086	3,260
Portfolio equity investment	-735	-1,957	-1,709	-1,284	-1,212	-875	-525	-175	175	525
Bonds and medium and long-term loans (net)	-120	375	1,282	4,095	2,598	1,723	2,268	2,802	3,017	3,514
Private sector loans	241	610	976	1,962	864	1,514	1,964	2,314	2,564	2,714
Bonds and loans (official)	-361	-235	306	2,133	1,734	209	304	488	453	800
Disbursements	475	444	1,342	3,268	2,981	1,498	1,398	1,340	1,785	1,754
Repayments 1/ 2/	-836	-679	-1,036	-1,135	-1,247	-1,289	-1,094	-852	-1,332	-954
Foreign-currency	...	...	...	1,733	483	127	144	390	393	771
Domestic -currency	...	...	...	400	1,251	82	160	98	60	29
Short-term capital (net)	205	-181	-645	-8,756	-714	-1,691	-1,905	-1,709	-1,385	-1,588
Of which: Natural gas arrears (net) 3/	137	166	...	...	...	...	...	...	...	...
Errors and omissions	-231	-885	-953	-38	-38	-38	-38	-38	-38	-38
Overall balance	1,293	1,238	2,260	2,539	6,750	2,684	1,530	1,106	1,470	1,395
Gross official reserves (- is increase)	-1,606	-1,045	-2,045	-2,226	-6,437	-2,254	-1,115	-786	-1,384	-1,395
Net use of IMF resources	-79	-191	-215	-313	-313	-430	-415	-320	-85	--
Purchases	375	...	...	...	...	...	...	...	...	...
Repurchases	-454	-191	-215	-313	-313	-430	-415	-320	-85	--
Official arrears to bilateral creditors (+ is increase)	-361	…								
Rescheduling 4/	775	85								
Memorandum items:										
Total public external debt 2/	10,118	10,194	10,843	12,496	12,667	12,364	12,093	12,163	12,471	13,241
Public external debt (in percent of GDP) 2/	26.6	24.0	21.6	19.2	15.6	12.5	10.2	8.9	8.4	8.1
Stock of external gas arrears 3/	1,714	1,880	...	...	...	...	...	...	...	...
Current account (in percent of GDP)	3.7	7.5	5.8	10.5	6.0	1.2	-0.8	-2.0	-2.3	-2.6
Excluding transfers	-0.1	3.0	1.4	6.5	2.7	-1.6	-3.3	-4.3	-4.5	-4.8
Debt service ratio (in percent of exports of goods and services) 2/ 4/										
Before rescheduling	8.7	5.7	...	...	...	...	...	...	...	...
After rescheduling	6.7	5.4	6.2	4.8	4.8	5.1	4.4	3.6	3.8	2.9
Of which: Interest payments	2.5	2.0	1.6	1.2	1.5	1.6	1.4	1.4	1.4	1.3
Gross international reserves (end of period)	3,089	4,417	6,937	9,525	15,962	18,216	19,332	20,117	21,502	22,897
In months of next year's imports of goods and services	1.7	1.9	2.4	2.7	3.9	4.1	4.0	3.8	3.7	3.6
Over next year's official debt service	2.3	2.6	3.6	4.3	6.5	8.2	10.1	9.2	12.0	12.8
Merchandise export values (percent change) 5/	8.7	9.2	27.2	40.8	13.5	6.1	4.7	4.5	8.1	8.7
Merchandise import values (percent change)	13.0	6.3	33.7	23.7	24.1	16.3	10.3	8.5	9.1	9.7
Merchandise export volume (percent change) 5/	7.0	7.1	14.2	16.5	3.2	6.9	7.4	7.9	9.3	9.2
Merchandise import volume (percent change)	12.8	5.9	30.4	15.7	13.8	10.9	9.8	9.4	8.8	8.8
Terms of trade (percent change)	1.3	1.6	8.6	16.4	0.0	-6.3	-3.2	-2.5	-1.4	-1.3

Sources: Ukrainian authorities; and Fund staff estimates and projections.

1/ Includes lease receipts and offsetting repayments under the Black Sea Fleet debt swap agreement.
2/ Public and publicly-guaranteed debt. Historic debt data are preliminary.
3/ Arrears stemming from natural gas imports as reported by Naftogaz.
4/ Rescheduling by the Paris Club and other bilateral creditors (on comparable terms).
5/ Estimates in 2000 and 2001 include goods-arrears swap transactions with Russia in 1999 and 2000.

Table 3. Ukraine: General Government Finances, 2003–06

	2003	2004	2005 Staff assessment 1/ 2/ General Gov't	2005 Staff assessment 1/ 2/ State Budget	2005 Gov't State Budget	2006 Baseline Scenario General Gov't	2006 Baseline Scenario State Budget	2006 Adjustment Scenario General Gov't	2006 Adjustment Scenario State Budget	2006 Gov't State Budget
					(In millions of hryvnias)					
Revenue	96,000	120,940	165,152	100,806	106,191	191,734	115,662	186,902	113,017	118,212
Tax revenue	81,720	100,821	140,928	80,086	84,566	168,334	96,303	163,541	93,657	98,028
Personal income tax	13,521	13,213	17,238	920	760	21,101	244	20,540	214	0
Enterprise profit tax	13,237	16,162	24,558	24,311	20,326	29,977	29,724	29,181	28,934	25,325
Payroll tax	21,195	29,042	36,179	0	0	41,685	0	40,235	0	0
Property tax	2,032	2,293	2,725	0	0	2,875	0	2,861	0	0
VAT 3/	12,598	14,808	27,727	27,727	33,703	34,357	34,357	33,444	33,444	38,959
Gross collections	22,919	28,701	45,590	45,590	46,862	55,841	55,841	54,357	54,357	55,446
Refunds	-10,321	-13,894	-17,863	-17,863	-13,159	-21,484	-21,484	-20,913	-20,913	-16,487
Other taxes on goods and services	10,966	14,961	18,669	16,864	18,537	21,384	19,187	20,776	18,637	19,709
Taxes on international trade	3,795	5,067	7,354	7,354	7,934	8,050	8,050	7,812	7,812	8,875
Other taxes	4,376	5,276	6,477	2,911	3,307	8,907	4,742	8,693	4,616	5,161
Nontax, capital revenue, and grants	14,280	20,119	24,224	20,720	21,625	23,399	19,358	23,360	19,359	20,184
State enterprise and NBU dividends	1,469	2,243	4,865	4,865	7,092	4,390	4,390	4,390	4,390	4,390
Ministry special resources	7,751	11,579	11,158	8,986	6,820	11,716	9,436	11,716	9,436	8,126
Other nontax 4/	5,060	6,296	8,201	6,869	7,713	7,293	5,533	7,254	5,534	7,668
Expenditure	98,413	136,148	177,404	111,428	113,762	207,504	128,604	205,713	128,604	128,604
Current expenditures	86,541	113,689	161,472	100,164	102,978	189,418	115,262	188,240	115,619	115,028
Wages	20,319	25,597	39,010	21,616	17,146	45,982	25,479	45,982	25,479	25,479
Goods and services	18,167	19,646	23,409	18,734	23,204	28,339	21,038	27,840	20,851	21,038
Subsidies	5,819	7,468	8,236	5,291	5,584	9,906	6,363	9,643	6,194	6,363
Transfers	39,592	57,768	87,325	51,225	53,465	99,957	57,816	99,664	58,639	57,582
Pension Fund	24,453	39,252	62,102	21,206	18,614	69,347	21,372	69,347	22,638	21,372
Other	15,139	18,516	25,222	30,020	34,851	30,610	36,444	30,317	36,001	36,209
Interest	2,644	3,210	3,492	3,298	3,579	5,234	4,566	5,112	4,455	4,566
Domestic	331	1,021	1,039	1,009	...	2,359	1,964	2,359	1,964	1,964
Foreign	2,313	2,189	2,453	2,289	...	2,876	2,602	2,754	2,491	2,602
Capital spending	11,510	20,665	15,840	11,172	11,342	17,947	13,202	17,339	12,852	13,437
Net lending	362	1,102	-802	-802	-802	140	140	134	134	140
Unallocated spending	0	692	895	895	245	0	0	0	0	0
Overall cash balance (without measures)	-2,413	-15,208	-12,252	-10,622	-7,571	-15,771	-12,942	-18,811	-15,588	-10,392
Measures (to be identified)	...	...	0	0	0	0	0	7,797	7,797	0
Overall balance (cash basis)	**-2,413**	**-15,208**	**-12,252**	**-10,622**	**-7,571**	**-15,771**	**-12,942**	**-11,014**	**-7,790**	**-10,392**
Net change in VAT refund arrears	-1,114	-1,828	0	0	0	0	0	0	0	0
Net change in energy and utility arrears	80	-140	0	0	0					
Net change in social arrears	-553	-325	0	0	0	0	0	0	0	0
Noncash property income 4/	521	521	518	518	517	494	494	473	473	494
Overall balance (commitment basis)	**-304**	**-12,394**	**-11,734**	**-10,104**	**-7,054**	**-15,277**	**-12,448**	**-10,541**	**-7,318**	**-9,898**
Financing	2,428	14,978	12,253	10,622	7,571	15,771	12,942	11,014	7,790	10,392
External	2,618	4,738	3,095	1,832	2,024	2,674	1,665	2,859	1,644	1,665
Disbursements	7,106	10,222	8,461	7,198	7,775	8,039	7,029	7,996	7,029	7,029
Amortization 4/	4,488	5,484	5,366	5,366	5,751	5,364	5,364	5,137	5,384	5,364
Domestic	-3,091	-329	5,768	6,350	3,107	4,212	3,142	-729	-1,988	592
Borrowing	-939	481	13,411	13,928	9,168	7,549	7,779	2,622	2,649	4,829
Amortization	...		6,061	6,061	6,061	4,237	4,237	4,237	4,237	4,237
Deposit finance	-2,152	-810	-1,582	-1,516	0	901	-400	886	-400	0
Privatization	2,901	10,569	3,390	2,440	2,440	8,885	8,135	8,885	8,135	8,135
Statistical discrepancy/financing gap	-14	229	0	0	0	0	0	0	0	0
Memorandum items:										
Stock of VAT refund arrears (end-period)	1,828	0	0	0	0	0	0	0	0	...
Earmarked revenue	38,706	55,070	...	...	...	...	...	...	...	...
Primary balance	231	-11,997	-8,760	-7,324	-3,992	-10,537	-8,376	-13,699	-11,132	-5,826
Nominal GDP	267,344	345,943	415,547	415,547	436,000	499,778	499,778	486,502	486,502	512,300

Sources: Ukrainian authorities; and staff estimates and projections.

Table 3 (cont'd). Ukraine: General Government Finances, 2003-06

	2003	2004	2005			2006		2006		
			Staff assessment 1/ 2/		Gov't	Baseline Scenario		Adjustment Scenario		Gov't
			General Government	State Budget	State Budget	General Government	State Budget	General Government	State Budget	State Budget
					(In percent of GDP)					
Revenue	35.9	35.0	39.7	24.3	24.4	38.4	23.1	38.4	23.2	23.1
Tax revenue	30.6	29.1	33.9	19.3	19.4	33.7	19.3	33.6	19.3	19.1
Personal income tax	5.1	3.8	4.1	0.2	0.2	4.2	0.0	4.2	0.0	0.0
Enterprise profit tax	5.0	4.7	5.9	5.9	4.7	6.0	5.9	6.0	5.9	4.9
Payroll tax	7.9	8.4	8.7	0.0	0.0	8.3	0.0	8.3	0.0	0.0
Property tax	0.8	0.7	0.7	0.0	0.0	0.6	0.0	0.6	0.0	0.0
VAT 3/	4.7	4.3	6.7	6.7	7.7	6.9	6.9	6.9	6.9	7.6
Gross collections	8.6	8.3	11.0	11.0	10.7	11.2	11.2	11.2	11.2	10.8
Refunds	-3.9	-4.0	-4.3	-4.3	-3.0	-4.3	-4.3	-4.3	-4.3	-3.2
Other taxes on goods and services	4.1	4.3	4.5	4.1	4.3	4.3	3.8	4.3	3.8	3.8
Taxes on international trade	1.4	1.5	1.8	1.8	1.8	1.6	1.6	1.6	1.6	1.7
Other taxes	1.6	1.5	1.6	0.7	0.8	1.8	0.9	1.8	0.9	1.0
Nontax, capital revenue, and grants	5.3	5.8	5.8	5.0	5.0	4.7	3.9	4.8	4.0	3.9
State enterprise and NBU dividends	0.5	0.6	1.2	1.2	1.6	0.9	0.9	0.9	0.9	0.9
Ministry special resources	2.9	3.3	2.7	2.2	1.6	2.3	1.9	2.4	1.9	1.6
Other nontax 4/	1.9	1.8	2.0	1.7	1.8	1.5	1.1	1.5	1.1	1.5
Expenditure	36.8	39.4	42.7	26.8	26.1	41.5	25.7	42.3	26.4	25.1
Current expenditures	32.4	32.9	38.9	24.1	23.6	37.9	23.1	38.7	23.8	22.5
Wages	7.6	7.4	9.4	5.2	3.9	9.2	5.1	9.5	5.2	5.0
Goods and services	6.8	5.7	5.6	4.5	5.3	5.7	4.2	5.7	4.3	4.1
Subsidies	2.2	2.2	2.0	1.3	1.3	2.0	1.3	2.0	1.3	1.2
Transfers	14.8	16.7	21.0	12.3	12.3	20.0	11.6	20.5	12.1	11.2
Pension Fund	9.1	11.3	14.9	5.1	4.3	13.9	4.3	14.3	4.7	4.2
Other	5.7	5.4	6.1	7.2	8.0	6.1	7.3	6.2	7.4	7.1
Interest	1.0	0.9	0.8	0.8	0.8	1.0	0.9	1.1	0.9	0.9
Domestic	0.1	0.3	0.3	0.2	0.0	0.5	0.4	0.5	0.4	0.4
Foreign	0.9	0.6	0.6	0.6	0.0	0.6	0.5	0.6	0.5	0.5
Capital spending	4.3	6.0	3.8	2.7	2.6	3.6	2.6	3.6	2.6	2.6
Net lending	0.1	0.3	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
Unallocated spending	0.0	0.2	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Overall cash balance (without measures)	-0.9	-4.4	-2.9	-2.6	-1.7	-3.2	-2.6	-3.9	-3.2	-2.0
Measures (to be identified)	...	...	0.0	0.0	0.0	0.0	0.0	1.6	1.6	0.0
Overall balance (cash basis)	**-0.9**	**-4.4**	**-2.9**	**-2.6**	**-1.7**	**-3.2**	**-2.6**	**-2.3**	**-1.6**	**-2.0**
Net change in VAT refund arrears	-0.4	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net change in energy and utility arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net change in social arrears	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Noncash property income 4/	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Overall balance (commitment basis)	**-0.1**	**-3.6**	**-2.8**	**-2.4**	**-1.6**	**-3.1**	**-2.5**	**-2.2**	**-1.5**	**-1.9**
Financing	0.9	4.3	2.9	2.6	1.7	3.2	2.6	2.3	1.6	2.0
External	1.0	1.4	0.7	0.4	0.5	0.5	0.3	0.6	0.3	0.3
Disbursements	2.7	3.0	2.0	1.7	1.8	1.6	1.4	1.6	1.4	1.4
Amortization 4/	1.7	1.6	1.3	1.3	1.3	1.1	1.1	1.1	1.1	1.0
Domestic	-1.2	-0.1	1.4	1.5	0.7	0.8	0.6	-0.1	-0.4	0.1
Change in debt	-0.4	0.1	3.2	3.4	2.1	1.5	1.6	0.5	0.5	0.9
Deposit finance	-0.8	-0.2	-0.4	-0.4	0.0	0.2	-0.1	0.2	-0.1	0.0
Privatization	1.1	3.1	0.8	0.6	0.6	1.8	1.6	1.8	1.7	1.6
Statistical discrepancy/ financing gap	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Stock of VAT refund arrears (end-period)	0.7	0.0	0.0	...	...	0.0	...	0.0	...	...
Earmarked revenue	14.5	15.9	...	...	...	...	...	...	...	...
Primary balance	0.1	-3.5	-2.1	-1.8	-0.9	-2.1	-1.7	-1.2	-2.3	-1.1
Nominal GDP (Hrv millions)	267,344	345,943	415,547	415,547	436,000	499,778	499,778	486,502	486,502	512,300

Sources: Ukrainian authorities; and Fund staff estimates and projections.

1/ Based on state budget expenditure appropriations, IMF staff macroeconomic and revenue estimates, and IMF staff estimates of budget transfers necessary to fill financing gaps in the pension and social funds.
2/ Staff projections exclude Hrv 6.3 billion (1.5 percent of GDP) in offsets from both revenues and expenditures.
3/ Clearance of VAT refund arrears is reflected in the consolidated government balance (cash basis) through a reduction of net VAT cash revenues
4/ Excludes US$ 98 million of non-cash property income paid annually by Russia in exchange for amortization of Ukraine's debt to Russia.

Table 4. Ukraine: Monetary Accounts, 2001–06

	2001	2002	2003	2004				2005				2006	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Aug.	Dec.	Dec.	Dec.
											Proj.	Baseline scenario	Adjustment scenario
							(In millions of hryvnias)						
Monetary Survey													
Net foreign assets	6,875	13,942	25,511	30,607	40,016	54,238	42,260	52,109	54,417	61,617	69,107	82,591	76,470
(In millions of U.S. dollars)	1,297	2,615	4,785	5,743	7,521	10,219	7,966	9,868	10,765	12,201	13,685	16,355	15,143
Net domestic assets	38,881	50,927	69,533	70,544	73,945	76,040	83,445	87,998	101,921	103,162	108,144	144,196	145,337
Domestic credit	48,074	61,986	86,505	87,850	93,183	95,932	106,266	112,254	123,302	126,694	130,094	171,949	165,173
Net credit to government	18,390	18,273	15,080	10,362	7,114	3,343	12,583	10,388	8,091	1,987	8,767	9,460	7,134
Credit to nongovernment	29,684	43,712	71,425	77,488	86,070	92,589	93,683	101,866	115,211	124,706	121,328	162,489	158,039
Other items, net	-9,193	-11,058	-16,973	-17,306	-19,238	-19,892	-22,822	-24,256	-21,381	-23,531	-21,950	-27,753	-19,835
Broad money	45,755	64,870	95,043	101,151	113,961	130,277	125,705	140,107	156,339	164,780	177,251	226,787	221,808
Currency in circulation	19,465	26,434	33,119	33,580	36,890	42,296	42,345	43,062	51,304	53,820	55,799	71,393	69,825
Total deposits	26,290	38,436	61,924	67,570	77,071	87,981	83,360	97,045	105,035	110,960	121,452	155,394	151,983
Domestic currency deposits	17,632	25,890	41,955	45,662	53,220	61,049	52,971	64,073	69,522	71,320	84,761	108,450	109,045
Foreign currency deposits	8,658	12,546	19,969	21,909	23,851	26,932	30,389	32,973	35,512	39,639	36,691	46,945	42,937
Accounts of the National Bank of Ukraine													
Net international reserves 1/	6,242	13,551	27,204	32,819	42,374	55,743	42,015	55,227	59,325	66,243	74,027	87,511	81,390
(In millions of U.S. dollars)	1,178	2,541	5,101	6,158	7,964	10,502	7,919	10,458	11,736	13,117	14,659	17,329	17,526
Net domestic assets 2/	16,803	18,572	12,885	8,619	4,848	-349	11,748	5,085	6,171	2,262	2,385	7,614	11,646
Net domestic credit	18,289	19,182	16,185	11,801	7,325	1,958	15,573	7,715	4,673	917	887	6,916	3,033
Net credit to government	18,518	17,449	13,575	9,555	6,088	2,560	11,458	9,494	6,268	186	5,261	5,190	5,082
Credit to gen. government	19,898	19,634	18,548	18,261	17,982	16,977	16,720	16,404	12,732	12,550	12,200	11,137	11,136
Deposits of gen. government	1,380	2,186	4,973	8,706	11,894	14,417	5,263	6,910	6,464	12,365	6,939	5,947	6,054
Net credit to nongovernment	69	-19	113	135	-400	116	98	107	147	167	150	147	150
Claims on banks	-298	1,752	2,497	2,111	1,637	-718	4,017	-1,886	-1,742	565	-4,524	1,579	-2,199
Refinancing	647	995	1,867	1,466	1,326	1,054	3,737	751	1,022	1,525	617	1,022	617
Other claims on banks	905	756	630	645	604	562	449	458	407	415	404	407	404
Claims on NBU (Repos + CDs)	-1,850	0	0	0	-293	-2,335	-169	-3,095	-3,171	-1,375	-5,544	150	-3,219
Other items, net	-1,475	-1,925	-3,300	-3,182	-2,477	-2,307	-3,824	-2,645	1,510	1,345	1,498	699	8,613
o/w revaluation												0	7,115
Base money	23,055	30,808	40,089	41,438	47,222	55,394	53,763	60,297	65,508	68,505	76,412	95,125	93,036
Currency in circulation	19,465	26,434	33,119	33,580	36,890	42,296	42,345	43,062	51,304	53,820	55,799	71,393	69,825
Banks' reserves	3,590	4,374	6,970	7,858	10,331	13,097	11,418	17,235	14,204	14,685	20,613	23,732	23,211
Cash in vault	759	1,270	2,929	2,258	2,675	3,129	3,324	3,202	3,860	3,918	4,463	5,710	5,585
Required reserves	3,418	3,036	4,087	4,385	4,933	5,631	5,335	6,211	6,722	7,101	8,380	10,722	10,487
Excess reserves	-587	68	-46	1,214	2,724	4,337	2,759	7,822	3,622	3,666	7,770	7,300	7,140
Deposit Money Banks													
Net foreign assets	656	233	-1,924	-2,265	-2,985	-2,109	-1,526	-3,602	-5,343	-5,376	-5,343	-5,343	-5,343
Net domestic assets	25,337	39,955	66,346	71,947	81,693	89,371	88,903	98,761	108,635	116,901	122,271	162,316	155,126
Domestic credit	29,377	44,350	72,740	78,102	86,899	93,175	94,608	102,558	116,835	126,305	124,635	166,560	159,893
Net credit to government	-128	825	1,505	807	1,026	783	1,125	894	1,823	1,802	3,505	4,270	2,052
Credit to the economy	29,505	43,526	71,235	77,294	85,874	92,391	93,483	101,664	115,012	124,504	121,130	162,290	157,841
Banks' reserves	3,590	4,374	6,970	7,858	10,331	13,097	11,418	17,235	14,204	14,685	20,613	23,732	23,211
Other Items Net	-7,630	-8,770	-13,365	-14,012	-15,537	-16,900	-17,123	-21,032	-22,404	-24,089	-22,977	-27,977	-27,977
Banks' Liabilities	25,992	40,188	64,421	69,682	78,708	87,263	87,377	95,160	103,292	111,525	116,929	156,973	149,784
Net credit to banks from NBU	-298	1,752	2,497	2,111	1,637	-718	4,017	-1,886	-1,742	565	-4,524	1,579	-2,199
Deposits	26,290	38,436	61,924	67,570	77,071	87,981	83,360	97,045	105,035	110,960	121,452	155,394	151,983
							(Percentage change from end of previous year)						
Memorandum items:													
Base money	37.4	33.6	30.1	3.4	17.8	38.2	34.1	12.2	21.8	27.4	42.1	24.5	21.8
Broad money	41.9	41.8	46.5	6.4	19.9	37.1	32.3	11.5	24.4	31.1	41.0	27.9	25.1
Credit to nongovernment	40.5	47.3	63.4	8.5	20.5	29.6	31.2	8.7	23.0	33.1	29.5	33.9	30.3
							(Percentage change year-over-year)						
Base money	37.4	33.6	30.1	32.9	34.2	45.7	34.1	45.5	38.7	29.6	42.1	24.5	21.8
Broad money	41.9	41.8	46.5	44.3	44.2	50.6	32.3	38.5	37.2	35.7	41.0	27.9	25.1
Credit to nongovernment	40.5	47.3	63.4	61.4	55.0	45.4	31.2	31.5	33.9	42.2	29.5	33.9	30.3
Real broad money 3/	35.7	42.3	38.3	37.6	36.2	39.9	20.0	23.7	24.1	14.8	27.0	14.9	16.1
Real credit to nongovernment 3/	34.4	47.8	55.2	54.8	47.0	35.0	18.9	16.7	19.2	27.4	15.5	20.9	21.3
							(Ratio)						
Velocity of broad money 4/	4.46	3.48	2.78	2.74	2.60	2.47	2.75	2.60	2.42	...	2.34	2.20	2.19
Money multiplier	1.98	2.11	2.37	2.44	2.41	2.35	2.34	2.32	2.39	2.41	2.32	2.38	2.38
							(In percent)						
Share of foreign currency loans 5/	41.3	39.5	38.5	38.4	37.4	37.4	39.1	39.1	38.4	...	...	...	...
Share of foreign currency deposits 6/	32.9	32.6	32.2	32.4	30.9	30.6	36.5	34.0	33.8	35.7	...	...	...

Sources: National Bank of Ukraine; and Fund staff estimates and projections.

1/ Historical data for NIR are at actual exchange rates. Projected NIR are at projected exchange rates.
2/ NDA are calculated as the difference between base money and NIR.
3/ Deflated by the CPI.
4/ Based on nominal GDP over the last four quarters.
5/ In percent of total bank loans to the economy.
6/ In percent of total bank deposits.

Table 5. Ukraine: Financial Soundness Indicators for the Banking Sector, 2000–05
(In percent, unless otherwise indicated)

	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Mar-05	Jun-05
Ownership							
Number of banks	153	152	157	158	160	161	162
Private	151	150	155	156	158	159	160
Domestic	120	122	135	137	139	138	138
Foreign	22	21	20	19	19	21	22
o/w: 100% foreign-owned	7	6	7	7	7	9	9
State-owned	2	2	2	2	2	2	2
Concentration							
Share of assets of largest 10 banks	55.3	52.5	54.1	53.7	53.1	53.0	...
Share of assets of largest 25 banks	71.4	66.8	71.0	71.7	72.0	72.5	...
Number of bank with assets less than $150 million	145	141	140	132	124	124	...
Capital Adequacy							
Regulatory capital to risk-weighted assets	15.5	20.7	18.0	15.2	16.8	17.1	15.2
Capital to total assets	16.2	15.6	14.7	12.3	13.1	12.4	11.9
Asset Quality							
Credit growth (year-over-year)	61.3	40.5	47.3	60.8	31.2	31.5	33.9
Credit to GDP ratio	12.4	14.5	19.4	26.6	27.1	28.3	30.7
Change of loan to GDP ratio (in precentage points)	2.4	2.1	4.8	7.3	-2.4	1.2	2.4
Loans in foreign currency to total loans	41.4	41.3	39.5	39.3	39.2	39.1	38.4
NPLs to total loans 1/ 3/	29.6	24.6	21.9	28.3	30.0	25.3	23.1
NPLs (excl. part of timely serviced substandard loans) 2/				8.5	8.9	7.4	6.6
NPLs net of provisions to capital 3/	68.0	62.9	66.6	144.6	147.2	124.0	127.7
Specific provisions to NPLs 3/ 4/	38.4	39.2	37.0	22.3	21.1	23.8	23.5
Specific provisions to total loans	11.3	9.6	8.1	6.3	6.3	6.0	5.4
Earnings and Profitability							
Return on assets (after tax; end-of-period)	-0.1	1.2	1.2	1.0	1.1	1.5	1.2
Return on equity (after tax; end-of-period)	-0.5	7.5	8.0	7.6	8.4	11.2	9.2
Net interest margin to total assets	6.3	6.9	6.0	5.8	4.9	4.8	4.6
Interest rate spreads (in percentage points; end-of-period)							
Between loans and deposits in domestic currency	28.5	18.9	14.9	9.9	9.6	7.7	7.8
Between loans and deposits in foreign currency	10.2	5.4	5.3	4.0	4.2	4.9	4.7
Between loans in domestic and foreign currency	21.3	18.0	10.5	6.9	6.2	5.0	4.4
Between deposits in domestic and foreign currency	3.4	4.6	0.9	1.1	0.8	2.2	1.4
Liquidity							
Liquid assets to total assets	20.8	15.3	13.5	15.3	16.7	18.4	15.1
Customer deposits to total (non-interbank) loans	59.1	87.6	87.6	87.1	89.2	95.3	91.2
of which: foreign currency deposits to total deposits	44.4	32.9	32.2	33.5	36.5	34.0	33.8
Sensitivity to market risk							
Net open positions in foreign currency to capital	32.9	23.6	21.5	17.7	14.7	12.3	9.5
Foreign currency loans minus foreign currency deposits to capital	49.6	47.2	49.2	55.1	33.8	34.8	42.9
Foreign currency loans to total loans to enterprises		41.6	39.2	36.0	36.1	35.7	34.3
Number of banks not complying with banking regulations							
Not meeting capital adequacy requirements for Tier I capital	7	3	1	1	2	0	0
Not meeting prudential regulations	27	21	16	9	14	8	9
Not meeting reserve requirements	3	6	2	0	11	2	3

Sources: National Bank of Ukraine; and Fund staff estimates.

1/ Increase in nonperforming loans (NPLs) in 2003 partly due to new classification rules.
2/ The NBU estimates that as of end-March 2004, 6.2 percent of loans classified as substandard were being timely serviced.
3/ NPLs are those classified as substandard, doubtful, and loss.
4/ About half of the drop in the provision to NPL ratio from end-2002 to end-2003 is due to new loan classification rules.

Table 6. Ukraine: Medium-Term Macroeconomic Framework, 2002–10

	2002	2003	2004 Prel.	2005 Proj.	Baseline scenario 3/ 2006	2007	2008	2009	2010	High growth scenario 4/ 2006	2007	2008	2009	2010
Output and prices														
Nominal GDP (in billions of hryvnias)	225.8	267.3	345.9	415.5	499.8	582.5	654.4	714.6	780.4	486.5	551.8	616.9	696.1	785.5
Real GDP growth (percent change)	5.2	9.6	12.1	4.0	5.5	5.0	5.0	5.0	5.0	5.0	6.0	7.5	8.5	8.5
Consumer prices (percent change; period average)	0.8	5.2	9.0	14.2	14.4	10.7	7.0	4.0	4.0	12.1	6.7	4.0	4.0	4.0
Consolidated budget (in percent of GDP)														
Revenue and grants 1/	36.0	35.9	35.0	39.7	38.4	38.6	38.4	38.3	38.2	38.4	38.7	38.6	38.5	38.4
Expenditure and net lending (cash basis)	35.5	36.8	39.4	42.7	41.5	42.6	42.8	42.9	42.7	40.7	40.8	40.5	40.2	39.9
of which: interest	1.3	1.0	0.9	0.8	1.0	1.0	1.1	1.2	1.3	1.1	0.9	0.8	0.8	0.7
Cash balance 1/	0.5	-0.9	-4.4	-2.9	-3.2	-4.0	-4.4	-4.6	-4.5	-2.3	-2.1	-1.9	-1.7	-1.5
Commitments balance	0.2	0.0	-3.6	-2.8	-3.1	-3.9	-4.3	-4.6	-4.5	-2.2	-2.0	-1.8	-1.6	-1.4
Privatization receipts	0.5	1.1	3.1	0.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Net domestic financing	-0.3	-1.2	-0.1	1.6	0.8	1.9	2.1	2.3	2.1	-0.1	-0.1	-0.5	-0.7	-1.0
Net external financing	-0.7	1.0	1.4	0.7	0.5	0.4	0.5	0.6	0.7	0.6	0.4	0.5	0.5	0.6
Public debt (in percent of GDP; end of period) 2/	35.7	27.7	25.1	22.8	19.9	18.7	19.0	20.1	21.0	18.5	15.9	14.4	12.6	10.9
Domestic	11.7	6.1	5.9	7.2	7.4	8.5	10.1	11.7	12.9	6.2	6.2	6.0	5.0	3.8
External	24.0	21.6	19.2	15.6	12.5	10.2	8.9	8.4	8.1	12.3	9.7	8.4	7.6	7.1
External sector														
Current account balance (in percent of GDP)	7.5	5.8	10.5	6.0	1.2	-0.8	-2.0	-2.3	-2.6	1.1	-1.5	-3.3	-4.7	-6.1
Merchandise exports, value (percent change)	9.2	27.2	40.8	13.5	6.1	4.7	4.5	8.1	8.7	5.6	4.4	4.9	8.1	8.7
Merchandise imports, value (percent change)	6.3	33.7	23.7	24.1	16.3	10.3	8.5	9.1	9.7	15.7	11.3	10.8	12.5	13.1
Foreign direct investment (in percent of GDP)	1.7	2.8	2.7	1.6	2.4	2.3	2.1	2.1	2.0	2.6	2.6	2.7	3.1	3.5
Gross official reserves (end of period)														
In billions of U.S. dollars	4.4	6.9	9.5	16.0	18.2	19.3	20.1	21.5	22.9	18.8	20.5	21.7	22.7	23.7
In months of imports of goods and services	1.9	2.4	2.7	3.9	4.1	4.0	3.8	3.7	3.6	4.1	4.1	3.9	3.6	3.4
External debt service (in percent of exports of goods and services) 2/	5.4	6.2	4.8	4.8	5.1	4.4	3.6	3.8	2.9	5.1	4.4	3.6	3.8	2.9
Savings-Investment Balance (in percent of GDP)														
Foreign savings	-7.5	-5.8	-10.5	-6.0	-1.2	0.8	2.0	2.3	2.6	-1.1	1.5	3.3	4.7	6.1
National savings	27.7	27.8	29.7	26.0	21.9	20.6	19.9	20.2	20.5	22.2	21.1	20.4	20.2	20.2
Private	24.2	24.2	27.9	25.3	21.4	20.0	19.7	20.3	20.5	20.8	19.5	17.7	16.9	16.2
Public	3.5	3.6	1.8	0.7	0.5	0.6	0.2	-0.1	0.0	1.3	1.6	2.6	3.3	3.9
Investment	20.2	22.0	19.2	20.1	20.7	21.4	21.9	22.5	23.2	21.1	22.6	23.6	24.9	26.2
Private	17.2	17.7	12.9	16.4	17.1	16.8	17.3	17.9	18.5	17.5	18.9	19.1	19.9	20.9
Public	3.0	4.3	6.3	3.6	3.6	4.6	4.6	4.6	4.6	3.6	3.7	4.5	5.0	5.4

Sources: Ukrainian authorities; and Fund staff estimates and projections.

1/ The consolidated government budget balance includes the central government, local governments and social funds. It excludes US$ 98 million of non-cash property income paid annually by Russia in exchange for amortization of Ukraine's debt to Russia, which are included in the authorities' official figures. Clearance of VAT refund arrears is reflected in the consolidated government (cash basis) through a reduction of net VAT cash revenues. Any outstanding stock of arrears is reflected in the general government balance (commitments basis).

2/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

3/ The baseline scenario is based on current macroeconomic policies and the authorities' plans for structural reforms.

4/ The high growth scenario assumes fiscal and monetary tightening in 2006, some nominal and real appreciation of the hryvnia, and an acceleration of structural reforms in line with the Ukraine-EU Action plan over the medium term.

Table 7. Ukraine: Selected Vulnerability Indicators, 2001–05

	2001	2002	2003	2004	2005 1/	Latest observation
Financial Market Indicators						
Short-term (ST) interest rate (in percent) 2/	17.0	4.5	9.3	16.3	4.1	20-Sep-05
EMBI secondary market spread (bps, end of period)	974	691	275	264	172	21-Sep-05
Foreign currency debt rating 3/	Caa1	B2	B1	B1	B1	22-Sep-05
Exchange rate NC/US$ (end of period)	5.3	5.3	5.3	5.3	5.1	22-Sep-05
Stock market index (PFTS)	42.7	57.3	85.4	260.1	350.8	21-Sep-05
Broad money to gross reserves (percent)	279.5	275.4	256.9	248.8	225.8	31-Aug-05
External Sector						
Exchange rate regime		de facto peg to U.S. dollar				
Current account balance (percent of GDP)	3.7	7.5	5.8	10.5	6.0	Proj
Net FDI inflows (percent of GDP)	2.0	1.6	2.8	2.7	1.6	Proj
Exports (percentage change of US$ value, GNFS)	8.0	10.7	24.0	37.2	13.8	Proj
Real effective exchange rate (2000 = 100)	106.0	101.7	95.3	94.4	...	December
Gross international reserves (GIR) in US$ billion	3.1	4.4	6.9	9.5	14.3	23-Sep-05
GIR in percent of ST debt at remaining maturity (RM)	30.2	42.6	64.0	80.0	116.7	June
GIR in percent of ST debt at RM and banks' FX deposits.	26.1	34.7	47.6	54.0	72.8	June
Net international reserves (NIR) in US$ billion	1.2	2.5	5.1	7.9	13.0	23-Sep-05
Total gross external debt (ED) in percent of GDP	55.5	52.1	47.5	46.1	43.6	June
o/w ST external debt (original maturity, in percent of total ED)	39.0	40.4	36.3	29.2	28.1	June
ED of domestic private sector (in percent of total ED)	52.7	53.8	54.5	58.4	65.5	June
ED to foreign official sector (in percent of total ED)	36.5	34.6	31.5	23.3	20.0	June
Total public external debt (in percent of GDP) 4/	26.3	24.0	21.6	19.3	14.5	June
Domestically issued public debt held by non-residents (in percent of GDP)	0.3	0.1	0.1	0.5	2.2	June
Total gross external debt in percent of exports of GNFS	101.4	94.5	82.3	75.7	...	December
Gross external financing requirement (in US$ billion)	8.8	7.2	7.9	5.1	8.7	Proj
Public Sector (PS) 5/						
Overall balance (percent of GDP)	-1.6	0.5	-0.9	-4.4	-2.9	Proj
Primary balance (percent of GDP)	0.4	1.8	0.1	-3.5	-2.1	Proj
Gross PS financing requirement (in percent of GDP) 6/	...	4.3	5.9	8.1	5.7	Proj
Public sector gross debt (PSGD, in percent of GDP)	38.6	35.7	27.7	25.1	21.8	June
o/w Exposed to rollover risk (in percent of total PSGD) 7/	6.6	9.2	8.2	9.3	11.4	June
Exposed to exchange rate risk (in percent of total PSGD) 7/	68.0	67.4	77.9	76.9	69.2	June
Exposed to interest rate risk (in percent of total PSGD) 7/	6.6	9.2	8.2	13.3	16.0	June
Public sector net debt (in percent of GDP)	37.2	34.0	25.5	22.9	18.4	June

Sources: Ukrainian authorities; and Fund staff estimates and projections.

1/ Projections are based on unchanged policies.
2/ Overnight interbank rate. Monthly average for December or month of latest observation.
3/ Moody's Investors Service. Note that Fitch and Standard & Poor's upgraded Ukraine from B+ to BB- in January and May 2005, respectively.
4/ Does not include domestically issued public debt held by nonresidents.
5/ Public sector covers the consolidated government. It excludes public enterprises. Public debt also includes arrears and debt by the central bank.
6/ Overall balance plus debt amortization.
7/ Estimated. Excludes debt to official creditors.

Table 8. Ukraine: Public Sector Debt Sustainability Framework, 2000–10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	45.5	38.6	35.7	27.7	25.1	**22.8**	**19.9**	**18.7**	**19.0**	**20.1**	**21.0**	**-2.2**
o/w foreign-currency denominated	0.0	0.0	24.1	21.6	19.2	15.6	12.9	10.6	9.7	9.4	9.2	
2 Change in public sector debt	-5.4	-6.9	-2.9	-8.0	-2.6	-2.4	-2.8	-1.3	0.4	1.1	0.9	
3 Identified debt-creating flows (4+7+12)	-10.6	-7.5	-4.3	-5.7	-5.0	-2.1	-2.5	-0.6	0.5	1.3	1.0	
4 Primary deficit	-1.7	-0.6	-1.4	-0.1	3.5	2.1	2.1	3.0	3.3	3.5	3.2	
5 Revenue and grants	33.4	33.5	36.0	35.9	35.0	39.7	38.4	38.6	38.4	38.3	38.2	
6 Primary (noninterest) expenditure	31.7	32.9	34.6	35.8	38.4	41.9	40.5	41.6	41.7	41.8	41.4	
7 Automatic debt dynamics 2/	-8.9	-5.6	-2.4	-4.6	-5.5	-3.4	-2.8	-1.8	-0.9	-0.4	-0.4	
8 Contribution from interest rate/growth differential 3/	-8.9	-5.6	-2.4	-4.6	-5.4	-3.4	-2.8	-1.8	-0.9	-0.4	-0.4	
9 Of which contribution from real interest rate	-6.6	-2.1	-0.6	-1.7	-2.8	-2.5	-1.7	-0.9	-0.1	0.5	0.5	
10 Of which contribution from real GDP growth	-2.3	-3.5	-1.8	-2.9	-2.6	-0.8	-1.0	-0.9	-0.8	-0.9	-0.9	
11 Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	-0.1	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	-1.3	-0.5	-1.1	-3.1	-0.8	-1.8	-1.8	-1.8	-1.8	-1.8	
13 Privatization receipts (negative)	0.0	-1.3	-0.5	-1.1	-3.1	-0.8	-1.8	-1.8	-1.8	-1.8	-1.8	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	5.2	0.6	1.4	-2.2	2.4	-0.3	-0.4	-0.7	-0.2	-0.2	-0.2	
Public sector debt-to-revenue ratio 1/	136.2	115.1	99.2	77.3	71.9	57.3	51.9	48.4	49.6	52.5	54.9	
Gross financing need 6/	1.8	2.3	3.3	4.8	6.9	5.4	5.5	5.8	6.1	6.9	6.8	
in billions of U.S. dollars	0.6	0.9	1.4	2.4	4.5	4.3	5.4	6.9	8.4	10.3	11.1	
Scenario with key variables at their historical averages 7/						**22.8**	**18.2**	**14.0**	**10.6**	**7.6**	**5.0**	**-2.9**
Scenario with no policy change (constant primary balance) in 2005-2010						**22.8**	**19.9**	**18.0**	**17.0**	**16.8**	**16.6**	**-2.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.9	9.2	5.2	9.6	12.1	4.0	5.5	5.0	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	7.7	5.3	3.7	3.3	4.3	4.0	5.5	6.0	6.7	6.8	6.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-15.5	-4.7	-1.4	-4.7	-11.1	-11.5	-8.5	-5.0	-0.3	2.8	2.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-24.1	2.7	-0.6	0.0	0.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	23.2	9.9	5.1	8.0	15.4	15.5	14.0	11.0	7.0	4.0	4.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	13.5	10.4	13.6	20.3	13.3	2.0	7.9	5.2	5.3	4.2	
Primary deficit	-1.7	-0.4	-1.8	-0.1	3.5	2.1	2.1	3.0	3.3	3.5	3.2	

1/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 9. Ukraine: External Debt Sustainability Framework, 2000–10
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt** 1/	63.6	55.5	52.1	47.5	46.1	**43.5**	**38.3**	**34.9**	**33.4**	**34.0**	**34.7**	**-4.8**
2	Change in external debt	24.1	-8.1	-3.5	-4.6	-1.4	-2.6	-5.1	-3.5	-1.4	0.6	0.7	
3	Identified external debt-creating flows (4+8+9)	-5.6	-14.7	-10.8	-15.0	-23.9	-9.7	-4.8	-3.3	-2.2	-2.2	-2.1	
4	Current account deficit, excluding interest payments	-8.1	-5.7	-9.1	-7.2	-11.7	-7.2	-2.5	-0.3	0.9	1.2	1.4	
5	Deficit in balance of goods and services	-5.0	-1.6	-4.4	-2.6	-7.5	-3.8	0.6	2.4	3.5	3.7	4.0	
6	Exports	62.4	55.5	55.1	57.8	61.1	55.8	48.8	42.9	39.1	38.6	38.3	
7	Imports	57.4	53.9	50.7	55.2	53.6	52.0	49.3	45.4	42.6	42.4	42.3	
8	Net non-debt creating capital inflows (negative)	-1.3	0.3	2.4	-1.0	-2.5	-2.3	-1.7	-2.5	-2.7	-2.9	-3.1	
9	Automatic debt dynamics 2/	3.8	-9.3	-4.1	-6.7	-9.6	-0.2	-0.7	-0.6	-0.5	-0.4	-0.4	
10	Contribution from nominal interest rate	3.4	2.0	1.6	1.4	1.3	1.2	1.3	1.0	1.0	1.1	1.2	
11	Contribution from real GDP growth	-2.4	-4.8	-2.6	-4.2	-4.4	-1.5	-2.0	-1.6	-1.5	-1.5	-1.6	
12	Contribution from price and exchange rate changes 3/	2.7	-6.5	-3.2	-3.9	-6.5	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 4/	29.7	6.7	7.4	10.4	22.5	7.1	-0.3	-0.1	0.8	2.7	2.8	
	External debt-to-exports ratio (in percent)	101.8	100.1	94.5	82.2	75.5	78.0	78.7	81.3	85.4	88.0	90.7	
	Gross external financing need (in billions of US dollars) 5/	0.8	7.3	6.1	7.3	3.8	7.2	14.2	16.5	18.4	19.8	20.9	
	in percent of GDP	2.7	19.1	14.4	14.6	5.8	8.9	14.3	13.9	13.4	13.3	12.8	
	Scenario with key variables at their historical averages 6/						**43.5**	**41.4**	**38.7**	**35.5**	**32.4**	**29.4**	**-2.8**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	5.9	9.2	5.2	9.6	12.1	4.0	5.5	5.0	5.0	5.0	5.0	
	GDP deflator in US dollars (change in percent)	-6.5	11.4	6.0	8.1	15.7	19.9	15.7	14.1	9.8	4.0	4.0	
	Nominal external interest rate (in percent)	8.4	3.9	3.3	3.1	3.5	3.4	3.6	3.3	3.4	3.6	3.8	
	Growth of exports (US dollar terms, in percent, goods and services)	14.4	8.0	10.7	24.0	37.2	13.8	6.7	5.5	5.1	7.8	8.2	
	Growth of imports (US dollar terms, in percent, goods and services)	17.8	14.1	5.0	28.7	26.0	21.0	15.8	10.2	8.3	8.5	9.0	
	Current account balance, excluding interest payments	8.1	5.7	9.1	7.2	11.7	7.2	2.5	0.3	-0.9	-1.2	-1.4	
	Net non-debt creating capital inflows	1.3	-0.3	-2.4	1.0	2.5	2.3	1.7	2.5	2.7	2.9	3.1	

1/ Includes private sector debt. These data are likely to include large on-lending by residents to their own corporations through off-shore accounts.

2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP γροωτη ρατε, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes. The large historical residuals mainly reflect balance of payment items (portfolio equity and short-term capital outflows) that are not included in the stock of foreign assets as captured by the official international investment position data.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

Table 10. Ukraine: Selected Actions Agreed Under the 2005 Ukraine-EU Action Plan

Legal framework and governance

- Adopt Joint Stock Company Law
- Improve the competence and independence of auditors
- Implement effectively competition and bankruptcy legislation
- Eliminate inconsistencies in the existing Economic and Civil Codes
- Adopt legislation necessary for implementing new Land Code; remove current restrictions in Land Code on non-agricultural land ownership
- Complete and implement reform of the court system to ensure independence, impartiality, and efficiency of the judiciary
- Promote transparency and accountability in the public administration, particularly concerning the reform of the civil service based on European standards
- Adopt a definition of state aid compatible with the EU, increase transparency of state aid, and prohibit state that distorts trade between Ukraine and the EU

Fiscal reforms

- Reinforce fiscal sustainability, including by taking measures to address medium-term trends in the pension system
- Implement comprehensive strategic plan for State Tax Administration
- Adopt Customs Code in line with WTO agreements and EU legislation
- Solve issue of VAT refund backlog
- Improve transparency of public finance management
- Continue approximation to EU legislation on public procurement

Energy sector

- Adopt law to allow operation of National Electricity Regulatory Commission
- Develop gas sector restructuring plan
- Implement Ukraine’s coal mine restructuring plan
- Ensure convergence of energy price developments in Ukrainian and EU markets

Financial sector

- Strengthen independence of NBU by bringing NBU law in line with EU standards.
- Comply with the IMF’s FSAP of November 2003
- Develop domestic securities market

Source: Cabinet of Ministers, March 2005.

Table 11. Ukraine: Millenium Development Goals 1/

	1990	1994	1997	2000	2003	2004
Goal 1. Eradicate extreme poverty and hunger						
Population below minimum level of dietary energy consumption (in percent)	..	..	26.4	..	*24.6*	..
Poverty headcount, national (percent of population)	..	..	..	..	..	..
Prevalence of underweight in children (under five years of age)	..	..	..	*43.7*	..	..
Goal 2. Achieve universal primary education						
Net primary enrollment ratio (percent of relevant age group)	..	..	..	75.5	*78.3*	..
Primary completion rate, total (percent of relevant age group)	64.8	..	..	..	*71.5*	..
Proportion of pupils starting grade 1 who reach grade 5	..	..	*62.9*	63.8	..	..
Youth literacy rate (percent ages 15-24) 2/	..	..	..	..	99.8	..
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliament (percent)	10.8	..	8.7	9.9	5.0	5.0
Ratio of girls to boys in primary and secondary education (percent)	73.7	..	*80.7*	81.5	*87.2*	..
Ratio of young literate females to males (percent ages 15-24) 2/	..	..	..	..	96.5	..
Share of women employed in the nonagricultural sector (percent)	21.6	19.6	20.9	21.7	22.6	..
Goal 4: Reduce child mortality						
Immunization, measles (percent of children ages 12-23 months)	88.7	95.5	97.8	98.8	99.0	99.2
Infant mortality rate (per 1,000 live births)	12.8	14.5	14.0	11.9	9.6	9.5
Under 5 mortality rate (per 1,000)	16.7	18.7	18.1	16.0	12.9	12.4
Goal 5: Improve maternal health						
Maternal mortality ratio (modeled estimate, per 100,000 live births)	32.4	31.3	25.1	24.7	17.4	13.1
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Incidence of tuberculosis (per 100,000 people)	190.2	192.4	211.7	250.6	298.1	226.6
Prevalence of HIV, total (percent of population aged 15-49)	..	..	..	*2.1*	2.1	..
Goal 7: Ensure environmental sustainability						
Access to an improved water source (percent of population)	63.8	..	..	97.7	..	..
Access to improved sanitation (percent of population)	20.4	..	..	99.1	..	..
CO2 emissions (metric tons per capita)	0.8	0.8	0.8	0.8	..	..
Forest area (percent of total land area)	28.9	..	..	26.1	..	..
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	3.5	3.5	3.7	3.9	*4.1*	..
Nationally protected areas (percent of total land area)	..	..	..	..	7.7	..
Goal 8: Develop a global partnership for development						
Aid per capita (current US$)	13.1	14	9.7	9.2	13.8	..
Fixed line and mobile phone subscribers (per 1,000 people)	6.3	9.4	14.8	25.4	55.8	..
Internet users (per 1,000 people)	0	0	0.3	3.7	16.2	..
Personal computers (per 1,000 people)	..	1.3	2.5	4.5	*6.9*	..

Sources: World Development Indicators database, April 2005; and Ukrainian authorities.

1/ Figures in italics refer to periods other than those specified.
2/ Based on All-Ukrainians Census 2001 data.

UKRAINE: FUND RELATIONS
(As of August 31, 2005)

I. **Membership Status:** Joined 09/03/1992; Article VIII

II. **General Resources Account:**	**SDR Million**	**Quota**
Quota	1,372.00	100.0
Fund holdings of currency	2, 286.78	166.67
Reserve position in Fund	0.00	0.0

III. **SDR Department:**	**SDR Million**	**%Allocation**
Holdings	0.58	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**% Quota**
Extended arrangements	914.70	66.67

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR Million)
Stand-by	03/29/04	03/28/05	411.60	0.00
EFF	09/04/98	09/03/02	1,919.95	1,193.00
Stand-by	08/25/97	08/24/98	398.92	181.33

VI. **Projected Payments to Fund (Expectations Basis)**[1] (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	83.85	278.97	278.98	215.62	57.28
Charges/Interest	8.82	29.19	18.29	7.85	1.21
Total	92.67	308.17	297.26	223.46	58.49

[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.

Projected Payments to Fund (Obligation basis)[2] (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	68.01	198.83	198.83	182.99	137.43
Charges/Interest	8.82	30.65	22.87	15.33	8.56
Total	76.83	229.48	221.70	198.32	145.98

VII. Safeguards Assessments:

The National Bank of Ukraine (NBU) was subject to a safeguards assessment with respect to the Stand-by Arrangement, approved on March 29, 2004. The safeguards assessment was completed on July 14, 2004. The assessment found that the NBU has made progress in recent years to strengthen its safeguards framework, however, further improvements can be made in some areas, notably the financial reporting and legal structure and independence areas. The main recommendations of the assessment include (i) full adoption of International Financial Reporting Standards (IFRS), (ii) a detailed review of the NBU Law, and other legislation that impinges on the central bank, in order to strengthen the NBU's independence, and (iii) semi-annual audits by the NBU's internal audit function of the monetary data reported to the Fund.

VIII. Exchange Arrangements:

In September 1996, the authorities introduced the hryvnia (HRV) at a conversion rate of karbovanets (Krb) 100,000 to HRV 1. The rate was initially informally pegged to the dollar. In September 1997, the peg was replaced by a formal band of HRV 1.7–HRV 1.9 per U.S. dollar. The limits of the band were moved on several occasions, most recently on February 9, 1999, to HRV 3.4–4.6 per U.S. dollar. Since March 19, 1999, the exchange rate for the hryvnia has been allowed to be determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention of allowing the free float of the hryvnia. However, the authorities intervene regularly to limit fluctuations in the exchange rate, so the exchange rate arrangement has been reclassified, effective January 1, 2001, as a conventional pegged arrangement. On August 30, 2005 the hryvnia stood at HRV 5.05 per U.S. dollar.

[2] This schedule is not the currently applicable schedule of payments to the IMF . Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations-except for SRF repayment expectations-would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country. SRF repayments are shown on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

On September 24, 1996, Ukraine accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement, and two remaining restrictions were eliminated in May 1997. A number of new restrictions were introduced in September 1998. The restrictions on current international transactions introduced in September 1998 were removed in March 1999.

IX. **Article IV Consultation:**

Ukraine is on the standard 12-months consultation cycle. The staff report (IMF Country Report No.05/15), and the Selected Issues (IMF Country Report No.05/20) and Statistical Appendix (IMF Country Report No.05/21) were considered by the Executive Board on October 25, 2004, and published January 24, 2005.

X. **FSAP Participation and ROSCs**

A joint World Bank-International Monetary Fund mission conducted an assessment of Ukraine financial sector as part of the Financial Sector Assessment Program (FSAP) between May 10–24, 2002. An update mission visited Ukraine between February 18–21, 2003,and the Financial Sector Stability Assessment (FSSA) report (IMF Country Report No. 03/340) was considered by the Executive Board on May 14, 2003. A further FSAP follow-up mission visited Kyiv between July 25-August 2, 2005. The observance of the following standards and codes were also assessed: Basel Core Principles for Effective Banking Supervision; Code of Good Practices on Transparency in Monetary and Financial Policies; CPSS Core Principles for Systemically Important Payment Systems; OECD Principles for Corporate Governance; Accounting and Auditing Practices; World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights System; and AML/CFT Methodology. A Data ROSC Module was conducted in April 3–17, 2002, and was considered by the Executive Board on August 5, 2003 (IMF Country Report No. 03/256). A Fiscal Transparency Module (experimental) was issued in September 1999, and an update in April 2004 (IMF Country Report No. 04/98).

XI. Fund Technical Assistance Missions, 2000-05

(As of August 31, 2005)

Department	Type of Mission	Timing
FAD	Customs Administration	June 7-21, 2005
	VAT Refund Management and Selected VAT Administrative Issues	January 30–February 9, 2002
	Treasury and Budget Reforms	April 16–29, 2001
	Expenditure Policy and Management	January 28–February 11, 2000
	Tax Administration	October 2000
		May 9–26, 2000
	Treasury Projects	April 6–29, 2001
		October 15–20, 2000
LEG	Workshop on Effective Enforcement of Criminal Justice Measures in Anti-Money Laundering and Combating the Financing of Terrorism	April 2005
MFD	Foreign Exchange Markets	July 20–28, 2005
	Debt Management Strategy (with ICM)	June 23–July 7, 2005
	Central Bank Accounting	June 1–15, 2005
	Implementing Effective AML/CFT Measures	May 11–20, 2005
	Management of Foreign Exchange Risk in Transitioning to Greater Exchange Rate Flexibility	April 18–29, 2005
	Dealing with Problem Banks	March 30–April 6, 2005
	Inflation Targeting	November 15–19, 2004
	Banking Supervision	October 25–November 12, 2004
	Banking Supervision, Monetary Framework and Operations, Government Securities Market	April 13–26, 2004
	Review of TA Needs	February 9–11, 2004
	Review of TA Needs and Inspection	June 10–12, 2002
	Accounting	October 22–November 2, 2001
	Internal Audit	October 8–19, 2001
	Accounting and Internal Audit	May 3–18, 2001
	Accounting and Internal Audit	October 30–November 10, 2000
	Bank Restructuring	June 20–29, 2000
	Internal Audit, Reserve Management, Accounting	May 24–June 13, 2000
	Banking Reform, Reserve Management, Accounting	March 28–April 12, 2000
	Bank Restructuring, Accounting	January 2000
STA	Balance of Payments Statistics	June 29–July 12, 2005
	Real Sector Statistics	March 21–April 1, 2005
	Money and Banking Statistics	October 17–23, 2002
	SDDS: Assessment	June 12–19, 2002
	ROSC Data Module Mission	April 3–17, 2002
	Consumer Price Index	November 5–16, 2001
	Monetary and Banking Statistics	May 16–30, 2001
	Consumer Price Index	March 12–22, 2001
	Monetary and Banking Statistics	February 23–March 7, 2000
ICM	Management of External Debt	May 31-June 3, 2005

XII. Fund Resident Representatives and Advisors, 2000-05

(As of August 31, 2005)

Purpose	Representatives/Advisors	Assignment
Resident Representatives		
Senior Resident Representative	Mr. Franks	Since September 2004
	Mr. Figliuoli	August 2001–August 2004
	Mr. Ghesquiere	March 1999–August 2001
Resident Representative	Mr. Lissovolik	July 2001–January 2004
	Mr. Orsmond	July 1999–July 2001
Advisors		
Advisor on Inflation Targeting to the National Bank of Ukraine	Mr. Vavra	November 2004 – November 2005
Macroeconomic Policy Advisor to the Ministry of Finance	Mr. Robertson	May 2001–May 2002
	Mr. Marion	October 1998–April 2001
Banking Supervision Advisor at National Bank of Ukraine	Mr. Livesay	April 2005–October 2005
	Mr. Lopes	March 2001–June 2002
	Mr. Herron	July 1998–July 2000
Treasury Advisor	Mr. Lepage	July 2001–January 2002
	Mr. Platais	July 1998–June 2001
Multisector Statistics Advisor	Mr. Piché	March 2000–March 2002
Tax Enforcement Advisor	Mr. McDonald	November 1999–April 2001

UKRAINE: RELATIONS WITH THE WORLD BANK
(September 2005)

Country Assistance Strategy

The World Bank Country Assistance Strategy (CAS) for Ukraine was approved on October 23, 2003. It covers fiscal years 2004–07, and its major focus is to support the "European choice" agenda of Ukraine—including further institutional reform that would lead to a business-friendly environment and a more inclusive and responsive government. It emphasizes the need to work toward Ukraine's European goal both from the top, through reform of institutions and policies, and from the bottom, through strengthening of civil society, which will help to increase public sector accountability. The strategy proposes a US$2.4 billion Base Case lending program. Allowance is also made for a more ambitious High Case (up to a maximum of US$3 billion).

A distinct feature of the Ukraine CAS is its results orientation—the amount and content of financial assistance will depend on the ability of the Government to accomplish the relevant benchmarks.

On July 5, 2005 the Executive Board reviewed the CAS Progress Report which assessed the first two years of the CAS implementation and discussed proposals for the program adjustment. While the overall goals remain broadly unchanged, the strategic priorities outlined in the CAS were adapted to the country's evolving needs.

World Bank Program

There are 11 operations under implementation in the current project portfolio with total net IBRD commitments of US$ 1,010.4 million, including 10 investment projects totaling US$759.1 million, and the first Development Policy Loan (DPL) in the amount of US$251.3 million. The second final tranche of the Programmatic Adjustment Loan 2 (PAL2) was disbursed in June 2005. Ten projects are currently under preparation.

The new series of Development Policy Loans were designed to integrate government and donor activities under three broad themes to improve public governance: investment climate; public administration and public finance management; and social inclusion.

Among other projects in the **public sector** are the State Tax Service Modernization Project (US$ 40million), and a Statistical System Modernization Project (US$30 million).

In the area of rural development, the World Bank supports establishment of the unified registry under Rural Land Titling and Cadastre Development Project (US$195 million).

The Bank's support for the **energy** sector has been significant and is expected to increase with a sequence of sector investment loans. The first one, the Hydropower Rehabilitation project (US$106 million), was approved in June 2005. The projects on power transmissions and pump storage are under preparation. The Kyiv District Heating Improvement Project

(US$160 million) is under implementation, and the US$18.29 million Kyiv Public Building Energy Efficiency Project has been successfully completed in June 2005.

In the **infrastructure**, the Lviv Water and Wastewater Project (US$24.25 million) is under implementation. An Urban Infrastructure Project (US$80 million) is under preparation, and is designed to provide loans to local governments and utilities for priority investments in water, wastewater and solid waste sector.

In the area of private sector development and financial-sector reform, the Bank has two projects under preparation: the Access to Financial Services project (US$125 million) will provide for increased access by the rural population and by municipalities to financial services, and a Second Export Development Project (US$150 million) is being prepared to build upon the success of the first project and to promote the Ukrainian economy's export capacity and to strengthen the institutional capacity of Ukreximbank. The Private Sector Development Loan (US$30 million), which was approved in March, 2002, has experienced serious implementation difficulties and has been cancelled.

The Bank has devoted considerable resources to the **social sector** assistance. The US$50 million Social Investment Fund Project, which supports the development of community-based social services for the most vulnerable groups, was approved in late 2001. The US$60 million Tuberculosis and AIDS Epidemic Control Project was approved in December 2002. An Equal Access to Quality Education project in the amount of US$86.6 million was approved in May 2005. Projects aimed at modernization of Social Assistance System (US$101 million) and at Health Reform (US$100 million) are under preparation.

The Bank is also providing significant **non-lending support**. Through the People's Voice Program, the World Bank initiated a new generation of programs in Ukraine that focus on the development of **civil society**. This program is aimed at building integrity at the municipal level through strengthening the voice of citizen groups demanding better governance and services, and by facilitating more responsive public organizations.

The main focus of the **Global Development Learning Network Project** is to help build and strengthen administrative and institutional capacity in Ukraine through provision of access to learning facilities from a variety of global sources.

The Bank also carries out extensive program of **economic research**, including recent studies on tax policy and tax administration, regional policy, intergovernmental reform, pension policy, public expenditures and the budget process, poverty, financial sector and corporate governance, procurement system, financial accountability, health, education, energy and agriculture. Recently published reports also include Country Economic Memorandum, and a Trade Study. Reports under preparation are Public Expenditure Review, and a package of policy notes linked to the PAL/DPL program.

World Bank Contact: Sergiy Kulyk, Country Program Coordinator (Tel.:(202) 458-4068).

UKRAINE: RELATIONS WITH THE EBRD
(September 2005)

Ukraine joined the EBRD in 1992 and since then the EBRD has been active in supporting Ukraine's transformation toward a market economy, promoting the business environment and improving the investment climate for all investors. The EBRD's main contribution has been the funding of projects in both the pubic and private sectors, including some equity investments. This has been supported by a range of technical cooperation activities and by engaging in policy dialogue with the government. The latter has included membership of the Foreign Investment Advisory Council, but more especially, and in a sector-focused manner, through the EBRD's co-chairmanship of the Energy Sector Task Force and the Transport Working group recently established between EBRD and the Ministry of Transport.

The EBRD's first country strategy for Ukraine was approved in October 1992 and was revised in November 1993. These two documents underlined the need for financing private sector projects, developing the financial sector and rehabilitating existing infrastructure. In June 1997, the Board of Directors approved a new country strategy which in addition to the objectives listed above, emphasized the need to restructure the energy sector. During the period covered by this strategy, the EBRD and the Ukraine authorities established the Energy Sector Task Force (ESTF). The ESTF became one of the main channels for the EBRD to engage in policy dialogue with the authorities on reform in the energy sector, a dialogue which continues today. Among the main achievements of the ESTF was its work setting appropriate conditions, especially with respect to tariffs, for the privatization of the first power distribution companies to strategic investors in April 2001.

A revised country strategy was approved by the Board in August 2000 which focused on strengthening the financial sector and supporting the needs of SMEs; promoting the commercialization and structural reform of public utilities; improving energy efficiency and supporting the transition of the enterprise sector, especially in agribusiness. In addition during these years the EBRD sought to improve nuclear safety through the Nuclear Safety Account and the Chernobyl Shelter Fund initiatives, and also sought to ensure a clear understanding of the conditions to be fulfilled in respect of the K2R4 project financing to cover the completion of two nuclear power plants. In order to help strengthen the implementation of its projects, the post of Director for Banking Operations in Ukraine, based in Kyiv, was established towards the end of 2000.

In the 2002 Country Strategy, which was approved by the EBRD Board in September 2002, the EBRD resolved to further expand its activities in Ukraine, building on the period of rapid economic growth, the progress in reform in some sectors, for example energy and agriculture, as well as its success in attracting more non-EBRD financing. The main elements of the EBRD's operational strategy since have been: encouraging sustained momentum in privatization and commercialization of major utilities, encouraging energy efficiency in both the state and private sectors, providing funding through the banks to develop the small and medium business sector (SMEs) and commence funding for the agricultural sector through the provision of working capital.

To support these activities the EBRD emphasized the importance of policy dialogue with the authorities to improve the investment climate, the need to maintain co-ordination with other IFI's and also with bilateral donors to secure valuable sources of TC funding.

This approach was endorsed in a first Program of Co-operation signed in April 2003 by the Government of Ukraine and the EBRD. The agreement identified several priority projects in the public sector including those in the transport, energy and municipal infrastructure sectors, and emphasized the importance of nuclear safety. The EBRD also stressed its support for the development of the private sector, particularly the banking sector.

With respect to the K2R4 project, this project was approved by the EBRD Board in July 2004 and signed later that month. The EBRD will lend US$42 million, with a further US$83 million from the European Commission (Euratom), to finance post start-up safety and modernization measures at the two nuclear reactors. The focus of the project is to enhance nuclear safety and was approved on the basis that the previously agreed safety levels (before start-up) at the two reactors had been attained and that the completion of the remaining safety features would be to internationally accepted standards. A further condition of the loan is that tariff levels within the nuclear sector should be sufficient to enable the authorities to establish a decommissioning fund, as well as other funds to commence a program of safety upgrades at the other 13 nuclear plants in Ukraine. The respective loan and guarantee agreements were ratified by the Parliament if Ukraine in September 2005.

As regards the development of the financial sector and financing for SMEs, the Bank continued to finance small and medium enterprises through a US$ 88 million sovereign SME II Credit Line and started to provide financing through local banks without sovereign guarantee. A new US$ 200 million framework for SME/MSE lending direct through local banks was approved in December 2004. During the strategy period, the EBRD also contributed to the good progress in developing the Warehouse Receipt Programme (WHR) through the finalization of three projects based on the provision of working capital financing against WHRs.

In 2004 EBRD continued its efforts in establishing a framework for direct lending to municipalities. The Bank began the preparation of the first investment project in the municipal sector without a sovereign guarantee for the city of Dnipropetrovs'k.

The current EBRD Country Strategy for Ukraine, which was approved by the EBRD Board in May 2005, outlined three main areas of operational focus:

- *Helping to improve the business climate and the competitiveness of private sector* by encouraging and sharing risk with foreign direct investors, promoting syndications, enhancing integrity and corporate governance in local private sector projects, and supporting environmental and energy efficiency related projects.

- *Strengthening the institutional capacity of the financial sector and increasing the level of finance for micro enterprises and SMEs* by supporting consolidation in the banking sector, providing specialized credit lines, working with more banks and starting to work with insurance companies and other non bank financial institutions.

- *Supporting the restructuring and modernization of Ukraine's road, railway, harbor, airport infrastructure, power and oil & gas sectors* by financing sovereign guaranteed projects that help promote transition goals such as greater commercialization or more cost reflective pricing, and promoting new non-sovereign guaranteed structures and providing pre-privatization finance.

The new strategy was underpinned by a second Program of Co-operation for 2005–06 signed in September 2005 by the Government of Ukraine and the EBRD. The agreement identified several priority projects in the public sector including those in the transport, energy and municipal infrastructure sectors.

The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 64 by the end of August 2005. These amount to a historical net cumulative business volume of EUR 1,935.2 million. Of this amount EUR 1,055.6 million represented the portfolio (operating assets plus undrawn commitments) of which about 60 percent was assigned to the private sector (EUR 628 million) and the remaining to the state sector (EUR 426.8 million). Operating assets amounted to EUR 533,9 million at the end of August 2004.

The outstanding commitments to Ukraine represent about 7.2 percent of the total of the EBRD's commitments to all its countries of operation as of end-August 2005. There are in addition Technical Cooperation activities in Ukraine which, as of March 2005, included 239 projects with a total value of commitments of almost EUR 57 million. These are mainly related to project preparation and implementation.

Projects in the financial sector account for about 23 percent of the EBRD's commitment to Ukraine, with much of this represented by the loans provided under sovereign guarantee to support the development of small and medium size companies through lending via participating banks. The energy sector accounts for a further 16 percent of all net commitments. The largest single project in this category is in the power sector; other projects include the development of oil and gas resources, gas transit and energy efficiency. Projects in general industries, including agribusiness, represent about 33 per cent of net cumulative commitments, while transport and municipal and environmental infrastructure account for about 20 percent of all commitments.

The EBRD will prepare a new country strategy for Ukraine during the first quarter of 2007.

UKRAINE: STATISTICAL ISSUES

Economic and financial data provided to the Fund is broadly adequate for surveillance, albeit with some shortcomings. The authorities continued to make improvements in a number of areas over the past year. The data module of the Report on the Observance of Standards and Codes (ROSC) was prepared in 2002, and published on IMF's website on August 19, 2003. On January 10, 2003, Ukraine became the first CIS country to subscribe to the SDDS. Ukraine's first international investment position was compiled by the National Bank of Ukraine (NBU) in 2002. The country's *IFS* page has been published since July 1996.

While the Fund's technical assistance has been significantly reduced in recent years, various multilateral and bilateral sources continued to play an important role. The data ROSC recommended strengthening the independence of the State Committee on Statistics (SCS). Some statistical deficiencies remain for the national accounts and balance of payments data and publication of external debt data has been delayed. A STA mission visited in Kyiv in June 2004 to assist in revising the International Transaction Reporting System (ITRS) and assess the quality of current account data .

Key statistical data are generally provided in a timely manner, as summarized below.

Real sector statistics

The 1993 *SNA* is the general framework for compiling national accounts. The classifications used are largely in accordance with international standards. The source data are obtained from the extensive survey program of the SCS, supplemented with data from administrative and other sources. The main survey report forms have been revised significantly in recent years to bring them into line with the definitions, scope, and classifications of national accounts data, and the new chart of accounts of enterprises.

Significant improvements have been introduced in the compilation of the quarterly GDP estimates as data are now compiled on a discrete basis and fourth quarter estimates are consistent with the other quarters estimates. Seasonally adjusted quarterly GDP data are also now compiled, but have been disseminated only to a few selected users. A STA real sector mission in March 2005 found that the lack of appropriate price indices hamper production of accurate long-term GDP volume series using the new classification of economic activities adopted since 2001. There are still no proper quarterly price indices for exports and imports, although the development of these indices has started. The authorities agreed that the methodology covering the informal economy needs to be revised and improved. A further improvement of the data collection and production environment is needed, in particular, through greater use of sample surveys, and improving data flow management and processing. To address the shortcomings, it is important to revive the Statistical Council to provide guidance to the SCS on the quality of the statistical series and on strategies for improving data production.

Government finance statistics

The Ministry of Finance and the State Treasury have made considerable progress in the compilation of fiscal data. The MoF publishes monthly data on operations of the central and regional government within 25 days of the reference period. The economic classification of transactions and the classification of outstanding debt are consistent with the methodology outlined in the 1986 Fund publication *A Manual on Government Finance Statistics* (*GFSM 1986*). From 2002, the functional classification is consistent with the *GFSM 2001*, the current standard. All central government transactions and local government revenue transactions are recorded in the Treasury Single Account. Starting in 2004, the authorities have provided STA with local government expenditures for the period through 2003.

The data ROSC report highlighted that Government Finance Statistics (GFS) are available monthly but do not provide the recommended coverage. The authorities have since reported central and local government data for 1999-2003 in the *GFSM 2001* format, for publication in the *GFS Yearbook*.

The staff also noted that reporting on arrears, both for receipts and payments, should be improved and that there remain significant delays in reporting on the operations of special social funds.

Monetary and financial statistics

The data ROSC recommended that the timeliness of the analytical accounts of the central bank be improved using the daily accounting records on monetary operations. Ukraine uses both SDDS flexibility options for monetary data: the first for timeliness of the analytical accounts of the banking sector and the second timeliness of the analytical accounts of the central bank.

The authorities are establishing a migration plan to adopt the recommendations included in the *Monetary and Financial Statistics Manual* and have submitted an experimental compilation of monetary data through February 2005, using STA's standardized report framework.

External sector statistics

Ukraine's balance of payments statistics are compiled in broad conformity with the fifth edition of the *Balance of Payments Manual* and are reporting quarterly to STA with a lag of about ten weeks. The principal data sources are the ITRS, administrative data sources, and a survey of enterprises. Following the recommendations of the data ROSC, the authorities have expanded the survey on inter-enterprise arrears to include information relevant for balance of payments purposes, and intend to implement lower reporting thresholds for banks. A one-off pilot survey of travelers is to be conducted in 2006, and it is hoped that this will be the basis for improving the quality of shuttle trade, compensation of employees, and travel estimates. Some methodological weaknesses exist in private portfolio and FDI surveys. The authorities have made progress in disseminating international reserves data. The release of monthly data, in line with the Fund's reserve template, started in mid-2002. Though the cooperation between different government agencies has improved in recent years, problems still exist in coordinating the work of the National Bank of Ukraine, the SCS, and the MoF, particularly regarding short-term external debt. Ukraine started disseminating external debt data that meet all SDDS requirements in September 2004. An IMF technical assistance mission visited Ukraine during June 29-July 12, 2005. The report dealt with issues concerning customs-based trade statistics, data validation procedures, and data exchange between the State Statistics Committee and the National Bank of Ukraine.

UKRAINE: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	9/22/05	9/23/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	8/31/05	9/19//05	W	W	M		
Reserve/Base Money	8/31/05	9/19//05	D	D	M	O, LO, O, O	O, O, O, O, NA
Broad Money	8/31/05	9/19//05	M	M	M		
Central Bank Balance Sheet	8/31/05	9/19//05	M	M	M		
Consolidated Balance Sheet of the Banking System	8/31/05	9/19//05	M	M	M		
Interest Rates[2]	8/31/05	9/19//05	D	D	M		
Consumer Price Index	8/31/05	9/10/05	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	7/31/05	8/26/05	M	M	M	O, LO, LO, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	7/31/05	8/26/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	7/31/05	9/07/05	M	M	M		
External Current Account Balance	Q2 2005	Sept. 2005	Q	Q	Q	O, LO, LO, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q2 2005	Sept. 2005	Q	Q	Q		
GDP/GNP	Q1 2005	Aug 2005	Q	Q	Q	O, LO, O, O	O, LO, O, O, LO
Gross External Debt	Q4 2004	June 2005	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); or Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in August 2003 and based on the findings of the mission that took place in April 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2005 Article IV Consultation
Supplementary Information

Prepared by the European Department
(In consultation with the Fiscal Affairs
and Policy Development and Review Departments)

Approved by Michael Deppler and Michael Hadjimichael

November 4, 2005

1. This supplement provides information on developments since the staff report was issued. These developments, particularly the successful re-sale of the Kryvorizhstal steel combine, point to an improvement in the investment climate, which is in line with staff's assumption that investment activity would pick up to support growth in 2006. At the same time, uncertainties regarding the use of the windfall proceeds from the Kryvorizhstal re-sale strengthen the staff appraisal's concern that fiscal policy may turn out insufficiently tight to support disinflation in 2006.

2. **Recent high-frequency indicators are broadly in line with staff's short-term projections.** The sharp deceleration of real GDP growth during 2005 came to a halt in September; GDP growth over January-September has declined to about 3 percent (over the same period last year). Annual CPI inflation in October slowed to 12.4 percent, following a deceleration to 13.9 percent in September, suggesting that end-year CPI inflation is now likely to reach 12 percent, somewhat lower than projected in the staff report (14 percent). Nevertheless, assuming full execution of fiscal spending plans and continued rapid growth of household incomes and spending, inflation is likely to remain in double-digits through early-2006. While annual base and broad money growth slowed somewhat in September (to 27 percent and 31 percent, respectively), reflecting declining intervention pressure in the foreign exchange market, credit expansion has picked up (44 percent), financed increasingly through borrowing from abroad. With declining excess liquidity in the banking system, overnight interbank rates have been trending upward to 4½-6½ percent in September and October, but most interest rates remain negative in real terms. On the external side, the third-quarter current account was weaker than previously envisaged, and the staff forecast for the full-year surplus has been revised down to 4.8 percent of GDP (from 6 percent of GDP). The weakening of the current account is likely to be more than offset by the impact of the Kryvorizhstal re-sale on the capital account, and, as a consequence, gross official reserve accumulation for 2005 could be higher than previously envisaged.

3. **Budget implementation has remained on track.** Cash revenue through September 2005 remained buoyant, including for VAT and profit tax collections. At the same time, the stock of VAT refund arrears was reduced to ½ percent of GDP at end-September (from ¾ percent of GDP at end-June). To ensure foreign financing of the budget, the government issued in October a ten-year EUR 600 million eurobond yielding 4.95 percent, consistent with a spread of only 155 basis points above the German benchmark bond. Parliament has approved a supplementary 2005 budget, which incorporates unbudgeted pension spending amounting to some ¾ percent of GDP (already anticipated in the staff's projections) and spending of ¼ percent of GDP to re-capitalize the two state banks. At the same time, recent data point to a significant underexecution of spending, which, if maintained, could broadly compensate for the additional spending measures. Against this background, the general government deficit target of 2½ percent of GDP for 2005 could still be within reach, or be exceeded by only a small margin.

4. **The re-auction of the Kryvorizhstal steel combine fetched an unexpectedly high price.** In a transparent auction, Mittal Steel acquired an equity stake of about 93 percent of the Kryvorizhstal steel combine for $4.8 billion (5¾ percent of GDP). This amounted to six times the price paid at last year's privatization auction, which was widely viewed as rigged. Observers have interpreted the re-auction outcome as signaling improved confidence by foreign investors in Ukraine's economic prospects, notwithstanding that parliament twice voted to stop the re-sale. After repaying Kryvorizhstal's previous owners $0.8 billion, net revenue to the budget from the sale will amount to about Hrv 20 billion (or 5 percent of GDP), significantly exceeding budgeted privatization revenue for 2005 (1¾ percent of GDP). The government and Mittal Steel have agreed that payments will be completed before end-2005.

5. **A wide range of options is being discussed for using the privatization windfall, with some options calling for adjustments in the macroeconomic policy mix.** According to staff estimates, 1½ percent of GDP of the proceeds will be needed to cover the remaining gross financing needs of the state budget in 2005 (assuming no additional borrowing takes place during the rest of the year), leaving a net windfall of 3½ percent of GDP. Government officials have stressed the need to restrict the use of the additional financial resources for operations that broadly preserve the net worth of government, particularly repaying debt and investing in public infrastructure. On the other hand, with parliamentary elections looming in March 2006, other leading politicians have advocated increasing recurrent spending, including social transfers and subsidies for agriculture and mining. Since additional recurrent spending would add to inflationary pressures, it would call for an offsetting monetary policy response. Moreover, even without changes in the fiscal stance, a shift in the budget's financing structure, for example from domestic debt toward the use of privatization receipts, could still impact liquidity conditions and require a compensatory monetary policy response.

6. **The outcome of the 2006 budget process remains uncertain**. Parliament rejected the government's draft budget during the first reading and proposed to increase revenue projections, including by removing proposed tax cuts, raise spending, and increase the deficit

ceiling by about 1 percent of GDP. The unexpected privatization windfall has added to pressures to raise spending and the deficit ceiling. However, government officials have consistently noted that there is no good reason to increase the deficit and that there is a need to reduce the tax burden. In a repeated first reading on November 1, parliament approved a revised government budget proposal that kept the deficit ceiling unchanged, but parliamentary pressures to raise spending and the deficit are likely to remain strong.

7. **The new government has made some headway toward tackling structural reforms.** The Cabinet of Ministers approved a new draft law on strengthening minority shareholder rights (three previous drafts were, however, rejected by parliament). The government is also considering eliminating the Economic Code, parts of which contradict the more business-friendly Civil Code. Moreover, parliament adopted two more bills required for WTO accession, while the EU Commission has confirmed that it will grant market economy status to Ukraine at the beginning of December. Finally, indicating progress toward more market-friendly institutions, the latest 2005 Transparency International corruption perception index upgraded Ukraine, which ranked 107th out of 158 countries in 2005, to be compared with 122nd out of 146 in 2004.

Staff Appraisal

8. **The transparent re-auction of Kryvorizhstal is welcome, but the proceeds should be used wisely.** The authorities should avoid using the additional financial resources in ways that could further complicate macroeconomic management, particularly by increasing inflation pressures through higher recurrent spending, such as social transfers or subsidies. Accordingly, the authorities should allocate the windfall proceeds primarily for debt redemptions that do not aggravate the domestic liquidity overhang, and, to a limited extent, for well-targeted spending on public infrastructure programs. Such a strategy would help avoid fuelling significant inflationary pressures, broadly preserve the government's net worth, and build room against future contingencies as well as for the country's sizable medium-term fiscal needs. Nevertheless, monetary policy makers would need to be vigilant to counteract in a timely manner any relaxation of monetary conditions entailed by the use of the Kryvorizstal privatization proceeds.

Table 1. Ukraine: Selected Economic and Social Indicators, 2001-06

	2001	2002	2003	2004	2005	2006	
				Prel.	Proj.	Baseline scenario 1/	Adjustment scenario
Real economy (percent change unless indicated otherwise)							
Real GDP	9.2	5.2	9.6	12.1	4.0	5.5	5.0
Nominal GDP (in billions of hryvnias)	204.2	225.8	267.3	344.8	415.5	499.8	486.5
Unemployment rate (ILO definition; percent)	11.8	10.1	9.1	6.1	...	...	...
Consumer prices, period average	12.0	0.8	5.2	9.0	13.7	12.9	10.5
Consumer prices, end of period	6.1	-0.6	8.2	12.3	12.0	13.0	9.0
Average monthly wages, annual average	35.2	21.0	22.8	27.5	...	...	...
Public finance (in percent of GDP) 2/							
Cash balance	-1.6	0.5	-0.9	-4.4	-2.9	-3.2	-2.3
Revenue 3/	33.5	36.0	35.9	35.0	39.7	38.4	38.4
Expenditure (cash basis)	35.1	35.5	36.8	39.4	42.7	41.5	40.7
Primary balance (cash basis)	0.4	1.8	0.1	-3.5	-2.1	-2.1	-1.2
Commitments balance 4/	-1.5	0.2	-0.1	-3.6	-2.8	-3.1	-2.2
Privatization proceeds	1.3	0.5	1.1	3.1	5.3	1.8	1.8
Net domestic financing	-0.1	-0.3	-1.2	-0.1	-2.9	0.8	-0.1
Net external financing 3/	0.4	-0.7	1.0	1.4	0.6	0.5	0.6
Public debt and arrears 5/	38.6	35.7	27.7	25.1	21.1	18.5	17.1
o.w. external debt	26.6	24.0	21.6	19.2	15.6	12.5	12.3
Money and credit (end of period, percent change)							
Base money	37.4	33.6	30.1	34.1	42.1	24.5	21.8
Broad money	41.9	41.8	46.5	32.3	41.0	27.9	25.1
Credit to nongovernment	40.5	47.3	63.4	31.2	49.5	28.6	25.5
Velocity 6/	4.46	3.48	2.78	2.75	2.34	2.20	2.19
Balance of payments (in percent of GDP)							
Current account balance	3.7	7.5	5.8	10.5	4.8	1.0	0.9
Foreign direct investment	2.0	1.7	2.8	2.7	4.7	2.4	2.6
Gross reserves (end of period, in billions of U.S. dollars)	3.1	4.4	6.9	9.5	18.9	21.4	21.6
In months of next year's imports of goods and services	1.7	1.9	2.4	2.7	4.7	4.8	4.8
Debt service (in percent of exports of goods and services)	6.7	5.4	6.2	4.8	4.9	5.1	5.1
Merchandise exports (annual volume change in percent)	7.0	7.1	14.1	16.5	2.2	7.9	7.4
Merchandise imports (annual volume change in percent)	12.8	5.9	30.4	15.7	14.2	10.3	9.8
Merchandise exports	45.0	44.0	47.4	51.4	45.8	40.4	39.6
Merchandise imports	44.4	42.4	47.9	46.3	45.6	43.2	42.3
Share of metals in merchandise exports (in percent)	39.3	38.2	35.8	39.1	...	...	...
Net imports of energy (in billions of U.S. dollars)	5.0	4.9	5.1	6.6	...	...	...
Savings and investment (in percent of GDP)							
Foreign savings	-3.7	-7.5	-5.8	-10.5	-4.8	-1.0	-0.9
Gross national savings	25.5	27.7	27.8	29.9	25.6	22.1	22.1
Nongovernment	24.0	24.2	24.2	28.0	24.9	21.7	20.7
Government	1.5	3.5	3.6	1.9	0.7	0.4	1.3
Gross investment	21.8	20.2	22.0	19.4	20.8	21.1	21.2
Nongovernment	18.7	17.2	17.7	13.1	17.2	17.5	17.6
Government	3.1	3.0	4.3	6.3	3.6	3.6	3.6
Exchange rate							
Exchange rate regime		*de facto* peg to U.S. dollar					
Hryvnia per U.S. dollar, end of period	5.3	5.3	5.3	5.3	...	...	...
Hryvnia per U.S. dollar, period average	5.4	5.3	5.3	5.3	...	...	...
Real effective rate, (percent change) 7/	6.0	-4.1	-6.3	-0.9	...	...	...

Social indicators

Per capita GDP: US$ 1,366 (2004); **Poverty** (percent of population): 27.3 (2004; national headcount index);
Life expectancy at birth: 68.2 years (2004); **Infant mortality** (per 1,000): 9.5 (2004); **Child malnutrition** (percent of children under 5): 3.0 (2001);
Income/consumption distribution (Gini index): 29.0 (2004); **Gross primary enrollment** (percent of school-age group): 87.9 (2004)

Sources: Ukrainian authorities; World Bank; Unicef; and Fund staff estimates and projections.

1/ Based on policy intentions by the authorities and staff's real GDP projections.
2/ The 2006 projections assume that the proceeds from the re-sale of Kryvorizhstal are held in the government account with the NBU.
3/ From 2003 onwards, based on an accounting treatment that excludes offset-based amortization to Russia, which decreases revenues and increases net external financing (and the budget deficit) by 0.2 percent of GDP relative to previous years.
Clearance of VAT refund arrears is reflected in the consolidated government balance (cash basis) through a reduction of net VAT cash revenues.
4/ Cash balance adjusted for the net accumulation of expenditure and VAT refund arrears, as well as for non-cash property income.
5/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
6/ Annual GDP divided by end-period broad money (M3).
7/ Period averages; (+) represents real appreciation; based on CPI and average trade weights for 1996-2002.

INTERNATIONAL MONETARY FUND

UKRAINE

Ex Post Assessment of Longer-Term Program Engagement

Prepared by a staff team from the European, Fiscal, Policy Development and Review, and Research Departments[1]

Authorized for distribution by the European and Policy and Review Departments

October 18, 2005

Contents Page

[1] The team led by Mr. Jaeger included Ms. Schaechter (both EUR), Mr. Johnson (RES), Mr. McGrew (PDR), and Mr. Pivovarsky (FAD).

Figures

Tables

Boxes

Appendices

ACRONYMS

CAS	Country Assistance Strategy
CIS	Commonwealth of Independent States
CPI	Consumer price index
EFF	Extended Fund Facility
EPA	Ex Post Assessment
EUR	IMF European Department
FSAP	Financial Sector Assessment Program
HRV	Hryvnia
IEO	Independent Evaluation Office
IFI	International Financial Institutions
KRB	Karbovanets
LEG	IMF Legal Department
MFD	IMF Monetary and Financial Systems Department
MONA	Monitoring of Fund Arrangements
na	Not available
n/a	Not applicable
NBU	National Bank of Ukraine
NDA	Net domestic assets
NIR	Net international reserves
PC	Performance criterion
PPP	Purchasing power parity
SBA	Stand-By Arrangement
SDDS	Special Data Dissemination Standard
SDR	Special drawing right
SOE	State-owned enterprises
STA	IMF Statistics Department
STF	Systemic Transformation Facility
WEO	World Economic Outlook

EXECUTIVE SUMMARY

Over the last 13 years, while drawing heavily on Fund policy advice and financial support, Ukraine's transition experience has been disappointing. This report discusses the reasons for Ukraine's lackluster performance, the Fund's role in shaping policies, and lessons for future Fund engagement.

Why did Ukraine's transition disappoint? The country had a difficult start during 1992-94, with collapsing output and bursts of hyperinflation. During the second half of the 1990s, Ukraine increasingly conducted monetary policy, and, with a lag, fiscal policy in a manner broadly conducive to macroeconomic stability. But the slow pace of reforming market-enhancing institutions kept the economy in a growth rut, rendering gains on macroeconomic stability fragile. The key factors accounting for the slow buildup of more market-friendly institutions included: (i) the prevalence of rent seeking and the absence of strong private-sector lobbies favoring reform; (ii) a lack of political consensus on the scope and pace of economic reforms; and (iii) a public administration with a generally thin economic knowledge base and weak capacity to prepare and implement policy decisions. As a result, Ukraine got stuck in an under-reform trap, with constrained growth dynamics, an expanding shadow economy, and a pervasive non-payment culture. The 1998 financial crisis proved, with hindsight, a turning point. Growth rebounded strongly during 2000-04, triggered mainly by a massive real devaluation combined with limited, but focused, structural reform efforts. Moreover, the export-led growth rebound and maintained fiscal discipline put Ukraine on a high-savings path, and, given the difficult investment climate, resulted in large and growing external surpluses. As a consequence, Ukraine has emerged from its transition with relatively low levels of public and external debt. At the same time, the backlog of more market-friendly institutions remained largely unaddressed, inflation started to trend up in early-2003, and the growth boosting effects of a fundamentally undervalued exchange rate and excess capacities seem to be fading.

What role did the Fund play in Ukraine's transition? Fund-supported programs had a mixed record in achieving their objectives. While the programs were quite effective in supporting macroeconomic stability, they did not succeed in accelerating the buildup of more market-friendly institutions. Lack of political consensus would always have been a major obstacle for success, but effectiveness also suffered from program designs that, at least until 1999, were too wide-ranging in the structural area and difficult to monitor. At the same time, the Fund can take credit for a widely-appreciated role of transferring knowledge through continuous policy dialogue and technical assistance; efforts that gradually allowed the authorities to develop improved home-grown capacities for analysis and policy.

What lessons can be drawn for future Fund engagement? While Ukraine has certainly come a long way from its 1990s travails, the past seems to hold three lessons for a future program engagement: (i) program ownership is key and needs to be tested; (ii) political and administrative constraints argue for streamlined conditionality; and (iii) in terms of objectives, a program should focus on Fund core areas, i.e. strengthening and maintaining macroeconomic and financial stability. Although there is no immediate external financing need, a Fund-supported program could provide a coherent macroeconomic framework as Ukraine seeks to catch up on its institutional backlog. A program may also be useful in providing insurance, given Ukraine's highly open and undiversified economy and its vulnerability to adverse shocks. A program would have to include sufficient conditionality in critical structural areas—anchored within the Ukraine-EU Action Plan and coordinated with the World Bank—to ensure that Ukraine's backlog of market-enhancing institutions is addressed. In this vein, it would also be desirable to first test the strength of political consensus behind a future program by making a prior action implementation of a few key, but long-delayed reforms, for example in the areas of strengthening transparency in the banking sector or improving corporate governance.

I. INTRODUCTION

1. **This Ex Post Assessment (EPA) focuses on three main issues:**

- **Accounting for Ukraine's macroeconomic record:** In particular, why did Ukraine during the 1990s turn in what was likely the weakest growth performance among transition economies unaffected by internal or external strife? But also, why did the economy, starting in 2000, stage an almost equally-surprising growth rebound?

- **Accounting for the Fund's role in Ukraine's difficult transition:** What were the Fund's contributions during Ukraine's economic rollercoaster experience? In particular, why did Fund-supported programs often not achieve their objectives?

- **Drawing lessons for future Fund involvement:** What can be learned from the past record under Fund-supported programs? And how can the Fund best contribute to Ukraine's further transition?

2. **The EPA draws on a number of disparate sources,** including IMF documents since Ukraine became a Fund member in September 1992 as well as studies by academics and by World Bank and Fund staff, including a 2002 *Country Strategy Paper*. The EPA also draws on interviews and discussions with Fund and Bank staff and with present and former government officials of Ukraine.

3. **The report is structured as follows.** Section II recounts Ukraine's macroeconomic record, moving from the traumatic years of 1991-99 that witnessed a dramatic output decline to the more recent strong-growth years of 2000-04. Section II also reports on the key features of IMF-supported programs and their tendency to often go awry. Section III tries to account for Ukraine's macroeconomic record. It attributes the precipitous output decline during the 1990s to slow institutional reforms. At the same time, it credits the growth turnaround since 2000 in part to the consequences of the 1998 financial crisis—these included a large real devaluation, improved fiscal discipline, and limited but well-targeted structural reforms. Section IV looks at the role of the IMF, asking in particular why the Fund almost consistently stayed engaged in program mode, at least before 2001, notwithstanding the programs' limited success in fostering reforms. Finally, Section V takes stock and reflects on what lessons to draw for future Fund engagement in Ukraine.

II. WHAT HAPPENED?

4. **Ukraine's economic development since independence and the Fund's role in shaping policies fall into three distinct phases (**see also the period averages in Table 1**)**:

- The **first phase**, spanning 1992-94, was characterized by incoherent policies, rampant inflation, and collapsing output. During this period, the Fund acted mainly as an educator and provider of technical assistance.

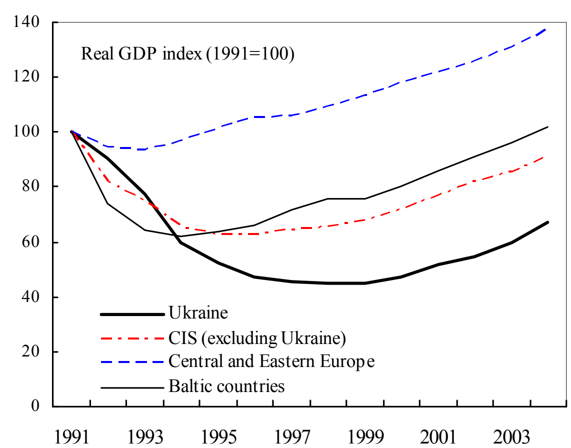
- The **second phase**, 1995-99, saw a fitful drive toward macroeconomic stabilization amidst continued output declines, while structural reforms were lagging behind. This phase was brought to an end by the financial crisis in 1998, which shattered foreign-investor confidence in Ukraine. During this phase, the Fund played a high-profile role in shaping policies through consecutive Fund-supported programs and by providing large amounts of technical assistance.

- The **third phase**, stretching from 2000-04, brought a strong rebound in growth, together with an all-around strengthening of Ukraine's financial fundamentals. Improved fiscal discipline and massive relative price shifts in favor of corporate sector profitability, combined with a difficult investment climate, transformed Ukraine into a "savings overhang" economy with little need for IFI financing. In this setting, progress on building more market-friendly institutions remained slow, stymied by lack of political consensus. Nevertheless, the Fund and the authorities maintained an intensive policy dialogue, punctuated by attempts to rekindle a formal program relationship.

A. The Macroeconomic Record: Some Snapshots

5. **Ukraine's economy has undergone a rollercoaster experience, but still has relatively low official income levels despite the recent upswing.** Initially, output slid cumulatively by 55 percent over eight consecutive years, followed by a cumulative output gain of 50 percent during 2000-04 (Figure 1). While Ukraine's output trajectory since independence shares a common component with the trajectories of other former Soviet Union countries, particularly during the rebound phase, the steepness and duration of Ukraine's output collapse during the 1990s seems unmatched by any other transition economy unaffected by internal or external strife.[2] In 2004, official gross national income per capita amounted to only $6,250, significantly

Figure 1. Economic Slump and Recovery in Transition Economies



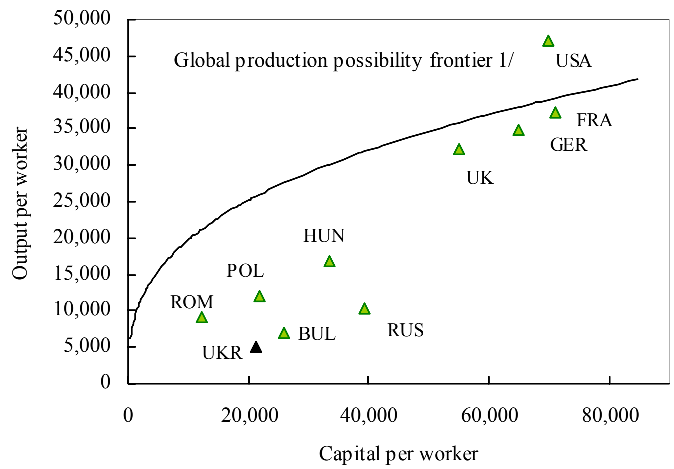
Source: IMF *International Financial Statistics.*

[2] Measures of output in transition economies, particularly during the early transition phase, are subject to numerous caveats (see Bloem and others, 1996). Nevertheless, the conclusion in the text seems reasonably robust with respect to cross-country differences in the size of the shadow economy, which is estimated, however, to be larger in Ukraine than in most other transition economies.

below levels in neighboring Poland ($12,640) and Russia ($9,620), but clearly above Moldova ($1,930) and several other CIS countries.[3]

6. **Ukraine's low per capita income reflects very low efficiency in using available resources.** In particular, cross-country data suggest that Ukraine has been using its abundant real and human resources poorly, especially when compared with industrial countries but also relative to other transition economies (Figure 2).[4] In fact, Ukraine's production efficiency in 2000—measured as the distance between a country's actual output per worker and the "best practice level" conditional on a country's real resources—is one of the lowest among transition economies. And, even after taking account of the 2000-04 growth rebound, Ukraine's income level remains at a fraction of its long-term potential.

Figure 2. Ukraine: Efficiency and Output, 2000
(US$, 1985 prices, PPP)



Source: Tiffin (2005).
1/ The frontier represents the implicit output that could be obtained if a country were to employ all its resources efficiently, using global best practices.

7. **Other social indicators suggest that Ukraine's transition experience has left deep scars in its social fabric.** As regards health standards, perhaps most striking, and mirroring Russia's experience, is the dramatic drop in male life expectancy since 1991 (Table 2). While spending on education in Ukraine has remained robust, enrolment ratios for secondary education seem not to have kept pace with those in Eastern European countries.[5] Birth rates have declined sharply, and, also reflecting high emigration rates, Ukraine's population has shrunk by 4 million since independence. Though only patchy measures are available on the distribution of income and wealth, the gap between the rich and the poor seems to have widened dramatically during the transition. Finally, survey data on life satisfaction, while also to be taken with a grain of salt, consistently rank Ukraine at the extreme bottom in cross-country comparisons (see, for example, Sanfey and Teksoz, 2005).

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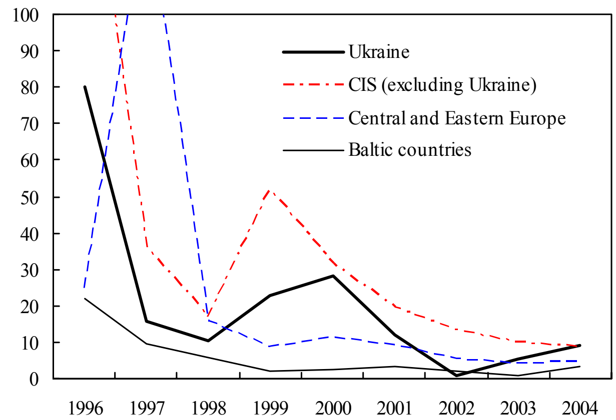
[3] Per capita income evaluated at purchasing power parities (PPP).

[4] See Tiffin (2005), who also discusses the econometric methods and data caveats underlying Figure 2.

[5] The authorities have noted, however, that the school enrolment data used in Table 2 may be unreliable.

8. **Over time, Ukraine's control of inflation has improved gradually, but the goal of keeping inflation low and stable has remained elusive.** Following two brushes with hyperinflation—monthly CPI inflation rates exceeded 50 percent in 1993 and again in late-1994—monetary control over inflation was broadly established by late-1996, notwithstanding the continued output decline until 1999 (Figure 3).[6] But inflation rates during recent years have shown little tendency to converge to a low and stable inflation rate, first veering toward deflation in 2002, and, since 2004, surging back into double-digits.

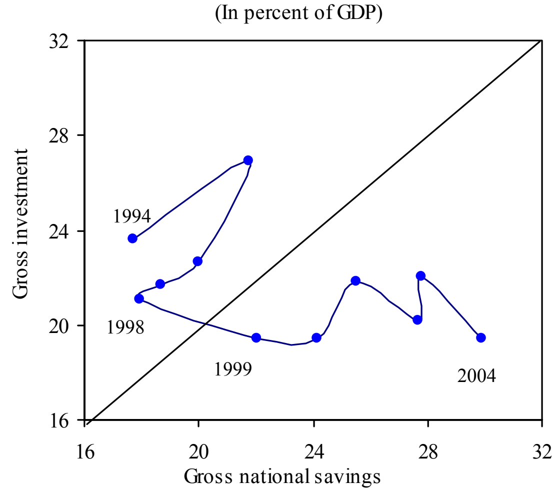
Figure 3. Inflation in Transition Economies
(Percent change)



Source: IMF *International Financial Statistics.*

9. **The 1998 financial crisis marked the beginning of a shift to high national savings and persistent external surplus positions.** After pressing up against tight external and domestic financing constraints for most of the 1990s, fiscal policy from 2000 onward adopted and broadly maintained a tight stance, reflected in a shift toward higher public savings. Private savings also increased, mainly driven by improved corporate profitability following a sharp real devaluation and favorable shifts in the terms of trade. The level of investment (as a percent of GDP) has remained fairly steady throughout the transition, reflecting a difficult investment climate, so the external current account surplus has ballooned (Figure 4).

Figure 4. Ukraine: Investment-Savings Balance
(In percent of GDP)

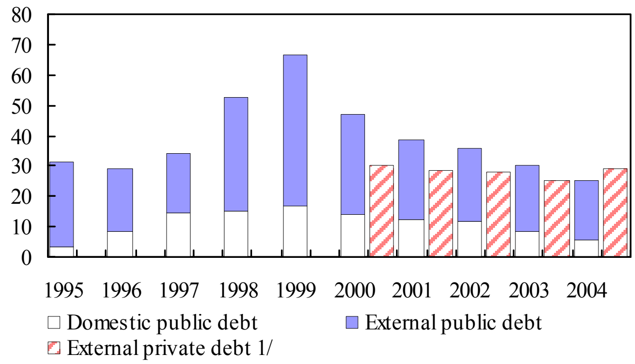


Source: IMF *International Financial Statistics* .

[6] For a detailed account of inflation determinants during 1993-2002, see Lissovolik (2003).

10. **External and public debt positions improved significantly following the 1998 financial crisis.** In fact, the World Economic Outlook (WEO) classifies Ukraine as a net creditor country, i.e., its cumulated current account balances since 1992 have been positive.[7] However, official data indicate an unusually high level of private external debt (29 percent of GDP, Figure 5) raising questions about the consistency of external flow and stock data. Public external indebtedness in 2004 was low (19 percent of GDP), and interest rate spreads have narrowed from more than 2,000 basis points in 2001 to only about 175 basis points in August 2005. Nevertheless, sovereign ratings are still three notches below investment grade.

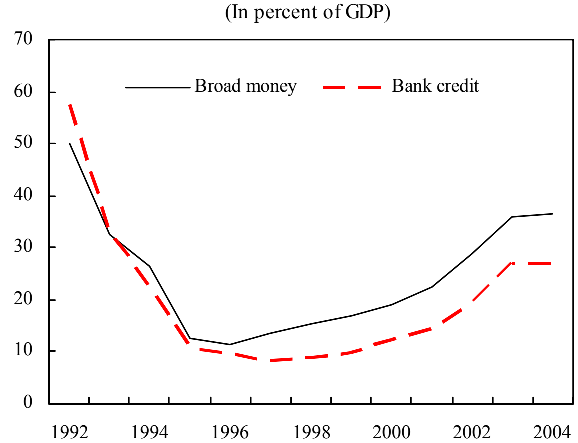
Figure 5. Ukraine: Public and External Private Debt
(In percent of GDP)



Sources: Ukrainian authorities; and staff estimates.
1/ Private external debt is only available from 2000 onward.

11. **The 1998 financial crisis also proved a watershed for financial sector development.** On the one hand, in the period since the crisis re-monetization of the economy and re-intermediation by banks accelerated (Figure 6). For example, the loan portfolio of Ukrainian banks, which had contracted to only 9 percent of GDP by 1998, has since surged on average by 3 percentage points per year, bringing it to a level similar to that of more advanced transition economies, such as Poland and Bulgaria. On the other hand, the 1998 financial crisis proved to be a major setback for developing more sophisticated financial markets and instruments. In particular, measures introduced to stabilize the foreign exchange market in 1998, such as export surrender requirements and the prohibition of forward transactions, were only lifted in 2005. And it took several years to revive a rudimentary market for government securities.

Figure 6. Ukraine: Monetization and Financial Intermediation
(In percent of GDP)



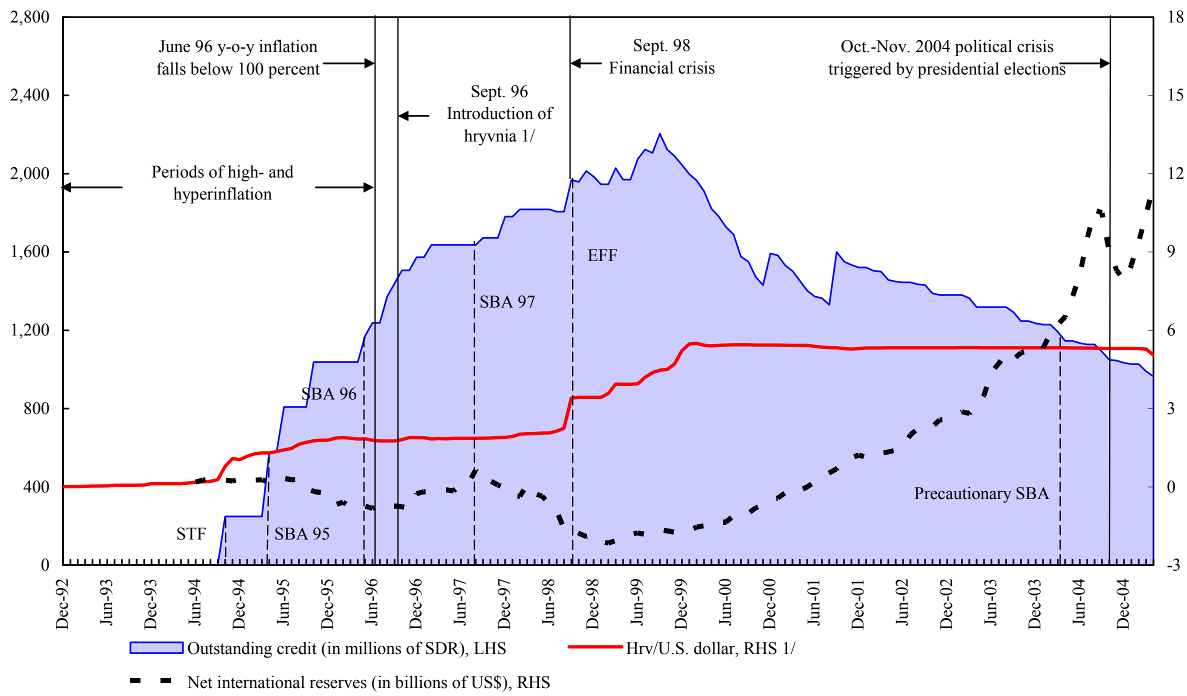
Source: IMF *International Financial Statistics*.

[7] Among 29 transition economies, the WEO classifies only five as net creditor countries.

B. The IMF Program Record: Objectives and Outcomes[8]

12. **Ukraine has had Fund-supported programs for most of the past 10 years, with the most recent disbursement occurring in 2001.** Ukraine first borrowed under the Systemic Transformation Facility (STF) (October 1994-April 1995), went through three Stand-By Arrangements (SBA) (April 1995-April 1996, May 1996-February 1997, and August 1997-August 1998), an Extended Fund Facility (EFF) arrangement (September 1998-September 2002), and following a program lull, a one-year precautionary SBA that expired in March 2005 (Figure 7). The Fund's exposure vis-à-vis Ukraine peaked at about 200 percent of quota at end-November 1998 and has since declined to 67 percent of quota as of end-July 2005.

Figure 7. Ukraine: Fund Relations and Key Financial Indicators



Sources: Ukrainian authorities; and International Monetary Fund.

1/ The hryvnia replaced the karbovanets at a rate of 100,000 to l; the exchange rate is shown for Hrv/US$ for the entire period.

[8] For details on the contents of individual programs and program compliance, see Appendix VI.

13. **Ukraine's program compliance was generally weak.** Ukraine was late in obtaining financing through the STF, despite the facility's more lenient conditionality. Four Fund-supported programs covered the next seven years almost continuously, but only three out of 13 reviews were completed on time and without waivers (Table 3). Measured by the number of reviews, programs were off-track for more than 85 percent of the time, or, if programs with delayed reviews are considered as still on track, 45 percent. Ukraine drew 68 percent of the approved amounts (excluding the recent precautionary SBA).

14. **The early programs aimed at restoring macroeconomic stability.** The programs' focus was threefold: (i) limiting central bank financing of the fiscal deficit; (ii) eliminating directed lending to so-called priority sectors; and (iii) preparing the ground for structural reforms. However, lack of policy resolve during mid-1995 delayed stabilization, depleted the NBU's international reserves, and pushed the first SBA off track. Financial stability was restored under the second SBA, with most quantitative performance criteria observed. But while the second SBA seems to stand out as a relative success—inflation was brought down to 25 percent by early-1997 and the fiscal deficit reduced to 3.2 percent of GDP in 1996 (from 4.9 percent in 1995)—the authorities achieved the latter mainly by running arrears. To address this problem, the next SBA established ceilings on arrears as new conditionality. When fiscal adjustment continued to lag, the new program went promptly off-track.

15. **After scoring some gains on macroeconomic stability, programs increasingly sought to tackle underlying institutional weaknesses.** A comprehensive medium-term reform agenda to be supported by an EFF arrangement was discussed in 1997. But it did not find political support in the run-up to the parliamentary elections in March 1998, and the authorities and the Fund instead agreed on a one-year SBA (approved in August 1997), with focus on structural reforms. When the political deadlock was resolved after the elections, new discussions for an EFF arrangement finally succeeded. The choice to move from short- to medium-term Fund-supported programs reflected the view that institutional shortcomings were the major obstacles for turning Ukraine's growth performance around. The outbreak of the Russian financial crisis, which occurred only days before the scheduled Board meeting to discuss the request for the EFF arrangement, did not change the Fund's assessment that a medium-term program would be the appropriate tool to support Ukraine's transition. Nevertheless, the EFF arrangement was adjusted to reflect short-term stabilization needs. The structural measures under the program included a wide range of areas, including: privatization; public, tax and customs administration; treasury operations; pension system; public employment; energy and agricultural sectors; external trade; and the banking sector. In contrast to programs with most other transition economies at the time, but in line with Russia's program, Ukraine's case placed much more weight on structural reforms in non-Fund core areas, particularly privatization (Table 4).

16. **Stabilization policies were broadly appropriate under the EFF arrangement, but the program was derailed by lagging structural reforms.** After a short period of determined stabilization efforts in the immediate aftermath of the Russian financial crisis to counter inflationary pressures from the depreciation, and relatively quick progress in

restructuring government debt, the EFF reviews came to a halt after twelve months. Progress on structural reforms stalled again, and a major misreporting incident cast a long shadow on already difficult relations with the Fund (Box 1). The Fund briefly disengaged, and, when it reengaged in December 2000, sought to assure program ownership with a new strategy. Structural measures followed a much more streamlined approach and, when program performance remained poor, the Fund interrupted the arrangement. Only one delayed review was completed before the program expired in September 2002. Major sticking points were the accumulation of VAT-refund arrears; failure to reduce tax exemptions and export taxes; the slow pace of banking sector reforms; delays in privatization; and poor transparency.

Box 1. Misreporting International Reserves

While under IMF Stand-By Arrangements during 1996-98, Ukraine consistently misreported its levels of foreign reserve assets. The misreporting arose from numerous incidents of counting as reserves items that did not meet performance criteria definitions under the programs. This included "round-tripping operations," in which NBU deposits in foreign banks were on-lent to domestic banks, which in turn deposited them in foreign banks, leading to double-counting of NBU reserve assets. Subsequent audits, commissioned by the NBU, found no evidence of misappropriation of Ukraine's reserves.

Blame had to be shared all around. The Fund's Executive Board concluded in September 2000 that, as a result of misreporting reserve assets, Ukraine had breached its obligations under the Articles of Agreement. At the same time, it was also observed that, on the Fund's side, a willingness to work under rushed and disorganized circumstances and a climate of forbearance to "make the programs work" had played a role in allowing the misreporting to go on for a prolonged period.

The misreporting incident, which was highly publicized in the international financial press, temporarily cooled relations between the Fund and the authorities. While the amounts of noncomplying purchases were relatively small, the attitudes that led to the incidents—on the authorities' side, a cavalier attitude toward complying with program undertakings; on the Fund's side, a willingness to cut corners—led to a period of re-assessment of relations. The EFF arrangement was off-track from September 1999 to December 2000, partly due to slow reform progress, but perhaps more importantly because the Fund and the international community were no longer willing to settle for waivers and modifications of programs given an apparent lack of commitment and ownership by the authorities.

17. **But Ukraine managed to restructure its public debt, including through private sector participation—one of the first cases encouraged by a Fund-supported program** (Box 2). Ukraine faced serious cash-flow problems in the wake of the financial crisis and resorted to selective debt restructuring with private creditors between 1998 and early 2000. But the extent of relief proved insufficient, and the authorities sought a comprehensive debt restructuring agreement, including a request to the Paris Club, which eventually entered into force after the completion of the fifth and sixth review under the EFF arrangement in September 2001.

Box 2. Public Debt Restructuring

The initial debt restructuring strategy, which focused on selected creditors and instruments, did not succeed in restoring debt sustainability. In August 1998, the government agreed with domestic banks on a voluntary exchange of short-term T-bills for long-term bonds. An exchange of T-bills for non-resident investors for a Eurobond and the restructuring of a fiduciary loan by Chase Manhattan followed. But as negotiations, strongly encouraged by the Fund, with ING Barings for debt falling due in June 1999 stalled, the second review of the EFF arrangement in May 1999 called for the completion of a financing review before the next purchase. As negotiations were prolonged beyond the completion of the financing review in June, the Board issued a statement at end-June 1999 insisting on an agreement with private creditors on terms comparable to those of recent agreements with other creditors, thus strongly urging private sector involvement in debt restructuring before resorting to official financing.[1/]

Later on, a comprehensive restructuring effort succeeded in lowering debt levels, but the initiative was launched relatively late, a year and a half after the financial crisis. At the third review of the EFF arrangement in August 1999, the Board concluded that the selective debt restructuring efforts had not resulted in medium-term sustainability. Ukraine then launched a comprehensive exchange with a 99 percent participation rate, which involved the swap of four Eurobonds and three Gazprom bonds maturing in 2000-01 for four Eurobonds maturing in 2007. Between 2000 and 2002, Ukraine restructured its external debt with Paris Club creditors, and with other bilateral creditors, most importantly Turkmenistan. The total debt restructuring operation covered US$2.5 billion of external debt and US$0.3billion of domestic debt, representing about 9 percent of GDP. Debt restructuring together with the rapid economic growth and fiscal discipline combined to bring the public debt down from 67 percent of GDP in 1999 to 25 percent of GDP in 2004.

[1/] For an account of the private sector involvement, see International Monetary Fund (2001).

18. **The recent precautionary SBA sought first to establish a track record, but nevertheless failed to meet most key objectives.** Agreement on the latest Fund-supported

program, which aimed at sustaining stabilization gains in a year of presidential elections, came after an extended period of negotiations and attempts to build ownership and political consensus. Structural reforms were considered as having advanced in a few areas, including the introduction of a new budget code, public administration and pension reform, reforms in the banking sector, and trade liberalization. In addition, five prior actions were met, including: various measures to reduce VAT refund arrears; a delay in a minimum wage increase; and an increase in banks' minimum capital adequacy ratio. Nevertheless, the program went quickly off-track, mainly derailed by a massive loosening of fiscal policy in the run-up to the presidential election, a renewed buildup of VAT refund arrears, and little follow-up on structural reforms; in fact, none of the structural performance criteria were observed.

C. IMF−World Bank Cooperation

19. **The World Bank also found it difficult to make headway on structural reforms.** Like the Fund, the World Bank engaged relatively late in Ukraine through project and program lending. Initially, the Bank focused its engagement mainly on sectoral developments, in particular the enterprise, coal, agricultural, and financial sectors. But implementation of its 1996-99 Country Assistance Strategy (CAS) was disappointing—disbursement ratios were significantly lower than in other CIS countries; many of the prepared projects did not materialize; and the Bank's resource cost in supervising projects and programs were 50 percent higher than the regional average (World Bank, 2000a). In 2000, the World Bank approved a new CAS that shifted from a strategy of separate sector adjustment operations, which was viewed as a major shortcoming (World Bank, 2000b), to an approach that would address institutional and governance issues that cut across sectors. While progress was slower than envisaged, and disbursements calibrated upon progress, achievements were made in World Bank supported areas, including better financial discipline, budget system and treasury reform, stepwise tax reform, passage of a laws for secured interest and mortgage finance, establishment of regulatory agencies for non-bank financial institutions and telecom, financial sector reform, and the legislative basis for pension reform. Nevertheless, many objectives of the strategy were not achieved and Bank disbursements, particularly for project lending, fell far short of the envisaged envelope.

20. **The Fund and the Bank proceeded generally in a coordinated fashion, but the two institutions' roles changed over time.** Overlapping conditionality was used for key reforms (such as conducting an audit of the state energy company, selling gas through cash auctions, completing audits of the largest banks, and resolving or rehabilitating problem banks), and the combined leverage helped to achieve some progress in these areas. Different timings in engagements by the two institutions, however, complicated program relationships with Ukraine. When in 1998 progress stalled under the Bank's first CAS and the disbursements under the Bank's adjustment program halted until the redesigned Programmatic Adjustment Loan (PAL), the Fund stepped up its efforts to promote structural reforms. At the same time, the Fund drew heavily on World Bank expertise in formulating and monitoring policies in non-core Fund areas. A shift in responsibilities back toward the

World Bank occurred in 2000 when the World Bank approved its new CAS. The timing of the new World Bank strategy coincided with the Fund's approach of streamlining conditionality. In 2003 and 2005, the World Bank opted to financially support Ukraine through a PAL and a Development Policy Loan, respectively, while the Fund had no formal program relationship. But, the Fund's assessment letters, on both occasions, were one factor that the World Bank took into account when considering design and loan amounts in the lead-up and during Board discussions.

III. Accounting for the Macroeconomic Record[9]

A. Accounting for the Trauma Years: 1992–99

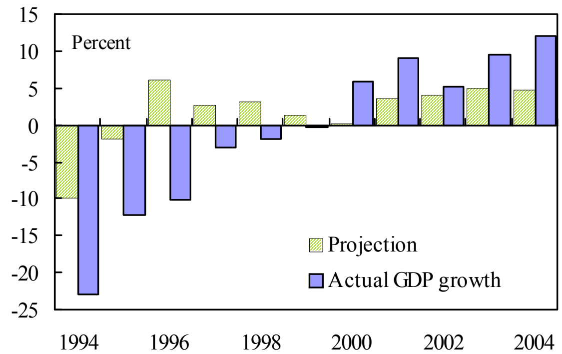
21. **Ukraine's initial conditions were unfavorable.** Prima facie, several potential tailwinds seemed to augur well for Ukraine's transition prospects: a well-educated population; excellent conditions for agriculture; a favorable geographic position; and an international community eager to provide support, not least to address security issues, particularly nuclear weapon stockpiles and Chernobyl. But two Soviet legacies proved to be major impediments:

- First, as in other CIS countries, external shocks caused an initial output collapse, reflecting primarily the loss of supply links to traditional trading partners and a sharp terms of trade deterioration. This combined with the fact that Ukraine was dependent on heavy, energy-intensive industries, including a large military goods sector.
- Second, Ukraine's knowledge base for managing the transition from plan to market was thin. Ukraine not only had to build its own state institutions almost from scratch, but its capacity for planning, implementing policies was weak.

[9] Other, and in part complementary, broad-brush accounts of Ukraine's macroeconomic record include Åslund (2005) and Litwack and Wetzel (2004).

22. **Nevertheless, the length and severity of Ukraine's economic downturn during the 1990s was very much unexpected.** For example, while the WEO projected Ukraine's real GDP to remain roughly stable between 1994 and 1999 (measured in terms of cumulative one-year-ahead WEO forecasts of real GDP growth), growth fell short of projections year after year, resulting in a record cumulative forecast error of more than 40 percent during 1994–99 (Table 5, Figure 8).

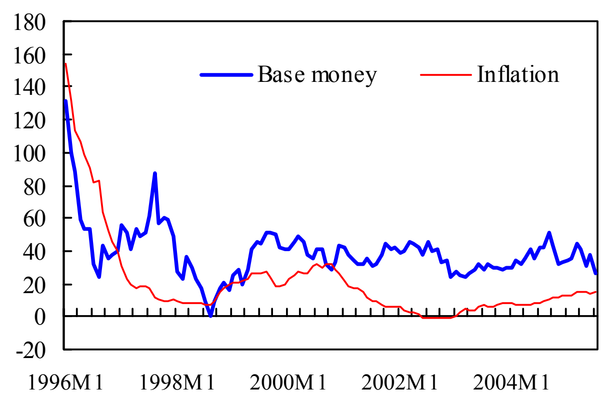
Figure 8. Ukraine: Forecast Errors for Real GDP Growth 1/



Source: IMF *World Economic Outlook* .
1/ Projections in the October WEO for the next year.

23. **Although lessons were initially learned the hard way, monetary policy gradually succeeded in reducing inflation.** The wrenching experience of very high inflation, which was fuelled by large monetized fiscal deficits and directed credits to state enterprises while accompanied by steep output declines, helped refute claims that a loose monetary policy was needed to protect the economy's supply side. At the same time, repeated bursts of hyperinflation undermined society's confidence in state institutions and policy making, and may in part account for later difficulties to build more market-friendly institutions. Nevertheless, by 1995, the National Bank of Ukraine (NBU) had a broad political mandate and had acquired the tools to counteract inflation by controlling money growth, even though fiscal policy once again relied heavily on NBU deficit financing in the run-up to the 1998 financial crisis (Figure 9). The introduction of a new currency—the hryvnia—in 1996 and its use as an exchange rate anchor contributed to stabilization.

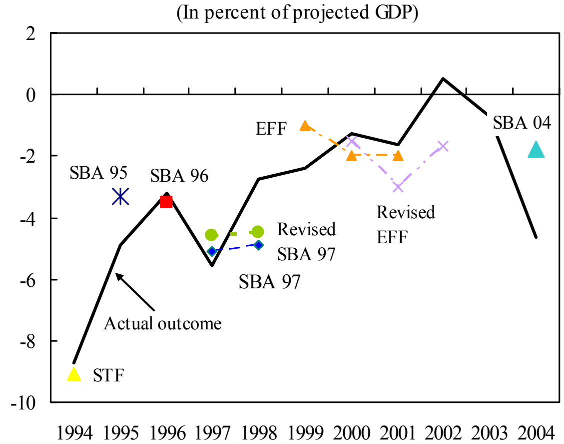
Figure 9. Ukraine: Inflation and Base Money Growth
(Y-o-y, in percent)



Source: IMF *International Financial Statistics* .

24. **However, fiscal discipline took longer to establish.** Modern budgetary institutions and practices (treasury, budget code) emerged only slowly. At the same time, fiscal discipline, as measured by deficit outcomes, seemed broadly maintained (Figure 10). But repeated GDP growth shortfalls, an ingrained culture of tax and spending arrears, high quasi-fiscal deficits, and sales of high-yield but short-term T-bills to non-residents created a potent mix for destabilizing the economy in case of adverse shocks. Nevertheless, when the 1998 financial crisis hit, and Ukraine was temporarily unable to roll over its short-term external debt, it proved to be a liquidity crunch rather than a solvency problem.

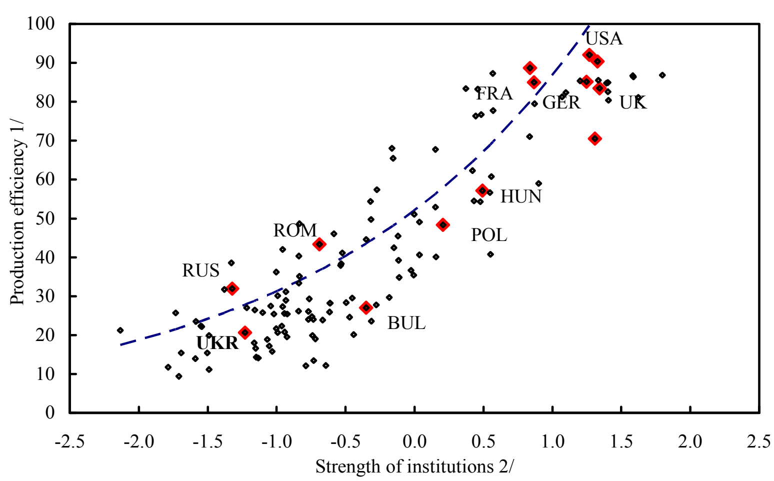
Figure 10. Ukraine: Fiscal Targets and Outcome
(In percent of projected GDP)



Source: IMF Staff Reports.

25. **Slow reform of market-enhancing institutions acted as the ultimate bottleneck for growth** (Box 3). Econometric analysis indicates that relatively market-unfriendly institutions—proxied by variables that capture the security of property rights, degree of corruption, competence of civil servants, and regulatory quality—account for Ukraine's large efficiency gap in producing output (Figure 11).

Figure 11. Efficiency and Institutions, 2000



Source: Tiffin (2005).
1/ Measures how closely (in percent) a country operates to the global production possibility frontier shown in Figure 2.
2/ Measured using the principal component of the indices compiled by Kaufman and others (2004) (ranging from -2.5 to +2.5) comprising rule of law, political stability, control of corruption, government effectiveness, and regulatory quality.

Box 3. Institutions, Growth, and Macroeconomic Stability: Three Lessons

Institutions are the rules of the game that shape economic actions. In the context of Ukraine's transition, it is useful to distinguish two broad types of institutions:

- **Market-stabilizing institutions** include monetary, fiscal, as well as financial sector prudential and supervisory arrangements. While these institutions are sometimes relatively easy to legislate—e.g., adopting a modern central bank law or budget code—, effective implementation can be difficult, creating gaps between formal and informal institutions. With strong support from the Fund, Ukraine made gradual but consistent progress on strengthening its market-stabilizing institutions, particularly following the 1998 financial crisis.

- **Market-enhancing institutions** are needed to allow markets to work efficiently, including by establishing secure property rights, enforce contracts, and regulate markets. These rules of the game are generally hard to legislate directly as they are the outcome of diffuse processes that also reflect the political and judicial systems. Moreover, in the case of Ukraine, formal laws and regulation are sometimes unclear or inconsistent (e.g., the Economic and Civil Codes). The indicators in Kaufmann and others (2005) are widely used to measures the strength of market-enhancing institutions.

Against this backdrop, the recent literature on institutions, growth, and macroeconomic stability has highlighted three cross-country lessons, all of which seem pertinent for Ukraine:

- **First, the strength of market-enhancing institutions is strongly positively correlated with countries' income levels and productive efficiency in the longer term** (see the cross-country evidence in International Monetary Fund, 2003, and Figure 11). Ukraine's own growth experience since 1992 seems consistent with this first lesson.

- **Second, growth accelerations can occur without a broad-based strengthening of market-enhancing institutions** (see the cross-country evidence in Hausmann and others, 2004)**.** Such growth spurts may, for example, be initiated by limited market-enhancing reforms or favorable external shocks. Ukraine's strong growth rebound during 2000-04 seems to fit this category. But the cross-country experience also suggests that growth rebounds that remain unsupported by broader institutional reforms tend to peter out as productive dynamism can not be maintained in the longer term.

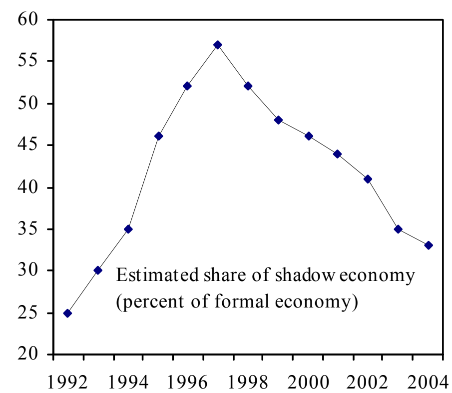
- **And third, progress on market-stabilizing institutions that is not complemented by progress on building market-enhancing institutions is unlikely to ensure durable macroeconomic stability** (see the cross-country evidence in Acemoglu and others, 2003). Thus, notwithstanding Ukraine's marked progress in building effective market-stabilizing institutions, this third lesson suggests that macroeconomic stability in the medium term needs to be anchored by progress in broader institution building.

26. **Mass privatization resulted in dispersed ownership and may have contributed to the protracted output decline**. For political and historical reasons, the Ukrainian privatization mechanisms used during 1992–98 involved mainly transfer of ownership to large numbers of individuals or to holdings of broadly-held financial intermediaries. In a legal environment that did not much support to minority shareholders, such dispersed ownership structures led to pilfering of enterprise assets by insiders, which may have undermined economic activity.[10] At the same time, allowing widespread strategic foreign ownership, perhaps the most promising alternative privatization method, was not the preference of the authorities and, in any case, would have been difficult to implement given the adverse investment climate.

27. **The economy responded to lagging market-enhancing institutions by creating further inefficiencies, setting in motion a vicious circle:**

- Activities migrated into the shadow economy—estimated to make up more than half of official GDP in1997 (Figure 12). To maintain fiscal revenues, the government had to levy a high tax burden on the formal economy, driving even more activities underground.

Figure 12. Ukraine: Shadow Economy



Source: Ukrainian Ministry of Economy.

- Given insufficient fiscal revenues and little scope to cut spending, the government resorted to financing through arrears. Wage, pension, and other payment arrears amounted to 3 percent of GDP in 1996, surging to 6 percent in 1999 after external financing had dried up during the financial crisis. With the government leading by example, a non-payment culture became ingrained.

- Lingering doubts about the solidity of the currency and lack of trust in the poorly supervised financial institutions led to demonetization of the economy and sharply restricted the availability of bank loans to newly privatized enterprises.

28. **But why did reforms of market-enhancing institutions not take off?** There seem to be four interlocking reasons:

- **No strong private sector lobbies for institution-building emerged.** Initially, the post-independence elite seemed more focused on consolidating its hold on power than on economic reform. As a result, there was no serious effort to limit the looting of state enterprises or to prevent rent-seeking. This led to the creation of powerful

[10] See Pivovarsky (2003).

insider groups bent on state capture and with a vested interest in maintaining a relatively disorganized and lawless situation.

- **The political system was fractured.** Early on there was little institutional clarity on the roles of the executive, legislative, and judicial branches. Moreover, policy making was hampered by the slow buildup of legal foundations[11] and a rapid succession of governments (Appendix IV). As regards parliament, vested interests came to dominate decisions, as up to one half of the members had no or only loose party affiliation, representing specific business or regional interests. Frequent switching between party lines added to instability and unpredictability of parliamentary majorities.

- **Policy making remained within a Soviet-style managerial framework** (Box 4). Government decision making at the highest levels was mainly focused on micro crises—for example, clearing wage arrears to teachers, closing specific coal mines, or dealing with the fate of specific enterprises—leaving little time or energy for pursuing the more strategic task of putting in place laws and regulations needed for the operation of a market economy. This focus on a managerial rather than a strategic mode of policy making partly reflected incentives: ministers and senior officials could expect most rewards from being seen pulling on available levers of power to resolve micro crises, which, in turn, tended to proliferate in an economy unmoored by agreed and credible rules of the game.

- **And Ukraine suffered from a version of the natural resource curse.** The dominance of heavy industries, including coal and steel, and large energy and agricultural sectors provided a ready habitat for corruption and rent-seeking activities (Box 5). A small set of people benefited from asset-stripping and brazen insider deals in these sectors, casting a shadow on the security of property rights as ownership structures came to be viewed as illegitimate by a large part of the population. This in turn provided incentives to the owners to invest heavily in political capital, re-enforcing the existing fracturing of the political system.

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[11] Ukraine was, for example, the last CIS country to adopt a constitution on June 28, 1996. The NBU Act and the Banking Law only became effective in 1999 and 2000, respectively.

Box 4. Retooling Ukraine's Policy-Making Machinery

Sundakov (1997, 2000) observed that, as a legacy of Soviet-era holdovers, policy making in Ukraine tended to focus on perpetual fighting of micro crisis, preventing the government from focusing on key strategic policy priorities. He identified three key issues that would need to be addressed to improve policy making at the government level:

- **Establishing a government agenda that focuses on strategic priorities**. With the government machinery prone to generating and responding to a multitude of specific issues, gaining control of the agenda would require that the government controls its policy agenda by restricting decision making to properly constituted meetings with a pre-announced and transparent agenda.

- **Preparing policy papers to inform policy meetings on options and risks**. Sundakov (2000) in particular noted that government decision making was largely based on draft legislation acts, which by their nature did not facilitate discussions of the different policy options and the risks entailed by these options.

- **Building requisite policy analysis skills**. Assuring the quality of papers underlying policy decisions would require a medium-term program to develop and upgrade the analytical and strategic skills of ministry staff involved in preparing policy background papers.

Box 5. The Energy Sector: From Rent- to Profit-Seeking

Ukraine started its transition with a highly energy-dependent economy. In 1991, measured on a per dollar of output basis, Ukraine's energy use surpassed that of other transition economies. Most energy needs were covered by imports, originally at a fraction of the world price. As a consequence, sharp rises in energy prices would impose immense adjustment costs on producers and consumers.

The energy sector became the fulcrum of industrial and social policies that led to a massive redistribution of rents. As energy prices rose, industrial lobbies pressed to delay an otherwise imminent output decline and the restructuring of their industries. Given intensive political pressures, state-owned energy companies failed to introduce hard budget constraints on enterprises and households, and arrears rapidly piled up. On several occasions, arrears were formally transformed into government debt (with the largest operation involving a $3.3 billion gas settlement with Russia and Turkmenistan in March 2005). Energy traders and other enterprises engaged in intransparent barter strategies, both inside and across Ukraine's borders, that quickly worsened governance problems in the energy sector while giving rise to the emergence of powerful and rich elites.

Quasi-fiscal activities in the energy sector declined substantially after reforms were introduced during 1999-2000. The cash collection ratio for electricity increased rapidly from a 15 percent in 1999 to 50 percent by end-2000 and over 90 percent by end-2004. However, the economy remains highly energy-intensive and governance in energy markets remains weak, constituting a potential source of economic instability. A key test will come once prices for gas supplies from Russia and Turkmenistan, which are still sold far below market rates, adjust to international levels.

B. Accounting for the Growth Turnaround: 2000–04

29. **The growth turnaround came as a big surprise to forecasters.** Given limited progress on institution-building, there seemed to be little basis for a sustained growth turnaround. Thus, Ukraine's growth boom during 2000-04 confounded most observers' expectations, this time in line with positive growth surprises for other CIS countries (Table 6). GDP during 2000-04 increased cumulatively by some 50 percent, while one-year-ahead WEO forecasts added to an increase of only about 19 percent, leaving a cumulative forecast error of 31 percent

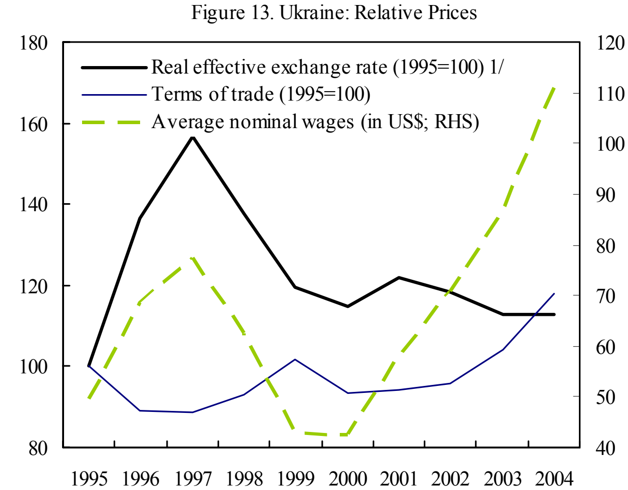
30. **Why did growth rebound with such unexpected vigor?**

- **Rising demand met idle capacities.** By the late-1990s, Ukraine had a large stock of unused capacities, and the growth rebound faced few supply constraints as soon as demand started to take off.

- **Massive relative price shifts turned the enterprise sector profitable** (Box 6). The sharp devaluation and fall in real wages following the financial crisis raised the competitiveness of Ukraine's products (Figure 13). Thus, the real devaluation, combined with the consolidation of previously dispersed ownership structures, effectively encouraged managers to behave in ways that spurred economic growth, even without far-reaching governance reforms. By then, enterprises had also learned how to make traditional products more marketable (see Berengaut and others, 2002). Subsequently, sharp terms of trade gains added to this growth momentum as Ukraine benefited from rapid increases in global prices for its exports of steel, other metals, and chemicals.

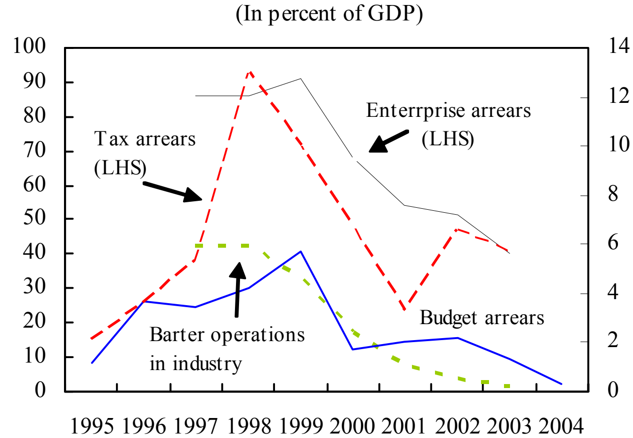
- **Limited but well-focused structural reforms also played a role.** These reforms—including successful insistence on cash payments for energy, withdrawal of the state from providing agricultural inputs, and the reduction in

Figure 13. Ukraine: Relative Prices



Sources: IMF *International Financial Statistics*; and staff estimates.
1/ Based on CPI and average trade weights.

Figure 14. Ukraine: Indicators of Non-Payment
(In percent of GDP)



Source: Ukrainian authorities.

social arrears—by the new government led by then-Prime Minister Yushchenko tackled the nonpayment culture in the energy and other sectors (Figure 14) and raised efficiency in the agricultural sector.[12]

31. **While the growth rebound facilitated fiscal discipline, tight external and domestic financing constraints also played a key role in keeping fiscal deficits in check.** Repeated positive growth surprises helped to meet budget deficit targets (Figure 10). At the same time, access to external and domestic financing was severely constrained during 2000-02, as demand by foreign and domestic investors for government securities had dried up and privatization revenue remained subdued (Table 1). But quasi-fiscal deficits, particularly in the energy sector, also started to decline sharply in 2001, while fiscal institution-building gathered momentum. By 1998, an interim treasury account that recorded most central government cash and noncash expenditure had become operational; and a modern Budget Code was introduced in 2001.

32. **Maintaining low and stable inflation rates has remained elusive.** Inflation declined sharply after 2000, notwithstanding continued robust nominal money growth (Figure 9). Rapid re-monetization of the economy and the nominal peg to the U.S. dollar seemed to have ushered in a period of low and stable inflation. But, following a phase of deflation in 2002, inflation started to trend upward again in early-2003, reflecting a complex mix of shocks, including: rapid economic growth since 2000; large terms of trade gains that boosted current account surpluses and incomes; supply-side disturbances to Ukraine's rigid food markets; and hikes in public wages and pensions in 2004 and 2005. However, the final impact and persistence of these multiple shocks on inflation was enhanced by a monetary policy framework primarily devoted to defending the peg to the U.S. dollar, a framework that left medium-term inflation outcomes seemingly unanchored.

33. **The main driving forces behind the recent growth spurt are waning.** Capacity bottlenecks have emerged, in particular since investment activity remained relatively subdued during the growth rebound. Also, the recent surge in inflation, combined with some nominal appreciation so far in 2005, has partly corrected the hryvnia's real undervaluation. Finally, prices for Ukraine's major exports, which had climbed rapidly since 2001, have started to reverse.

34. **At the same time, the crux of Ukraine's growth problem—weak market-enhancing institutions—remains unaddressed.** The World Bank's broad indicators of institutional strength point to no significant improvements in governance since 1998 (Figure 15). Moreover, in 2004, Ukraine still ranked 122 out of 146 countries in the corruption index compiled by Transparency International. And the business climate remained difficult during 1998-2004, as indicated by the miniscule cumulative FDI flows to Ukraine.

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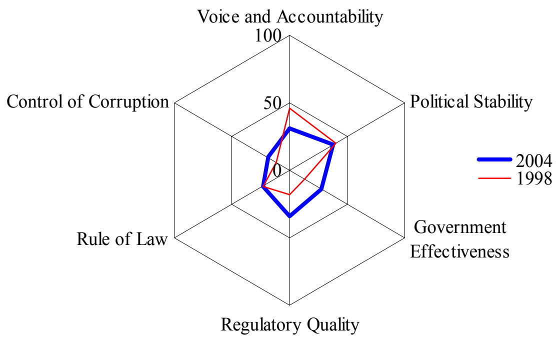
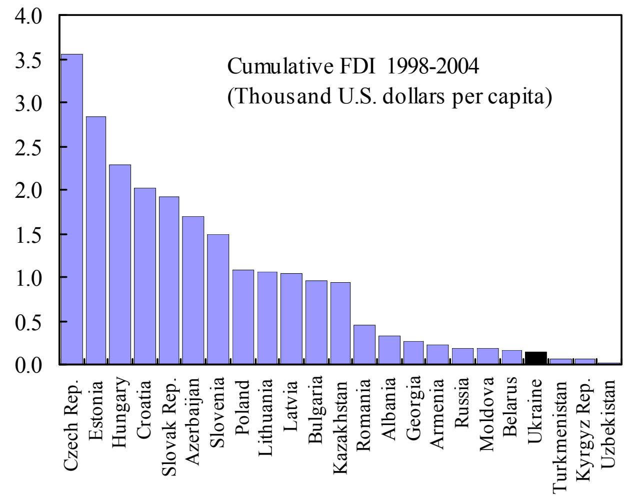
[12] For an attempt to link the growth revival almost exclusively to the reforms by the Yushchenko government, see Åslund (2001).

Figure 15. Ukraine: Indicators for Institutional Strength, 2004 vs. 1998 1/



Source: World Bank, Governance Indicators Data Base.
1/ Ukraine's percentile rank vis-à-vis all other countries.

Figure 16. Foreign Direct Investment in Transition Countries



Source: IMF *International Financial Statistics*.

Among transition economies, only the Kyrgyz Republic, Turkmenistan, and Uzbekistan have fared worse in FDI per capita terms (Figure 16).

IV. The Role of the IMF

35. **Ukraine proved a difficult counterpart for the Fund, but there were successes as well as disappointments.** IMF-supported programs were instrumental for supporting the authorities' gradual drive toward macroeconomic stability. But programs also had little traction as commitment devices for the authorities and were not able to permanently tip the balance toward accelerating the pace of building more market-friendly institutions. As a consequence, during most of the 1990s output kept declining, rendering gains on macroeconomic stability tenuous. As discussed in the previous section, the Russian financial crisis and its fallout "resolved" Ukraine's growth problem, albeit in a second-best manner and most likely only temporarily. This section first reviews the main obstacles that made it difficult for Fund-supported programs to play a more effective role in Ukraine's transition. The section further discusses issues related to program implementation and design that may also have diminished program effectiveness. Finally, it highlights that the Fund played a crucial role in the transition of the Ukrainian economy by: (i) transferring knowledge about macroeconomic policy making and implementation through a continuous policy dialogue; (ii) facilitating coordination and communication of the authorities' policy agenda; and (iii) helping to block, or at least mitigate, errant policy initiatives.[13]

[13] Stone (2002) also assesses the role of the Fund in Ukraine's transition process.

36. **At the outset, it is also important to keep in mind that policy developments and Fund advice in Ukraine (and other CIS countries) often shadowed trends in Russia.** For example, the move toward, and then away from, a long list of structural conditions in Ukraine almost exactly mirrored the pattern in Russia.

A. Political and Administrative Obstacles to Program Effectiveness

37. **Lack of political consensus to pursue market-friendly reforms was the main cause for repeated program failures.** Ukraine started the reform process with a strong degree of resentment against outside recommendations on how to move to a market economy. After the wrenching experience of hyperinflation and output collapse in 1992-94, the authorities became more receptive—albeit reserved–subscribers to IFI advice, a change of mind no doubt also driven by a pressing need to obtain external financing. But, while there was no lack of sweeping structural reform visions as early as in 1994, these visions were never anchored in a broad political consensus. In particular, parliament, riddled with special interest groups, often proved a stumbling block for reform initiatives. This lack of political consensus set Ukraine not only apart from many Eastern European and Baltic countries, many of which could rely on European integration as an external anchor or commitment device, but also from Russia, where reformers were able to push their agenda more effectively.

38. **Implementation of programs was hampered by weak administrative capacities**. It took Ukraine much longer than other CIS countries to raise the quality of its administrative apparatus, establish decision-making capacities, and create mechanisms of communication among the various public institutions, all of which hampered its ability to implement reforms. For example, the World Bank, in its 2000 *Country Assistance Evaluation* report (2000a, p. 19) concluded that "one consistent weakness has been an over-estimation of … the government's implementation capacity."

39. **Unfunded social promises may also have undercut policy making and commitments**. Ukraine started its transition with a comprehensive set of social protection programs that quickly proved fiscally unsustainable. Given the hardships that radical changes to this system would have meant, social mandates were maintained, or even extended, notwithstanding the government's rapidly shrinking fiscal room for maneuver. When funding proved insufficient, adjustments either took the form of arrears, or more often, the social mandates were simply ignored. As a result, there was always an unresolved tension between legislated social promises and fiscal reality, adding to the population's mistrust in the country's political institutions. Moreover, the accumulated "social mandates overhang" also meant that there would always be strong incentives for the government to use fiscal resources procyclically and strategically for political aims, as indeed happened in the case of the massive public pension hikes during the run-up to the 2004 presidential elections (Box 7).

Box 7. Ukraine's Social Mandate Overhang

A surprise hike of public pensions in 2004 brought actual pension practices in line with the legal obligations—at substantial fiscal costs. In September 2004, during the run-up to the presidential elections, in a snap decision taken without consulting the Fund as agreed under the program, the government raised monthly pensions to the subsistence minimum level of Hrv 284. The massive pension hike was rationalized by noting that it fulfilled (for the first time in Ukrainian history) the social mandate guaranteed by Article 46 of Ukraine's Constitution, which states that no pension should be below the subsistence minimum level. Staff estimates suggested that the annualized budget cost of the decision was about 3½ percent of GDP. Together with a further increase in the subsistence level later in the year, pension spending rose by 5 percent of GDP to an estimated 14 percent of GDP in 2005. As a further side effect, the pension hike decision also derailed the shift to a multi-pillar pension system, as foreseen by legislation approved in 2003, nullifying many years of pension reform efforts.

Ukraine's Constitution and other laws include many other social mandates that are either only partially fulfilled or simply ignored. They include guarantees of the right to free education, healthcare, and public housing. According to some estimates, the costs of fulfilling all these social mandates could amount to about 10 percent of GDP. At the same time, the potentially most costly unresolved social promise is the compensation for the savings lost during the hyperinflation periods. While a law to recognize those losses as public debt was vetoed by the President in June 2005, the proposal could resurface and create additional official government debt up to about 30 percent of GDP.

B. Additional Factors Hampering Program Effectiveness

40. **At least until 1999, the authorities' perception of the Fund's willingness to be engaged in a continuous program relationship may have undermined program effectiveness**. The Fund's strong interest in supporting Ukraine was reflected in the nearly uninterrupted program coverage during 1994-99, the large number of missions, and other efforts including delivery of copious technical assistance (Table 7). Additionally, Fund management was generally closely involved in program negotiations and reviews. The aim of tipping the balance toward reformers was the main driving force behind the desire to stay involved—a goal which was shared by the Fund's shareholders whose security and strategic considerations also lent support for Fund engagement. However, major shareholder pressure, while existent, was considered by interviewees to have played a much less prominent role

than in the case of Russia.[14] At least at the time of the 1998 financial crisis, the Fund was also concerned about regional contagion given Ukraine's size and trade links. Against this backdrop, failure to implement agreed program commitments may have seemed to the authorities to carry little practical consequences in terms of delaying program approvals and disbursements. Some staff involved in Fund operations at that time suggested that almost uninterrupted access to Fund (and other IFIs) financial support may well have delayed reform efforts before 1999.

41. **In the face of a truly unique challenge, the design of structural conditionality in early transition programs may have lacked focus**. The Fund entered uncharted territory, particularly in the CIS, with challenges not well understood and with little practical experience. It is therefore not surprising that program design itself underwent a learning and adjustment process over time. For example, the early programs did not include conditionality on arrears buildup, or the establishment of more effective fiscal institutions, while they did place much emphasis on numerical targets for privatization. In hindsight, the early programs focused on a set of reforms that were already on the government's own agenda, while not tackling the authorities' creative ways of evading fiscal discipline and delaying the buildup of more effective fiscal institutions. At the same time, and again judged with the benefit of hindsight, the early programs' focus on the speed, rather than the modus and quality, of mass privatization may have been misplaced.[15]

42. **On the other hand, in later programs, structural measures proliferated.** To step up the pace of institutional reforms, the EFF-supported program introduced a large policy matrix with the objective of providing the authorities with a step-by-step action plan. However, the policy matrix, which included 88 measures (and 150 sub-measures), proved unwieldy, taxing the staff's and the authorities' limited capacities to monitor implementation. The matrix included many measures in non-core Fund areas, including the energy sector and privatization—areas viewed as critical for triggering an economic rebound, even though progress under earlier World Bank programs had been unsatisfactory.[16] But some interviewees noted that, with Fund staff struggling to properly monitor these non-Fund core areas, attention and resources had to be diverted from core areas.[17] Finally, the fact that none

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[14] For an account of this influence on relations between the IMF and Russia see Odling-Smee (2004).

[15] See Elborgh-Woytek and Lewis (2002) for an account of the Fund's shift in conditionality on privatization from speed to quality of process.

[16] By 1998, the World Bank had disbursed $1.8 billion to Ukraine (90 percent adjustment loans), but with little to show for it, in particular in the energy sector (World Bank 2000a).

[17] Detailed measures in the highly intransparent energy sector were difficult to monitor as were such wide-ranging areas as streamlining the road construction industry, restructuring

(continued…)

of the measures were performance criteria under the original program (four of the measures later became structural performance criteria) may have been viewed by the authorities as a signal that there was substantial leeway to waive progress in reforms for completion of reviews. The staff sought to remedy this problem by introducing a large number of prior actions for completing reviews, an approach, however, that came to be seen by the authorities as an arbitrary shifting of goalposts.

43. **At the same time, the detailed policy matrix was welcomed by the authorities at a technical as well as at a political level, but without necessarily strengthening weak program ownership.** On a technical level, the policy matrix was not unlike the central plans sent from Moscow during Soviet times, providing guidance and serving as a coordination tool. However, at a political level, the matrix was a convenient device for deflecting criticism to the Fund when implementation faced heavy political opposition or was bungled at the administrative level.

44. **In the event, Ukraine's EFF supported-program became a leading example of excessive structural activism.** In response to an initiative by Fund management to streamline structural conditionality, at the second review the structural policy matrix of the EFF arrangement was reduced from 88 to 36 measures. Views within the Fund on whether the smaller number of structural measures remained excessive or not differed, however, and pressures for further streamlining continued. In particular, the conditionality on reducing the export tax on sunflower seeds became a rallying cry for those arguing that the Fund had drifted toward excessive micromanaging, although based on its merits the case seems less than straightforward (Box 8). The recent precautionary SBA-supported arrangement shifted to a highly parsimonious approach on structural conditionality, including only five structural measures (in addition to five prior actions), all clearly located in Fund-core areas (see Appendix VI).

45. **Finally, there were also claims that the Fund made mistakes in its policy advice, in particular because it lacked sufficient insight into the workings of the Ukrainian economy and politics.** The authorities felt that the Fund's insistence in 1997-98 on the government letting T-bill rates to be market-determined and avoiding restrictions on purchases by non-residents contributed to the severity of the 1998 financial crisis. Regarding structural reforms, interviewees that were involved on the Ukrainian side suggested that the Fund not only overestimated the political support for reforms, but that in a few cases measures were ill-advised and had later to be adjusted, providing ammunition for reform

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the sugar sector, revising the house subsidy scheme, conducting a land reform, and strengthening the bankruptcy mechanism.

Box 8. Why was the IMF Concerned About Sunflower Seeds?

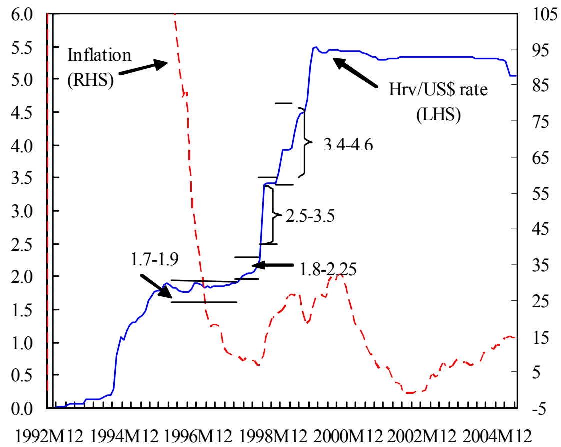
An export tax on sunflower seeds turned into a well-publicized test case on enforcing highly specific structural conditionality. Ukraine is one of the world's largest producer and exporter of sunflower seeds. In August 1999, in a clear breach of the EFF–supported program undertaking to refrain from introducing any new restrictions on exports, Ukraine imposed a 23 percent export tax on sunflower seeds. Fund staff strongly argued for eliminating the export tax, arguing that the tax was emblematic of the ability of powerful groups (in this case, domestic oilseed crushing plants) to bend the rules of the game to their advantage at the expense of weaker groups (in this case, growers of sunflower seeds). Moreover, the tax not only redistributed income but also imposed a significant deadweight cost. At the same time, it was difficult to make a compelling case that reducing the tax was critical for achieving key program objectives. And some policy-relevant aspects of the tax—particularly to what extent it could be avoided or evaded—remained unclear, and staff spent much time trying to clarify the situation. In the event, in December 2000, an EFF review was completed without the tax having been eliminated, but a structural benchmark to reduce the tax to 10 percent was agreed. In June 2001, the tax was reduced to only 17 percent, but the sunflower seed issue was quietly dropped from the agenda. In July 2005, to fulfill a precondition for WTO accession, parliament adopted legislation to lower the tax by 1 percentage point per year upon WTO membership.

opponents. Two specific examples mentioned were the increase in housing and rental tariffs in 1995 (a structural benchmark of the 1995 SBA), which led to large arrears buildup, and the increase in the alcohol excise tax in 1998 (a prior action of the EFF arrangement), which caused sharp increases in smuggling. The Fund's underestimation of the rapid remonetization after the 1998 financial crisis and repeated calls for more exchange rate flexibility—including a call for tighter monetary policy in 2001 when, as it turned out later, Ukraine was in fact on the brink of deflation—were singled out as telling examples of how the Fund would sometimes cling to unduly dogmatic positions (Box 9). While these and other examples may confirm that the Fund made policy mistakes, the criticism appears to single out individual measures, without acknowledging that these measures were part of a much broader policy package advised by the Fund.

Box 9. Disagreements on Exchange Rate Policy

The exchange rate has been the monetary policy anchor over the past 10 years. The NBU steered the hryvnia within a band against the U.S. dollar from June 1996 but had to shift the band upward three times during the financial crisis. The hryvnia floated briefly between May 1999 and February 2000 but remained de facto fixed until April 2005 when the NBU allowed it to appreciate by 5 percent.

Ukraine: Exchange Rate Policy 1/



Sources: Ukrainian authorities; and staff estimates.
1/ The hryvnia replaced the karbovanets in 09/96 at a rate of 100,000/1.

The authorities early on developed a strong affinity for a peg, while the Fund frequently called for more exchange rate flexibility. Controversy already surrounded the timing of the initial introduction of the exchange rate band. While the authorities intended to adopt it in 1995, the Fund insisted to delay it to mid-June 1996 after central bank financing had become less rampant and inflation had come down somewhat. Once the regime was introduced though, the Fund, though often reluctantly, no longer made exchange rate policy a sticking point to its program support. In hindsight, it appears that before the crisis the hryvnia was overvalued as the real effective exchange rate appreciated and institutional reforms had stalled. A more gradual depreciation might have contributed to an earlier recovery, but the effects were difficult to gauge at the time when the focus was predominantly on closing the reform gap. During the financial crisis, the Fund agreed to defend the exchange rate including through administrative controls—a mistake in hindsight as the NBU lost substantial amounts of reserves and ultimately had to float the currency. After the crisis, the Fund strongly favored a more flexible regime but accepted the authorities' choice of a de facto peg partly because a peg had also been agreed under the Fund-supported program for Russia. Over the coming years, the Fund regularly pointed at the risks that rapid reserve accumulation under the peg would pose for inflation and the lack of incentives to hedge bank lending in foreign currency, but the de facto peg generally served Ukraine well by disciplining fiscal policy and serving as an external anchor. The uncertainty about the speed of remonetization, which allowed inflation to remain relatively low until 2004, and the strength of the U.S. dollar explains why the exchange rate regime did not become a hurdle under the EFF arrangement and the precautionary SBA (even though it became a key issue under the SBA program review).

Today the authorities favor a very gradual approach to more exchange rate flexibility. The Fund has argued for some time that the peg has outlived its utility (see IMF Staff Report 2004), but the Ukrainian authorities have been cautious and have emphasized that the Fund underestimates the risks and unique features of the Ukrainian economy.

C. Other Impacts of Fund-Supported Programs and Involvement

46. **Despite their mixed record as commitment devices, Fund-supported programs, and Fund involvement more generally, played important roles in Ukraine's transition.** Even when programs were off track, the frequent attempts to reconcile assured that the Fund stayed involved in addition to the technical assistance provided (Table 7). More broadly, within and outside the program context, the Fund served three valuable functions in Ukraine: transferring knowledge, coordinating policies, and advising on policy initiatives. In fact, particularly during the 1990s, the Fund may have faced a trade-off between running the risk of repeated program disappointments and exercising these valuable functions.

47. **Perhaps the most-widely appreciated role of the Fund's engagement in Ukraine was transferring economic knowledge.** Interviewees, including the authorities, stressed the positive impact of the continuous policy dialogue in establishing a more widespread understanding of the requirements for a market economy, and the functioning and interaction of macroeconomic policies. The knowledge transfer was viewed as highly beneficial by policy makers as well as at the technical level. The Fund was also instrumental in setting up key policy-making institutions, such as the central bank, and has continuously supported the buildup and strengthening of the banking supervisory function. Another example is the Fund's guidance in preparing statistics according to market economy standards—in fact, in 2003 Ukraine became the first CIS country to subscribe to the Fund's Special Data Dissemination Standard (SDDS). While the Fund's functional departments supplied technical support, the area department helped in identifying technical assistance needs and priorities. It also used the EFF arrangement as leverage to foster progress in some areas that were supported by technical assistance, such as tax collection, the creation of a single treasury account, setting up of fiscal analysis and forecasting, strengthening bank supervision, and dealing with banks in distress. The findings of the Financial Sector Assessment Program (FASP) were used to formulate one prior action and conditionality under the precautionary SBA. However, according to the Independent Evaluation Office (2005), this link between program conditionality and technical assistance may have impaired effectiveness of technical assistance by blurring technical and policy decisions.

48. **As a coordinator, the Fund had some success in facilitating the policy dialogue among the government agencies.** Fund-supported programs introduced the authorities to the need for consistent macroeconomic frameworks that take into account the interlinkages between monetary and fiscal policies. They also facilitated the sometimes difficult communication among different policy makers, including the NBU and the Ministry of Finance. The Fund's role as a coordinator, however, often took time to yield results. For example, fiscal policy interfered for quite some time with monetary policy, either through NBU deficit financing or the directing of credit.

49. **As an advisor, the Fund commented on a wide range of policy initiatives, sometimes trying to fend off errant ideas.** The Fund's close engagement served as a constant reminder of the need to conduct appropriate macroeconomic policies, particularly during times when there were no programs in place. The Fund was particularly useful in

screening potentially detrimental policy proposals, for example the introduction of new tax exemptions and amnesties, proposals that have had a tendency to proliferate in Ukraine's political environment. The Fund was also partially successful in shielding particular policy areas. For example, quite recently, it helped to fend off government pressure on the NBU to provide cheap refinancing loans to banks for on-lending to the agricultural sector when it made the elimination of this practice (which had been introduced against the recommendation of the NBU) a precondition to complete discussions of the precautionary SBA.

V. Lessons

A. Taking Stock

50. **Ukraine's transition to a market economy has—so far—not worked out as well as expected.** The sustained rebound in output that got underway in 2000 seems to owe much to exceptional and temporary conditions. And Ukraine's income levels remain relatively low, reflecting an economy that is highly inefficient in using its available resources. Ukraine's disappointing transition experience is ultimately rooted in lagging progress in adopting more market-friendly institutions. While the growth turnaround since 2000 has been underpinned by clear progress on structural reforms at important margins, as illustrated by the rapid re-monetization of the economy over the last few years, available indicators suggest that Ukraine's institutional landscape has seen little fundamental improvement during 1998-2004.

51. **Thus, while Fund-supported programs were broadly successful in supporting macroeconomic stabilization, they tried hard but did not succeed in accelerating reform of market-enhancing institutions.** High inflation and excessive fiscal deficits were gradually but successfully reigned in from the mid-1990s, as Fund-supported programs redirected monetary and fiscal policies to focus on macroeconomic stability. By contrast, the programs' other key objective—to initiate sustained reforms of the institutions needed for a well-functioning market economy—was not achieved. For this outcome, the main blame has to fall on the lack of a reform-oriented political consensus within Ukraine. Until 1999, the Fund's perceived eagerness to stay in a continuous program relationship, and program designs characterized by perhaps excessive structural activism were unhelpful but not decisive in delaying reforms.

52. **Against this backdrop, President Yushchenko has put reforms at the top of his government's agenda.** The President has stressed that Ukraine's market-unfriendly institutions are the root cause of its disappointing economic performance, pledging in particular to tackle corruption and rent-seeking. He also argued that Ukraine's chances to succeed would be maximized by anchoring its reform drive within closer integration with the EU and global markets (see, for example, Yushchenko, 2005).

53. **The main payoff for Ukraine from Fund involvement may well have come from successful knowledge transfer.** Ukraine started its transition from plan to market with a thin

economic knowledge base. In addition to wide-ranging technical assistance, the close and continuous policy dialogue between the Fund and the authorities, within and outside program contexts, helped provide the authorities with the tools for macroeconomic analysis and policy making.

B. Lessons for Future Fund Engagement

54. **What role could an IMF-supported program in the near-term play?** Under plausible baseline projections, Ukraine has no immediate external financing need. In this setting, a potential Fund-supported program could have two major benefits. First, together with the EU-Ukraine Action Plan and other IFI engagement, it could help anchor and coordinate the authorities' reform agenda, particularly by reestablishing a coherent macroeconomic framework that aims at bringing inflation back into the single-digits. And second, a program could provide some insurance given Ukraine's exposure to external shocks. For example, a sharp decline in metal prices and export demand, uncertainty about foreign direct investment and short-term capital flows, and a potential convergence of energy import prices to world levels constitute key external risks for Ukraine's economy. At the same time the banking sector, which has taken on large credit and indirect foreign exchange risks during the rapid growth years, also remains vulnerable to a slowdown of the economy.

55. **But what conditions would need to be in place for more successful Fund program engagement?** This paper's review of past program experiences points to the following checklist for assessing the risks to program effectiveness:

- **Is there sufficient political support behind a program?** Strong program ownership and political support would be the key preconditions. In the past, underestimating political constraints led to program failures. In this context, President Yushchenko's vision of the need for sweeping institutional reform is encouraging. So far, the present parliament has been reluctant to adopt proposed reform legislation. The upcoming March 2006 parliamentary election should clarify the extent of political support for a strong structural reform agenda. In this context, the Ukraine-EU Action plan could be viewed as a blueprint, serving the authorities as a compass for where they want to go during the program period and beyond.

- **Are the policy-making capacities to implement a program in place?** The present authorities' decision-making process seems to exhibit many of the tendencies noted by earlier observers as inhibiting government effectiveness (Box 4). In particular, there may still be too much focus on addressing micro crises (reflected in recent heavy-handed interventions in fuel, meat, and sugar markets) at the cost of focusing the government's energies on achieving strategic goals (such as WTO accession).

- **Is the program sufficiently focused on addressing the key obstacles to sustained growth?** Currently, the main issues to be addressed in a Fund-supported program would seem to comprise: (i) as regards monetary and exchange rate policy, tightening loose monetary conditions and re-orienting the monetary framework toward achieving low and stable inflation, including through a shift to a more flexible exchange rate regime; (ii) as regards fiscal policy, maintaining a tight fiscal stance, restoring a viable public pension fund, systemic tax reform, and strengthening the transparency of fiscal and quasi-fiscal operations; (iii) as regards the financial sector, strengthening the resilience of the banking sector and developing domestic capital markets; and (iv) improving the investment climate through stronger governance and institutions. Past experience suggests that measures would need to be kept streamlined and focused on critical institutional bottlenecks. This paper's analysis and the authorities' own diagnostics leave little doubt that building more market-friendly institutions remains the key to relaunching sustained catch-up growth, and closing the institutional gap should therefore play a key role in a Fund-supported program. In marked contrast to earlier programs, such a structural reform agenda could be anchored externally in the Ukraine-EU Action Plan.

56. **What form should a Fund program engagement take?** Given no immediate external financing needs, the program would likely be a low-access, precautionary arrangement. Moreover, to be able to address the medium-term challenges for Ukraine's economy, a Fund-supported program would have to consider a duration that exceeds one year. At the same time, given Ukraine's circumstances and uncertain prospects for closer EU integration, it will be difficult to design a credible exit strategy. Before re-engaging in a program, and to address potential concerns about ownership given the past record, the Fund could therefore ask first for a demonstrated track record of good macro policies and prior implementation of key structural reform measures that serve to demonstrate that the authorities command the political consensus needed to see a program through. Potential candidates for such prior actions could be long-delayed measures to strengthen transparency in the financial sector (such as making ownership structures more transparent) or to improve corporate governance (such as adopting a market-friendly joint-stock company law).

57. **What would be the benefits of a Fund-supported program over Fund surveillance and technical assistance for Ukraine?** A program could serve the authorities as an additional external anchor, both in terms of jumpstarting structural reforms, including through prior actions, and staying the course during the program period. The Fund played a similar role in Bulgaria's and Romania's EU accession process, but these experiences also suggest that the Fund's leverage was closely linked to the status and progress in EU membership negotiations. Whether an additional anchor has merit for improving policy making in Ukraine will ultimately be the authorities' decision, but the success of a future program will clearly rest on their willingness and ability to implement agreed policies. As an alternative, the Fund could remain engaged through a close policy dialogue and technical assistance, an option that would allow it to continue to provide valuable support through transferring knowledge and advising on policies.

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Table 1. Ukraine: Selected Economic and Social Indicators, 1992–2004

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Period average		
													Prel.	1992-94	1995-99	2000-04
Real economy (percent change unless indicated otherwise)																
Real GDP	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	-15.6	-5.5	8.4
Nominal GDP (in billions of U.S. dollars)	20.8	13.9	23.6	37.1	44.6	50.1	41.8	31.6	31.3	38.0	42.4	50.1	64.8	19.4	41.0	45.3
Consumer prices, period average	1,210.0	4,734.9	891.2	376.4	80.2	15.9	10.5	22.7	28.2	12.0	0.8	5.2	9.0	2,278.7	101.1	11.0
Consumer prices, end of period	2,733.6	10,155.0	401.0	182.0	39.7	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	4,429.9	54.2	10.4
Average monthly wages, annual average	1,303.0	2,331.7	317.0	306.0	22.0	16.0	6.8	16.1	30.2	34.9	20.7	23.0	27.7	1,317.2	73.4	27.3
Public finance (in percent of GDP)																
Cash balance	-24.2	-11.8	-8.7	-4.9	-3.2	-5.4	-2.8	-2.4	-1.3	-1.6	0.5	-0.9	-4.4	-14.9	-3.7	-1.5
Revenue 1/	34.2	42.8	41.9	37.8	36.7	38.8	36.0	33.8	33.4	33.5	36.0	35.9	35.0	39.6	36.6	34.8
Expenditure (cash basis)	58.4	54.6	50.6	42.7	39.9	44.2	38.7	36.1	34.7	35.1	35.5	36.8	39.4	54.5	40.3	36.3
Primary balance (cash basis)	...	...	-7.6	-3.4	-1.6	-3.7	-0.4	0.2	1.8	0.4	1.8	0.1	-3.5	...	-1.8	0.1
Commitments balance 2/	...	...	...	...	-6.8	-5.0	-3.0	-1.4	2.1	-1.5	0.2	-0.1	-3.6	...	-4.1	-0.6
Privatization proceeds	...	...	...	0.1	0.2	0.3	0.5	0.6	1.3	1.3	0.5	1.1	3.1	...	0.3	1.5
Net domestic financing	...	...	7.5	5.8	3.3	5.1	1.0	1.5	0.3	-0.1	-0.3	-1.2	-0.1	...	3.3	-0.3
Net external financing 1/	...	...	1.0	-0.9	-0.1	0.3	1.8	0.2	-0.3	0.4	-0.7	1.0	1.5	...	0.3	0.4
Public debt and arrears 3/	...	...	...	31.2	28.9	34.0	52.4	66.7	47.7	38.6	35.7	27.7	25.1	...	42.6	35.0
o.w. external debt	...	...	...	28.1	21.2	23.4	27.5	49.9	33.1	26.6	24.0	21.6	19.2	...	30.0	24.9
Money and credit (end of period, percent change)																
Base money	1,670.5	4,260.0	466.0	133.0	38.0	44.6	21.9	39.2	40.1	37.4	33.6	30.1	34.1	2,132.2	55.3	35.1
Broad money	858.9	1,777.9	573.1	117.4	35.1	33.9	25.3	40.4	45.5	41.9	41.8	46.5	32.3	1,070.0	50.4	41.6
Credit to nongovernment	...	1,894.0	358.0	116.0	29.0	2.4	16.7	43.5	61.3	40.5	47.3	63.4	31.2	1,126.0	41.5	48.7
Velocity 4/	2.0	3.1	3.8	7.9	8.7	8.5	7.3	5.9	5.3	4.5	3.5	2.8	2.7	3.0	7.7	3.7
Balance of payments (in percent of GDP)																
Current account balance	-3.0	-6.1	-5.9	-4.4	-2.7	-2.7	-3.1	2.6	4.7	3.7	7.5	5.8	10.5	-5.0	-2.0	6.5
Foreign direct investment	0.8	1.4	0.4	0.7	1.2	1.2	1.8	1.5	1.9	2.0	1.7	2.8	2.7	0.9	1.3	2.2
Gross reserves (end of period, in billions of U.S. dollars)	...	...	0.6	1.1	2.0	2.4	1.5	1.1	1.5	3.1	4.4	6.9	9.5	0.6	1.6	5.1
In months of next year's imports of goods and services	...	0.5	2.3	3.7	4.8	1.5	0.6	0.7	0.9	1.7	1.9	2.4	2.7	1.4	2.3	1.9
Debt service (in percent of exports of goods and services) 4/	...	1.2	12.1	9.3	6.0	7.5	11.2	15.8	10.4	8.7	5.7	6.2	4.8	6.7	10.0	7.2
Savings and investment (in percent of GDP)																
Foreign savings	3.0	6.1	5.9	4.4	2.7	2.7	3.1	-2.6	-4.7	-3.7	-7.5	-5.8	-10.5	5.0	2.0	-6.5
Gross national savings	10.9	25.6	17.7	21.7	20.0	18.8	16.7	24.6	24.2	25.5	27.7	27.8	29.9	18.1	20.4	27.0
Nongovernment	32.2	6.4	22.4	23.6	21.1	22.3	17.6	22.0	22.6	24.0	24.2	24.2	28.0	20.3	21.3	24.6
Government	-21.3	19.2	-4.7	-1.9	-1.1	3.5	-0.9	0.0	1.5	1.5	3.5	3.6	1.9	-2.2	-0.1	2.4
Gross investment	13.9	31.7	23.6	26.9	22.7	21.4	19.5	19.4	19.4	21.8	20.2	22.0	19.4	23.1	22.0	20.6
Nongovernment	10.9	0.6	19.6	24.0	20.6	19.6	17.7	17.0	16.6	18.7	17.2	17.7	13.1	10.4	19.8	16.7
Government	3.0	31.1	4.0	3.0	2.1	1.8	1.8	2.4	2.8	3.1	3.0	4.3	6.3	12.7	2.2	3.9
Exchange rate																
Hryvnia per U.S. dollar, end of period	0.0	0.1	1.0	1.8	1.9	1.9	3.4	5.2	5.4	5.3	5.3	5.3	5.3	0.4	2.8	5.3
Hryvnia per U.S. dollar, period average	...	0.0	0.3	1.5	1.8	1.9	2.4	4.1	5.4	5.4	5.3	5.3	5.3	0.2	2.3	5.4
Real effective rate, (percent change) 5/	...	...	...	12.0	31.0	7.4	2.3	-16.3	-4.4	6.0	-4.1	-6.3	-0.9	...	7.3	-1.9

Sources: Ukrainian authorities; and Fund staff estimates.

1/ From 2003, based on an accounting treatment that excludes offset-based amortization to Russia, which decreases revenues and increases net external financing (and the budget deficit) by 0.2 percent of GDP relative to previous years.
2/ Cash balance adjusted for the net accumulation of expenditure and VAT refund arrears, as well as for non-cash property income.
3/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
4/ Annual GDP divided by end-period broad money (M3).
5/ Period averages; (+) represents real appreciation; based on CPI and average trade weights for 1996-2002.

Table 2. Social Indicators in Transition Economies[1/]

		Health		Education			Income distribution	
		Male life expectancy at birth (years)	Public expenditure on health 2/	Total upper secondary education enrolment 3/	General secondary education enrolment 3/	Public expenditures on education 2/	Distribution of earnings: Gini coefficient	Distribution of income: Gini coefficient
Ukraine								
	1991	66.0	3.3	63.9	24.4	na	0.25	na
	1995	61.8	3.8	57.4	24.1	5.4	0.41	0.47
	2002	62.4	3.4	60.8	31.4	5.6	0.42	0.33
CIS (excluding Ukraine)								
	1991	65.5	3.8	62.3	32.8	5.8	0.31	na
	1995	63.3	2.7	47.6	26.4	3.4	0.42	0.35
	2002	65.2	2.5	51.2	30.9	3.9	0.46	0.36
Baltic countries								
	1991	64.5	3.0	62.4	30.3	4.1	0.25	na
	1995	61.9	4.3	61.9	37.1	6.5	0.36	0.40
	2002	65.6	4.1	72.7	45.8	6.7	0.36	0.37
EU accession countries								
	1991	66.1	4.6	71.8	22.9	5.0	0.24	0.25
	1995	65.9	5.6	79.0	29.3	5.8	0.33	0.29
	2002	68.7	4.9	89.1	38.0	5.6	0.32	0.32
All transition economies								
	1991	66.4	4.3	65.8	25.9	5.3	0.26	0.25
	1995	65.0	4.1	62.0	25.5	4.6	0.36	0.33
	2002	66.8	3.5	67.6	32.1	4.6	0.39	0.34

Source: Unicef TransMONEE database 2004.

1/ Unweighted averages.
2/ In percent of GDP.
3/ Gross rates in percent of relevant population.

Table 3. Ukraine: Program Compliance

	Number of reviews envisaged	Number of reviews completed	*o/w* with delay or waivers	Percent of disbursement
STF (October 1994-April 1995)	0	n/a	n/a	100
SBA (April 1995-April 1996)	4	3	3	54
SBA (May 1996-February 1997)	3	3	0	100
SBA (August 1997-August 1998)	4	1	1	45
EFF (September 1998-September 2002)	12	6	6	62
Precautionary SBA (March 2004-March 2005)	1	0	n/a	0
Total 1/	24	13	10	68

Source: IMF Staff Reports.

1/ Total share of disbursement excludes the precautionary SBA.

Table 4. Distribution of Structural Program Conditions and Implementation Rates by Sector of Reform[1/]

	Conditions under each sector as a percent of total number of conditions					Average implementation rate 2/			
	Other developing	Transition excl. Ukraine and Russia	Ukraine	Russia	Total	Other developing	Transition excl. Ukraine and Russia	Ukraine	Russia
Fund core areas	**26.5**	**30.8**	**15.3**	**20.4**	**27.5**	**1.4**	**1.6**	**0.8**	**1.3**
Tax policy	6.4	5.0	1.4	3.7	5.7	1.3	1.3	0.0	2.0
Tax/customs administration	5.6	8.4	4.2	7.4	6.6	1.4	1.6	1.0	1.0
Expenditure policy	1.1	1.0	0.0	0.0	1.0	1.4	1.8	n/a	n/a
Expenditure administration	4.1	7.1	8.3	1.9	5.3	1.6	1.5	1.2	0.0
Fiscal reviews	2.1	0.7	0.0	0.0	1.4	1.3	1.8	n/a	n/a
Fiscal vulnerabilities (domestic arrears)	0.1	1.1	0.0	5.6	0.6	0.0	1.4	n/a	2.0
Fiscal vulnerabilities (public debt)	1.6	3.0	0.0	0.0	2.0	1.6	1.8	n/a	n/a
Exchange rate regime and policy	1.6	1.0	1.4	0.0	1.3	1.5	1.9	1.0	n/a
Capital account issues	0.1	0.0	0.0	0.0	0.1	2.0	n/a	n/a	n/a
Monetary policy	1.7	1.7	0.0	1.9	1.6	1.6	1.6	n/a	n/a
Macro data/statistics issues	2.1	1.9	0.0	0.0	1.9	1.4	1.0	n/a	n/a
Areas shared with World Bank	**39.9**	**27.2**	**25.0**	**33.3**	**34.6**	**1.3**	**1.5**	**1.0**	**1.8**
Financial sector reforms (laws, rules)	5.4	5.0	4.2	3.7	5.2	1.3	1.5	0.3	2.0
Financial sector reforms (banking supervision)	9.9	6.0	1.4	5.6	8.1	1.1	1.6	1.0	2.0
Dealing with problem banks	18.0	8.4	6.9	9.3	13.9	1.1	1.4	1.2	2.0
Trade liberalization	1.7	4.4	5.6	7.4	3.0	1.5	1.6	1.0	2.0
Governance and corruption	1.8	0.0	0.0	5.6	1.2	1.5	n/a	n/a	1.0
Business environment	3.1	3.4	6.9	1.9	3.3	1.4	1.3	1.5	n/a
Non-IMF-core areas	**33.6**	**42.0**	**59.7**	**46.3**	**37.9**	**1.3**	**1.5**	**1.3**	**0.9**
Poverty reduction	0.9	0.6	0.0	0.0	0.7	1.3	1.8	n/a	n/a
Social safety nets	0.3	1.1	1.4	0.0	0.6	1.3	1.3	2.0	n/a
Education and health	0.5	1.8	1.4	0.0	1.0	1.8	1.4	1.0	n/a
Other social sectors (e.g., pensions)	4.2	3.4	2.8	7.4	4.0	1.2	1.1	0.5	1.0
Wage and employment	1.7	2.5	1.4	1.9	2.0	0.8	1.2	2.0	...
Civil service reform	2.0	1.1	1.4	0.0	1.6	0.9	1.5	1.0	n/a
Public enterprises	4.6	7.8	8.3	27.8	6.5	1.3	1.6	0.6	0.7
Regulatory reforms in utilities	2.5	2.1	5.6	3.7	2.5	1.4	1.2	1.0	...
Privatization of public enterprises	10.5	15.7	26.4	1.9	12.7	1.1	1.2	1.4	...
Sector policies (land, agriculture, roads)	1.0	2.6	2.8	0.0	1.6	1.6	1.3	2.0	n/a
Marketing and pricing reforms	1.3	1.5	6.9	1.9	1.6	1.5	1.8	1.6	...
Other non-core	2.7	1.1	1.4	1.9	2.0	1.3	1.9	...	1.0
Labor market reforms	0.6	0.7	0.0	0.0	0.6	1.3	1.6	n/a	n/a
Natural resource management	0.9	0.1	0.0	0.0	0.6	1.2	2.0	n/a	n/a
Total									
Mean	3.2	3.2	3.2	3.2	3.2	1.3	1.5	1.1	1.4
Standard deviation	3.8	3.4	5.1	5.3	3.4	0.3	0.3	0.5	0.7
Minimum	0.1	0.0	0.0	0.0	0.1	0.0	1.0	0.0	0.0
Maximum	18.0	15.7	26.4	27.8	13.9	2.0	2.0	2.0	2.0

Source: MONA database.

1/ SBA and EFF arrangements, excluding prior actions.
2/ Index ranges from 0 to 2 (0=no implementation, 1=partial implementation, 2=full implementation).

Table 5. Ukraine's Unexpected Output Slump, 1994–99[1/]
(Cumulative growth; in percent)

	Projected GDP growth 1994-99	ActualGDP growth 1994-99	Cumulative forecast error 1994-99
Ukraine	0.2	-42.2	-42.4
CIS (excl. Ukraine)	19.9	-8.0	-27.9
Baltic countries	35.7	20.4	-15.3
Central and Eastern Europe	22.5	5.4	-17.1
Memorandum item:			
EU accession countries	27.4	24.3	-3.1

Source: IMF *World Economic Outlook* .
1/ Projections in the October WEO for the next year.

Table 6. Ukraine's Underestimated Output Recovery, 2000–04[1/]
(Cumulative growth; in percent)

	Projected GDP growth 2000-04	Actual GDP growth 2000-04	Cumulative forecast error 2000-04
Ukraine	18.5	49.3	30.8
CIS (excluding Ukraine)	24.1	50.5	26.5
Baltic countries	28.8	39.3	10.6
Central and Eastern Europe	24.4	38.7	14.4
Memorandum item:			
EU accession countries	23.8	26.5	2.7

Source: IMF *World Economic Outlook* .
1/ Projections in the October WEO for the next year.

Table 7. Ukraine: Number of Missions and Resident Advisors, 1994–2005

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 1/
Area department missions	**4**	**6**	**6**	**10**	**8**	**7**	**5**	**5**	**5**	**4**	**2**	**3**
Article IV	1 **	1	0	1*	1*	1	1 *	1 *	2 *	1 **	1 *	1
Program negotiations	1	3	3	4	1	0	0	0	1	3	0	0
Program review	0	2	3	1	3	4	3	3	1	0	0	0
Staff visit	2	0	0	4	3	2	2	1	1	0	1	2
Functional department missions	**10**	**11**	**11**	**10**	**15**	**8**	**10**	**8**	**4**	**0**	**4**	**12**
MAE/MFD 2/	2	1	2	2	3	2	4	3	1	0	4	6
FAD	3	2	5	3	7	3	4	2	1	0	0	2
STA	4	4	2	2	3	3	2	3	2	0	0	2
LEG	...	0	1	1	1	0	0	0	0	0	0	1
Other	1	4	1	2	1	0	0	0	0	0	0	1
Resident advisors	**6**	**6**	**7**	**8**	**7**	**7**	**8**	**8**	**6**	**2**	**2**	**3**
EU2/EUR (Resident Respresentatives)	1	2	2	2	2	2	2	2	2	2	1	1
MAE/MFD	2	1	1	3	2	2	2	2	2	0	1	2
FAD	2	2	3	2	2	3	3	3	1	0	0	0
STA	1	1	1	1	1	0	1	1	1	0	0	0

Sources: Travel Information Management System; IMF Staff Reports; and IMF *Independent Evaluation Office* Report on Technical Assistance.

* Combined with program review.
** Combined with program negotiations.
1/ As of October 10, 2005.
2/ There were also two FSAP missions in 2002.

APPENDIX I. UKRAINE: HISTORY OF LENDING ARRANGEMENTS
(In millions of SDRs)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Percent Drawn	Notes
STF	Oct-94	n/a	249	249	100	Intended to pave the way to SBA.
STF	Apr-95	n/a	249	249	100	Approved concurrently with first SBA; disbursed together with part of first SBA tranche.
SBA	Apr-95	Apr-96	997	539	54	First two reviews completed, with several waivers, including external arrears and NDA. No structural benchmarks fully met. Second purchase later found non-complying due to unreported arrears.
SBA	May-96	Feb-97	598	598.2	100	Monthly monitoring and purchases. Virtually all PCs met, as well as most structural benchmarks.
SBA	Aug-97	Aug-98	399	181	45	Monthly monitoring and purchases. Went off-track after January 1998 purchase. Two purchases later found to be non-complying due to misreporting of foreign reserves.
EFF	Sep-98	Sep-02	1,920	1,193	62	Monthly monitoring and purchases for first year. Original size of SDR 1,646 million was augmented by SDR 274.4 million in May 1999.
SBA	Mar-04	Mar-05	412	0	0	Precautionary program. The only envisaged review not completed.
Total 1/			4,824	3,009	62	

Source: International Monetary Fund.
1/ The percent share of the total amount drawn includes the precautionary SBA.

APPENDIX II. UKRAINE: PERFORMANCE UNDER FUND-SUPPORTED PROGRAMS

Arrangement 1/	Number of quantitative performance criteria		
	Total	Met	Not met
SBA (April 7, 1995-April 6, 1996)	20	13	7
SBA (May 10, 1996-February 23, 1997)	38	37	1
SBA (August 25, 1997-August 24, 1998)	23	18	5
EFF (September 4, 1998-September 3, 2002)	89	70	19
Precautionary SBA (March 29, 2004-March 28, 2005)	12	10	2

Arrangement 1/	Number of								
	Prior actions	Structural performance criteria				Structural benchmarks 2/			
		Total	Met on time	Partially met	Not met	Total	Met on time	Partially met	Not met
SBA (April 7, 1995-April 6, 1996)	9	--	--	--	--	15	6	1	8
SBA (May 10, 1996-February 23, 1997)	7	--	--	--	--	11	8	2	1
SBA (August 25, 1997-August 24, 1998)	37	--	--	--	--	14	4	5	5
EFF (September 4, 1998-September 3, 2002)	105	4	2	--	2	28	17	5	6
Precautionary SBA (March 29, 2004-March 28, 2005)	5	2	--	--	2	3	--	--	3

Sources: MONA and IMF Staff Reports.

1/ Systemic Tranformation Facility (STF) program approved October 1994 is not included since it did not have performance criteria or formal prior actions, though it did have eight structural benchmarks.
2/ Does not include the two quarterly quantitative structural benchmarks that were part of the EFF arrangement (but not Ukraine's other Fund-supported programs).

Appendix III. Ukraine: Overview of Quantitative Performance Criteria, Benchmarks, and Indicative Targets

	STF '94 1/	SBA '95	SBA '96	SBA '97	SBA '98 Modified	EFF '98	EFF 1st review	EFF 2nd review	EFF 3rd review	EFF 4th review	EFF 5th + 6th reviews	SBA'04
Quantitative PCs	**3**	**5**	**5**	**6**	**6**	**6**	**7**	**7**	**7**	**8**	**8**	**6**
Monetary policy												
NDA ceiling	X	X	X	X	X	X	X	X	X	X	X	X
NIR floor	X	X	X	X	X	X	X	X	X	X	X	X
Net credit of banking system to government	X	X										
Fiscal policy												
Ceiling on consolidated budget deficit			X	X	X	X	X	X	X	X	X	X
Ceiling on budgetary arrears on wages, pensions, and benefits				X	X	X	X	X	X	X	X	X
Ceiling on stock of VAT refund arrears												X
Floor on unearmarked state cash revenue							X	X	X	X	X	
Ceiling on non-cash netting operations on consolidated government obligations										X	X	
External debt												
Ceiling on nonconcessional external loans		X	X	X	X	X	X	X	X	X	X	X
Ceiling on government and the NBU external payment arrears		X	X	X	X	X	X	X	X	X	X	
Quantitative Benchmarks and Indicative Targets	**0**	**2**	**3**	**4**	**5**	**5**	**7**	**8**	**8**	**6**	**6**	**4**
Monetary Policy												
Ceiling on base money		X	X	X	X	X	X	X	X	X	X	X
Ceiling on net credit to non-government		X	X									
Sub-ceiling on net domestic credit of the NBU to government for domestic expenditure purposes												
Net NBU credit to government ceiling			X									
NBU's gross purchase of T-bills from the primary market						X	X	X	X			
Fiscal policy												
Floor on general government revenue				X	X							
Floor on cash revenue of the government					X							
Accumulation of arrears on gas payments by the central government and institutions financed by the state budget				X	X							
Floor on balance of state reserve fund				X	X							
Floor on unearmarked state cash revenue						X	X					X
Collection rate for household gas payments						X	X	X	X			
Cumulative reduction in the number of budgetary employees						X	X	X	X			
Energy sector												
Sale of gas in auctions								X	X			
Total cash collection rate for electricity										X	X	X
Total cash collection rate by Naftogaz										X	X	X
Raise tariffs on gas and electricity							X	X	X	X	X	
Achieve cost recovery on communal services							X	X	X	X	X	
Cost recovery for Kyiv city services								X	X	X	X	

Sources: MONA data base; and IMF Staff Reports.

1/ The STF, which was a single-tranche program, had "quantitative" (also known as "intemediate") policy targets rather than performance criteria.

APPENDIX IV. GOVERNMENTS IN UKRAINE, 1991-2005

Presidential elections:
December 1991; July 1994; November 1999; November/December 2004

Parliamentary elections:
March 1990; March 1994; March 1998; March 2002

President	Prime Minister	Minister of Finance	Minister of the Economy	NBU Governor
Leonid Kravchuk Dec. 1991-Jul. 1994	Vitold Fokin Oct. 1990-Oct. 1992	Oleksandr Kovalenko 1990-1991	Anatoliy Minchenko May 1991-Mar. 1992	Volodymyr Matvienko Aug. 1991-Mar. 1992
Leonid Kuchma Jul. 1994-Nov. 2004	Valentyn Symonenko Oct. 2-12, 1992	Hrygoriy Pyatashenko 1991-1994	Volodymyr Lanovyj Mar. 1992-Jul. 1993	Vadym Hetman Mar.-Dec. 1992
Victor Yushchenko Since Dec. 2004	Leonid Kuchma Oct. 92-Sep. 93	Petro Hermahchuk 1994-1996	Victor Pynzenyk Oct. 1992-Apr. 1993	Victor Yushchenko Dec. 1993-Dec. 1999
	Yukhym Zvyagilsky Sep. 1993-Jul. 1994	Valentyn Koronevskyj 1996-1997	Yuriy Bannikov Apr.–Aug. 1993	Volodymyr Stelmakh Jan. 2000-Dec. 2002
	Vitaly Masol Jun. 1994-Mar. 1995	Ihor Mityukov 1997-2001	Roman Shpek Aug. 1993-Mar. 1995	Sergiy Tihipko Dec. 2002–Dec. 2004
	Yevhen Marchuk Mar. 1995-May 1996	Ihor Yushko 2001-2002	Vasyl Gureev Mar. 1995-Feb. 1997	Volodymyr Stelmakh Since Dec. 2004
	Pavlo Lazarenko Jun. 1996-Jun. 1997	Mykola Azarov 2002-Jan. 2005	Yuriy Yekhanyrov Feb.-Jul. 1997	
	Vasyl Durdynets Jul. 2-30, 1997	Victor Pynzenyk Since Jan. 2005	Viktor Suslov Jul. 1997-Apr. 1998	
	Valeriy Pustovoitenko Jul. 1997-Dec. 1999		Vasyl Rogovyj Apr. 1998-Dec. 1999	
	Viktor Yushchenko Dec. 1999-May 2001		Sergiy Tihipko Dec. 1999-Jul. 2000	
	Anatoliy Kinakh May 2001-Nov. 2002		Vasyl Rogovyj Aug. 2000-May 2001	
	Victor Yanukovich Nov. 2002-Jan. 2005		Qlexandr Shlapak Jul. 2001-Nov. 2002	
	Yulia Tymoshenko Jan. 2005-Sep. 2005		Valeriy Horoshkovskyj Nov. 2002-Nov. 2004	
	Yuriy Yekhanurov Since Sep. 2005		Mykola Derkach Nov. 2004-Jan. 2005	
			Sergiy Terjokhin Jan. 2005-Sep. 2005	
			Arseniy Yatseniuk Since Sep. 2005	

APPENDIX V. UKRAINE: CHRONOLOGY OF MAIN ECONOMIC AND POLITICAL EVENTS

1991	
March	Land code enacted.
August	Ukraine declares independence following coup in Moscow.
October	Central bank law adopted.
December	Independence is confirmed in nationwide referendum, Leonid Kravchuk elected first president.
December	Securities and stock exchange law adopted.
1992	
January	Multi-use coupon system introduced.
February	Competition agency established.
March	Small and large scale privatization begins.
May	Bankruptcy law enacted.
June	Stock exchange begins trading.
September	Ukraine joins IMF and IBRD.
November	Interim currency (karbovanets) introduced. Ukraine withdraws from the ruble area.
December	VAT introduced.
1993	
January	Income tax law adopted
August	Multiple exchange rates reintroduced.
1994	
July	Second round of presidential elections: Leonid Kuchma succeeds Leonid Kravchuk.
October	Most prices liberalized.
November	Most export quotas and licenses abolished.
December	Exchange rate unified.
November	Voucher privatization begins.
1995	
January	New corporate profits tax introduced.
March	Treasury bills market initiated.
June	Securities and Exchange Commission established.
December	Indicative export prices removed.
1996	
January	Licensing requirement for grain exports abolished.
June	New constitution of Ukraine adopted.
September	New currency (hryvnia) introduced.
1997	
March	Land code amended.
April	Full current account convertibility introduced.
June	Export surrender requirement revoked.
July	New corporate tax rate introduced.
August	First sovereign Eurobond issued.
October	VAT rate changed.
	Market-based monetary policy instruments introduced.
1998	
January	IAS introduced for commercial banks.
May	Limits on foreign ownership of banks lifted.
September	Foreign exchange restrictions reintroduced.
September	Currency band widened.
September	Domestic debt restructuring starts.
	Agricultural sector given VAT exemption.
1999	
February	Currency band widened further.
March	Inter-bank currency market liberalized.
April	Large increase in utility tariffs.
June	New central bank law approved.
July	Law on concessions adopted.
August	Presidential decree on privatization of electric power utilities.
October	Law on production sharing agreement takes effect.
November	President Kuchma reelected for the second term.
December	Presidential decree on reform of agricultural collectives.

Chronology of Main Economic and Political Events (continued)

2000	
January	New bankruptcy law becomes effective.
February	De facto peg of the hryvnia against the U.S. dollar introduced.
February	Law providing tax breaks to joint ventures repealed.
March	Commercial debt rescheduling agreement.
June	Law on payment reform in the electricity sector adopted.
July	Law on telecommunications privatization enacted.
July	Presidential decree issued on banning sector development.
September	Disappearance of journalist Heorgyi Gongadze.
October	Minority shareholder rights strengthened.
December	Law on banks and banking adopted.
December	Chernobyl nuclear plant closed.
2001	
January	SME support program initiated.
February	Law on settlement of tax liabilities signed.
February	EU calls for an inquiry into the murder of Heorgyi Gongadze.
April	Six power utilities privatized.
April	Tax amnesty enacted.
July	External debt restructuring agreement.
July	License of Bank Ukraina withdrawn.
July	Presidential decree on measures to improve investment climate.
July	Modern Budget Code adopted.
September	Law on deposit insurance adopted.
October	The last Soviet-era nuclear missile silo destroyed.
2002	
March	Parliamentary election results in hung parliament.
September	Opposition stages mass protests demanding resignation of President Kuchma.
2003	
March	Tens of thousands of people join Kiev demonstrations demanding that Kuchma resigns.
June	First Eurobond issued since the financial crisis.
	Single Treasury Account implemented.
2004	
January	Pension reform takes effect.
January	Tax reform takes effect.
February	The Financial Action Task Force on Money Laundering (FATF) removes Ukraine from its "black list."
November	Second round of presidential election (between Prime Minister Yanukovich and opposition candidate Viktor Yushchenko) results in mass street protests ("Orange Revolution").
December	Opposition candidate Viktor Yushchenko wins re-run of second round of Presidential elections.
2005	
February	President Yushchenko publishes his reform aganda "Ten Steps for Meeting the People."
March	The Ukraine-EU Action Plan is signed.
April	Export surrender requirements revoked.
April	Central bank lets hrynia appreciate by 5 percent against U.S. dollar.
April	President Yushchenko addresses a joint session of the U.S. Congress.
May	Government starts to reprivatize enterprises.
June	Presidential Memorandum signed to protect property rights after World Economic Forum in Kyiv.

Sources: EBRD Transition Report 2001; BBC Timeline: Ukraine; and IMF Staff Reports.

APPENDIX VI. UKRAINE: SUMMARY OF FUND-SUPPORTED PROGRAMS AND PROGRAM COMPLIANCE

Membership: Joined September 3, 1992. **Article VIII**: Yes. **Quota**: SDR 1,372 million.
Active Arrangement: None
Outstanding Fund Credit as of 7/31/2005: SDR 914.7 million under Extended arrangements

ARRANGEMENT 1

Systemic Transformation Facility (STF), approved October 26, 1994, in the amount of SDR 249.325 million (25 percent of quota):

- **As measures to be taken at the beginning of the program, the Memorandum of Economic Policies (MEP) listed**: price liberalization; cuts in producer and consumer subsidies; foreign exchange market unification and liberalization; elimination of export quotas and licenses; increase in NBU refinancing rate; presentation to parliament of revised budget; indexing of pension and other benefits to inflation; steps to allow ownership and transfer of land and property; ceilings on credit extended by banks; and implementation of a system for monthly budget cash management.

- **Quantitative policy targets (3)**: ceilings on NDA of the NBU; net credit of the banking system to the government; and floors in NIR at the NBU. All targets were met.

- **Structural benchmarks (8)**: government approval of 1995 budget; presentation to congress of a new budget law that would allow better review and control by the Ministry of Finance; implementation of competitive tender process for selling government securities; agreement with external creditors on arrears resolution; consolidation of all official foreign exchange reserves at the NBU; removal of export quotas and licenses; public procurement reform; distribution of privatization certificates to population. Of the 8 structural benchmarks, 4 were postponed, 2 partially implemented, and 2 implemented.

ARRANGEMENT 2

- **Twelve-month Stand-By Arrangement** in the amount of SDR 997.3 million (100 percent of quota) and second purchase under the STF in the amount of SDR 249.325 million, approved April 7, 1995.

- **Prior actions (9):** approval by parliament of 1995 budget; strengthening of bank supervision and regulation; elimination of most remaining export quotas and licenses; government procurement measures; reduction of gas subsidies; presentation to parliament of amendments to the Land Code to facilitate more rapid privatization of land and buildings; linking of social benefits to CPI instead of to minimum subsistence income; regularization of external payments arrears; and securing adequate financing.

- **Performance criteria (5):** quarterly ceilings on NDA of NBU; ceilings on net credit of banking system to the government; floors on NIR of the NBU; ceilings on nonconcessional official external debt (separately by up to one year, 1-5 years, and 1-12 years); ceilings on external payments arrears of the government.

- **Financial benchmarks (2):** base money ceiling; non-banking system credit to the non-government.

- **Structural reform benchmarks:**

  - By June 30, 1995 (10), including adjustment of housing rents and prices of communal services to cover at least 30 percent of costs by May 1; approval by parliament of new central bank law to strengthen its independence; liberalize grain exports; privatize at least 1,000 medium and large enterprises; liquidate 5 loss-making SOEs; simplify bankruptcy procedures; prepare strategy to break up processing monopolies; and complete strategy papers on reform of social assistance programs, pensions, and unemployment compensation.

  - By September 30, 1995 (2): adjustment of housing rents and prices of communal services to cover at least 60 percent of costs by July 1.

  - By December 31, 1995 (3): complete privatization of 95 percent of small-scale enterprises, at least 8,000 medium and large enterprises, and at least 25 medium and large enterprises with majority foreign participation.

- **Program compliance record:**

  - First review completed June 9, 1995 and purchase (23 percent of quota) made. All quantitative performance criteria observed on April 1, but performance criterion on the accumulation of external payments arrears by the government was not observed in April. Waiver granted for non-observance of this performance criterion as well as modifications of certain performance criteria established for July 1 (NDA and NIR targets tightened) and of financial benchmarks on base money and net banking system credit to non-government.

  - Second review completed September 29, 1995, and purchase (23 percent of quota) made. Performance criteria on NDA and external arrears not met; waivers and modifications approved. Financial benchmarks on base money and net banking system credit to non-government for July 31 not met;

benchmarks modified. Structural reform benchmarks: none fully met. (It later emerged that Ukraine also had arrears of $17 million to western creditors that it had not reported to the Fund, and therefore its September 29 purchase was non-complying; in December the Fund granted Ukraine a waiver for that non-compliant purchase.)

- Third review, to be based on October 31 test date, was postponed due to "repeated non-observance of the performance criteria on external payments arrears, serious slippages in the area of privatization, and continuing uncertainties about the budget."

- SBA expired on April 6, 1996, without a third or fourth review and associated purchases.

- **Summary of Program Compliance:**

  - Quantitative performance criteria (20): 13 met, 7 missed (this counts the ceiling on non-concessional debt as a single PC, although it applied separately to short-term and MLT debt).

  - Financial benchmarks (8): 1 met, 7 missed.

  - Structural reform benchmarks (15): 6 met, 1 partly met, 8 not met. (Note that 1,450 medium and large enterprises were privatized, compared to a target of 8,000 by December 31).

ARRANGEMENT 3

- **Nine-month Stand-By Arrangement** in the amount of SDR 598.2 million, approved May 10, 1996. Monthly monitoring and purchases, with bi-monthly Board reviews. First 8 purchases SDR 67 million each; ninth SDR 62.2 million (first purchase approved May 10).

- **Prior actions (7):** parliamentary approval of 1996 budget with 3.5 percent of GDP deficit; discharge of all foreign debt service contracts and settlement of past external payments arrears; do not guarantee gas imports; maintain NBU refinancing rate at positive level in real terms, speed up privatization; raise tariffs for communal services, rents, public transport fares, and energy for households by enough to cover at least 60 percent of costs; and issue decree on Implementation Committee.

- **Performance criteria (5):** no new external payments arrears during period of arrangement (continuous PC); ceiling on NDA of NBU; ceiling on consolidated fiscal deficit; floor on NIR of NBU; ceiling on nonconcessional external loans (divided into up to one year, 1-5 years, and 1-12 years).

- **Financial benchmarks (3)**: on net NBU credit to government; base money; and banking system credit to non-government.

- **Structural reform benchmarks (11):** 4 by May 31, 3 by July 31, and 4 by September 30. Areas included privatization, price liberalization, cost recovery on government rents and communal services, de-monopolization, and auditing of large banks.

- Second (May 30) and third (June 28) monthly purchases of SDR 67 million made prior to first review on July 31. First review found all PC through June 30 were met. All indicative targets through June 30 also met, except NBU credit to the budget exceeded ceiling by KRB 15 trillion at end-June. Virtually all structural benchmarks were complied with though there were delays in structural benchmarks related to privatization and to increasing cost recovery ratios in rent and communal services. Fourth purchase made August 5, for SDR 67 million.

- Fifth purchase made August, 30 based on end-July PCs, without a review.

- Second review completed September 26 (on lapse of time basis), and sixth purchase made September 30, for SDR 67 million.

- Seventh purchase made October 31 based on observance of end-September PCs, without a review.

- December 16, completion of third review based on all end-October PCs being met. Eighth purchase, SDR 67 million.

- Performance criterion on NIR of NBU for end-November and financial benchmark on net NBU credit to the government not met, because of delay in parliament approving World Bank loans. Program expiration extended from February 9 to February 23 to allow time to assess whether waiver should be granted.

- Waiver for missed PC granted in February and ninth and final purchase made.

<u>Summary of Program Compliance:</u>

- 36 out of 37 PCs met (4 monthly PCs for 9 months (April to November) and 1 continuous PC (external arrears)

- 17 out of 18 financial benchmarks met (2 financial benchmarks for 9 months)

- 11 structural benchmarks: 8 met, one largely met, one delayed, one not done (benchmark that was missed: audits of 10 largest banks; the savings bank, which was the largest by far, was not audited).

ARRANGEMENT 4

- **Twelve month Stand-By Arrangement, approved August 25, 1997, in the amount of SDR 398.9 million (40 percent of quota).** Monthly monitoring and 11 monthly purchases of SDR 36.3 million each; quarterly reviews.

- **Performance criteria (6)**: Monthly PCs (4): ceiling on NDA of NBU; ceiling on consolidated deficit; ceiling on budgetary arrears on wages, pensions, and benefits; and floor on NIR. Quarterly PC: ceiling on nonconcessional external public debt (separate subceilings for less than one year, 1-5 years, and more than 5 years). Continuous PC on accumulation of external arrears by government and NBU.

- **Indicative targets/financial benchmarks (4):** base money ceiling and government revenue floor; two continuous financial benchmarks: accumulation of arrears on gas payments and floor on balance of state reserves.

- **Structural benchmarks (11)** (1 by 9/30/97, 5 by 12/31/97, and 5 by 3/31/97): including parliamentary approval of NBU law; privatization, deregulation, including reduction of license requirements on businesses; pension reform; electricity reform; elimination of state orders for grain; harmonization of taxes on domestic and foreign production; and reduction in number of imports subject to combined ad valorem and specific import duties.

- Monthly purchases for September and October did not occur because of missed PC on fiscal deficit for August and September. Also, continuous PC on nonaccumulation of external arrears not met, for technical reasons, in September.

- First review completed November 26, 1997. Waiver granted for missed October PC on non-accumulation of external arrears and November and December PCs modified. Purchase (second and third combined) of SDR 72.5 million. Rephasing of eligible purchases, with final three purchases (April, May, and June 1998) each augmented by SDR 12.1 million. Three additional structural reform benchmarks agreed in areas of deregulation, cash privatization, and gas sector reform.

- Fourth purchase made December 29, 1997 based on end-November PCs.

- Request for waiver for nonobservance of PC for end-December fiscal deficit and nonaccumulation of external arrears, and modification of program targets approved January 28, 1998. Fifth purchase approved, for SDR 36.3 million. Cumulative purchases under program SDR 181.3 million.

- Program went off track after purchase approved January 28, 1998. No further purchases. Program expired August 24, 1998.

<u>Summary of Program Compliance:</u>

- Total PCs: 23, of which 18 met and 5 missed. (Four monthly PCs for five months (20): 16 met (fiscal deficit missed four times; NIR, NDA, and wage arrears all met); 4 missed. 1 continuous PC on nonaccumulation of external arrears missed. 2 quarterly PCs on ceiling on non-concessional debt met for Q3 and Q4)

- Financial benchmarks (indicative targets): out of 12 (two monthly criteria over 5 months and two continuous criteria), 7 met and 5 missed.

- Structural benchmarks: 4 done, 1 done with delay, 4 partly done, 5 not done. (Of 11 original: 3 done, 1 done with delay, 2 partly done, 5 not done. Of 3 additional measures agreed during first review: 1 done, 1 mostly done, 1 partly done.)

ARRANGEMENT 5

- **Three-year EFF arrangement (starting September 4, 1998), approved September 4, 1998 in the amount of SDR 1,645.55 million.** Access phasing: SDR 648.2 million (65 percent of quota) in first 12 months and SDR 498.6 million (50 percent of quota) in second and third years. Within first year: SDR 190 million available mid-September; SDR 55.55 million available after October 20, 1998, November 20, 1998, and December 20, 1998; and SDR 41.66 million due after January 20, 1999, February 20, 1999, March 20, 1999, April 20, 1999, May 20, 1999, June 20, 1999, and August 20, 1999. Thirty prior actions including reforms in following areas: fiscal structural, tax, subsidies, pensions, bank supervision, domestic treasury bill market, land reform, privatization, public administration, trade liberalization, electricity tariff deregulation.

- **Performance criteria:** Monthly monitoring of PCs and monthly purchases during August-December 1998, with quarterly reviews. Four monthly PCs: ceiling on consolidated fiscal deficit; ceiling on budgetary arrears of wages, pensions, and benefits; ceiling on NDA of NBU; floor on NIR of NBU. Continuous PC on nonaccumulation of external official arrears. Quarterly PC: ceiling on nonconcessional public debt (five separate categories: up to 1 year; 1-3 years, with sublimit on credit lines; and more than 1 year, with sublimit on credit lines). Four structural PCs (not in original program but added later): increase in communal tariffs (two PCs), reduction in commodities subject to mixed specific/ad valorem import tariffs, and adoption of formula-based transfers to local governments.

- **Indicative targets:** Three monthly indicative targets from August to December; base money; floor on unearmarked state cash revenue; ceiling on NBU gross purchases of t-bills from the primary market;

- **Quantitative structural benchmarks (2)** (quarterly): collection rate for household gas payments; cumulative reduction in the number of budgetary employees.

- **Structural benchmarks (11):** in areas of tax administration, privatization, pension reform, deregulation, central bank reform, and reorganization of ministry of finance.

- First purchase of SDR 190 million made September 1998.

- October: Financing assurances review and request for waivers and modification of performance criteria. Waivers requested and approved for nonobservance of 3 PCs: end-September PCs on NIR and NDA of the NBU and continuous PC on the introduction of exchange measures subject to Fund jurisdiction; modification of program targets for end-October on NIR and NDA of the NBU. Second purchase, of SDR 55.5 million.

- First review could not be completed on time (December) due to cash revenue shortfalls, uncertain 1999 fiscal prospects, and delayed structural reforms. March 1999: first review and request for waivers of PCs (on NIR of the NBU; NDA of the NBU; and arrears on pensions, wages, and benefits and continuous PC on exchange restrictions) and for rephasing of purchases approved. New structural PC: tariffs on gas and electricity to be raised by 25/20 percent, respectively, by April 1, 1999; and local government tariffs to achieve full cost recovery for communal services by May 1, 1999. (Both those structural PCs were met, with except cost recovery in Kyiv). New quarterly PC and monthly indicative targets added on non-earmarked cash revenue of the central government. Nine new structural benchmarks added, in areas of tax administration; banking; privatization; land reform; cost recovery for communal services; budget administration; and lifting of exchange restrictions.

- New phasing: SDR 111.1 million available after March 10, 1999 and SDR 48.6 million available after 20th of each month from April through September.

- Fourth purchase could not be made on time (April 1999) because of nonobservance of end-March PCs on budgetary arrears for pensions/wages/benefits and on accumulation of external arrears. On May 27, 1999 Board approves second review and request for waiver of those PCs, modification of monthly PCs for May—August, and augmentation of the extended arrangement by 20 percent of quota or SDR 274.4 million. Fourth purchase of SDR 134.7 million. Structural PC added to require full cost recovery of heating, water, sewer, rent, and transport services in Kyiv.

- Fifth purchase made after June 20, 1999 SDR 86.1 million.

- Sixth purchase could not be made on time in July because of non-observance of end-June PC on state cash revenue.

- Third review and request for waiver and modification of PCs approved September 7, 1999: waiver for nonobservance of end-June PCs on unearmarked state cash revenue and on communal tariffs; modification of PCs on state cash revenues at end-September and on stock of budget arrears, fiscal deficit, and NDA of NBU for end-

August and end-September. SDR 134.7 million (seventh) purchase. Cumulative drawings under extended arrangement: SDR 712.5 million.

- Eighth purchase (based on September PCs) could not be made due to missed end-September structural PC on communal tariffs and five end-December quantitative PCs (consolidated deficit, nonearmarked state cash revenue, stock of budgetary arrears, NDA of NBU, and continuous PC on nonaccumulation of external payment arrears).

- December 19, 2000: completed fourth review and waiver of missed September 1999 structural PC and December 1999 quantitative PCs, and extension (to September 2002) and rephrasing of extended arrangement. Purchase of SDR 191 million. Program for October 2000 to December 2001 elaborated, including quarterly quantitative PCs, indicative targets, and quantitative structural benchmarks for December 2000 and March 2001; and structural benchmarks. New PC relating to netting operations on consolidated government obligations and two quantitative structural benchmarks on cash collection ratios for gas and electricity added (previous quantitative structural benchmarks on collection rates for household gas payments and on cumulative reduction of budgetary employees dropped). Quarterly reviews and purchases from first quarter of 2001 to second quarter of 2002 set. Three prior actions: approval of budget, submission to parliament of privatization list, and passage of banking law. Seven structural benchmarks: reduce export tax on oil seeds; publish information on privatization; progress on Naftogaz audit; medium-term strategy for Bank Ukraina; review Free Economic Zones and Special Investment Regimes; publish NBU's audited statements; and initiate bankruptcy procedures on 5 of 50 largest tax debtors.

- All PCs for end-December and end-March and indicative targets for end-June met (except for base money, which exceeded target in December, March, and June by large margins due to NBU forex purchases), but structural reforms delayed. Delay in completion of program review. Concerns about fiscal implementation due to tax amnesty.

- September 20, 2001: Fifth and Sixth reviews completed, purchases of SDR 290.8 million. PCs and benchmarks set for September and December 2001, and remaining purchases rephrased. New structural PC added: adopt formula-based transfer to local governments in the context of the 2002 budget. Cumulative purchases SDR 1,193 million.

- September 3, 2002: extended arrangement expires without completion of seventh or subsequent reviews, due to non-implementation of prior actions, including steps to reduce VAT arrears and eliminate tax exemptions.

- Summary of Program Compliance:

- Total PCs: 70 met, 19 not met, 89 total.
  - Monthly quantitative PCs: 33 met, 15 not met, 48 total. (12 months times 4 PCs per month; only 12 months because reviews were delayed several times and monthly indicative targets were not turned into PCs, and then PCs became quarterly starting with December 2000)
  - Quarterly PCs: 33 met, 3 not met, 36 total. (much better record because until 12/00, QPCs were on non-concessional debt issuance and non-earmarked cash revenue, both of which had good compliance; after 12/00 all quantitative PCs became quarterly and performance on them was significantly better than in earlier program period)
  - Continuous PCs: 1 met, 1 not met, 2 total. (Continuous PCs were no external arrears and no netting operations. Missed external arrears PC (three times), did not miss netting PC)
  - Structural PCs: 2 met, 2 not met, 4 total.
- Quarterly quantitative benchmarks: 8 met, 18 unmet, 26 total.
- Structural benchmarks: 17 done, 5 partly done, 6 not done. 28 total.

ARRANGEMENT 6

- **Twelve months precautionary SBA (approved March 29, 2004) approved, in amount of SDR 411.6 million (30 percent of quota), with quarterly disbursements and one review (scheduled for completion by September 2004).**
- **Prior actions (5):** suspend certain VAT exemptions; reduce stock of VAT refund arrears; agreement by parliament to postpone minimum wage increase; adopt NBU decree to raise capital adequacy ratio; and enact 2004 budget law with specified provisions.
- **Quantitative performance criteria (6):** (a) ceilings on cash deficit of central government; (b) ceiling on stock of budgetary arrears; (c) ceiling on stock of VAT refund arrears; (d) ceilings of NDA of NBU; (e) floors on NIR of NBU; and (f) ceiling on external debt contracted or guaranteed by the government. PCs for March and June and indicative targets for September and December set, and continuous PC on non-accumulation of external arrears.
- **Structural performance criteria (2):** eliminate VAT exemptions; and enact amendments to banking law and NBU regulations to tighten related-party lending.

- **Structural benchmarks (3):** steps to develop domestic securities market; adoption of monitoring system for quasi-fiscal operations; and reduce fiscal cost of remaining VAT preferences.

- **Indicative targets (4):** Quarterly indicative targets for (a) base money growth; (b) nonearmarked cash revenue; (c) cash collection ratio for electricity; and (d) cash collection ratio by Naftogaz.

- Review not completed due to disagreement on 2004 fiscal stance and 2005 fiscal prospects, non-compliance with structural PCs and structural benchmark, and issue of exchange rage flexibility. All end-March and end-June quantitative PCs met except ceiling on VAT refund arrears.

- <u>Summary of Program Compliance:</u>

- 10 out of 12 quantitative PCs met.

- Two structural PCs: both missed.

- One structural benchmark (by time of review): missed.

- One of four quarterly indicative targets missed (on base money).

INTERNATIONAL MONETARY FUND
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November 11, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Ukraine

On November 9, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.[1]

Background

After four years of strong activity, annual growth has slowed sharply, from a peak of about 12 percent in 2004, to 3 percent for January-September 2005. In part, the decline reflects a somewhat less favorable external environment—export growth has fallen from 41 percent in 2004 (in nominal terms) to about 9 percent over the first half of 2005; while import growth remained roughly unchanged from 24 percent to 23 percent respectively. However, the fall in domestic growth also reflects the impact of continuing political uncertainty on domestic investment.

Inflation has been trending upward since mid-2003. From a low of -0.6 percent in 2002, the 12-month Consumer Price Index (CPI) reached 12.3 percent by end-2004, peaked at 14.9 percent in August 2005, and declined somewhat to 12.4 percent in October 2005. Much of the recent surge in inflation has been concentrated in select food-related items, reflecting in part the impact of higher pensions and wages on consumer demand. Prices at the wholesale level, however, have eased from the highs of last year; the Producer Price Index (PPI) reached a peak of about 25 percent toward the end of 2004, and has since fallen to 12.9 in October 2005 owing to a slowing economy.
Wages continue to grow strongly. In July 2005, the average nominal monthly wage was 38 percent above its level the previous year, representing an increase of about 20 percent in real terms.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Fiscal policy in 2005 has aimed at a significant fiscal tightening, with the supplementary 2005 budget targeting a general government deficit of 2½ percent of GDP; compared to the 4½ percent of GDP realized during 2004, and the 6-7 percent of GDP implicit in the original 2005 budget. However, the budget allowed for a substantial increase in public pensions and wages, and offset this additional spending by a large increase in the tax burden, partly reflecting the closing of tax loopholes, and steep cuts in capital investment. The spending provisions have helped raise average public pensions and wages by over 50 percent (against an inflation target of just under 10 percent), with a noticeable impact on household income and consumer prices. Budget implementation in 2005 has been on track. Cash revenue through September have been buoyant, reflecting tax measures introduced in the 2005 budget, while recent data point to a significant underexecution of spending at the central government level. If maintained, it could compensate for the unbudgeted pension spending pressures that have materialized (some ¾ percent of GDP) and should put achieving the general government deficit target of 2½ percent of GDP within reach. The stock of value added tax refund arrears amounted to ½ percent of annual GDP at end-September 2005. The re-auction of the steel company Kryvorizhstal resulted in unexpectedly high net privatization revenues (after repaying the previous owners) of $4 billion (5 percent of GDP), significantly in excess of the overall budgeted privatization revenue for 2005 (1¾ percent of GDP).

Monetary conditions have remained loose. Apart from a 5 percent nominal appreciation of the hryvnia against the U.S. dollar during the first four months of the year and, more recently, a somewhat reduced presence in the interbank foreign exchange market, the NBU has continued to purchase foreign exchange rather than allow the exchange rate to appreciate. Moreover, sterilization efforts have remained limited. The largest support in absorbing liquidity has come from the government; which has issued new T-bills to buy back the higher-yield restructured securities held by the National Bank of Ukraine (NBU), and which has built up deposits by maintaining a tight fiscal stance. With continued foreign exchange inflows, there is excess liquidity in the banking system, and most interest rates are now negative in real terms. Monetary aggregates have expanded more slowly in 2005, compared to 2004, but this comes against a backdrop of decelerating money demand, as inflation has risen into double digits.

Reflecting high domestic inflation, the real exchange rate has appreciated markedly; with the real effective rate rising by about 12 percent during the 12 months to end-July 2005. However, all indicators, including cross-country wage data, suggest that price competitiveness of Ukrainian exporters remains strong.

The NBU has taken tentative steps toward greater nominal exchange rate flexibility, and has relaxed a number of foreign exchange restrictions, including Ukraine's export surrender requirements and the provision that non-residents predeposit the full amount of their auction T-bill bids. In August, the NBU allowed banks to operate on both sides (buy/sell) of the foreign exchange market within the same day, and also allowed forward operations. Together with the 1.5 percent foreign exchange transaction tax, which the draft 2006 budget envisages to halve, these restrictions were the main elements impeding development of Ukraine's foreign exchange markets and instruments. In contrast, however, the NBU has introduced a new, but likely non-binding, restriction on purchases by non-residents of government securities with original maturities of less than one year (government papers generally have original maturities that exceed one year) and a 20 percent reserve requirement on foreign currency loans with a maturity of up to 180 days from non-residents.

The banking system weathered last year's political turmoil well. However, credit expansion and credit quality are still a concern. Credit growth remained high at 44 percent in September 2005, after some deceleration in late 2004 and early 2005. Banks are refocusing their lending on household-sector loans (their share in total loans has increased from 5 percent at end-2001 to 20 percent by end-September 2005), including mortgage lending to the buoyant housing market. The non-performing loans ratio of the banking system is declining, but remains high.

Executive Board Assessment

Executive Directors noted that Ukraine made impressive economic gains during 2000–04, largely as a result of favorable external factors and prudent macroeconomic policies. However, the period since late 2004 has been a turbulent time for Ukraine, involving political uncertainties and major shifts of policy that adversely affected business confidence and investment. In tandem with less favorable external conditions—notably on the terms of trade—and slow progress on structural reforms, this turbulence led to a significant weakening in economic performance in 2005: growth slowed sharply, inflation accelerated, and the current account surplus halved. Directors welcomed the tentative signs of stabilization of the macroeconomic situation in recent months.

Directors stressed that a focused effort by the authorities to restore macroeconomic stability and implement structural reforms to complete the transition to a full-fledged market economy will be needed to unleash the economy's significant untapped potential. They considered that Ukraine's medium-term growth outlook is highly favorable, provided the right policies are put into place. Against this background, Directors welcomed the authorities' expressed commitment to fiscal discipline and their progress in implementing a sound fiscal policy in 2005, as well as their initial steps toward greater exchange rate flexibility, their commitment to market-strengthening structural reforms, and their efforts to resolve lingering uncertainty regarding property rights in Ukraine.

Directors observed that the relaxation in the fiscal stance during the run-up to the 2004 presidential elections, together with the large increases in public pensions and wages in the supplementary 2005 budget, contributed significantly to recent inflationary pressures. While this has been partly offset by targeting a reduced 2005 fiscal deficit of 2½ percent of GDP, higher spending has necessitated a significant increase in the overall tax burden, although in good part through the welcome closing of tax loopholes and improvements in taxpayer compliance. Directors commended the prudent budget implementation in 2005, noting that the authorities seem broadly on track toward achieving their 2005 general government deficit target, and encouraged the authorities to clear all legitimate VAT refund arrears.

Looking ahead, Directors underscored the need for a fiscal stance that supports disinflation. They urged the authorities to continue to resist strong pressures to raise spending, particularly on social transfers and subsidies, and the fiscal deficit in the run-up to elections in 2006. They recommended that the general government deficit not exceed 2¼ percent of GDP in 2006, underpinned by a freeze on recurrent expenditure in real terms and realistic macroeconomic assumptions. In line with this target, Directors called on the government to allocate the Kryvorizhstal privatization windfall primarily to debt redemptions that do not add to domestic liquidity, and to resist pressures to re-open the tax loopholes that were closed in the 2005 budget. Such a fiscal strategy would avoid fuelling inflationary pressures, and would increase the authorities' ability to address future contingencies as well as Ukraine's sizeable medium-term fiscal needs, including spending on public infrastructure.

Directors considered the reestablishment of a viable public pension fund to be a key medium-term priority. They noted that the recent massive pension hikes have put the pension fund in a precarious financial position, requiring large budget transfers to cover contribution shortfalls and constraining the authorities' scope for reducing the high tax burden on labor. Directors encouraged the authorities to improve the targeting of the minimum pension subsidy, raise effective retirement ages, and prune privileged pension regimes.

Directors stressed that tighter monetary conditions are needed to help contain inflation, while acknowledging both the limitations of interest rate policy given the absence of a developed monetary transmission mechanism and the need to pay attention to ongoing relative price adjustments. They urged the NBU to reduce further the excess liquidity in the banking sector through a deceleration in money growth. Directors cautioned against the NBU's tentative plans to support bank intermediation by establishing a long-term credit facility, since the NBU's main role should be to provide liquidity rather than long-term credit.

Directors broadly agreed that a gradual shift to increased exchange rate flexibility and inflation targeting would increase the NBU's ability to achieve low and stable inflation, particularly in the context of strong foreign investor interest and a competitive exchange rate. They therefore welcomed the NBU's recent steps toward a more flexible exchange rate regime. However, they stressed the need for the NBU to communicate its policies and intentions more consistently, and to ensure that the appropriate preconditions and technical capacity for a successful policy shift are in place. In this regard, they encouraged the NBU to build on its recent efforts to deregulate the foreign exchange market and further strengthen its operational framework, while developing financial markets. Directors noted Ukraine's low productivity relative to potential, and stressed that competitiveness is best enhanced through productivity-boosting reforms and prudent policies to lower inflation.

Directors saw a strong case for improving macroeconomic policy coordination, and welcomed the recent NBU initiative to reach a more formal understanding on policy coordination between the NBU and the government.

Directors welcomed the authorities' vision of sweeping structural reforms. They observed that Ukraine's lagging growth performance since 1992 relative to that of most other transition economies—even accounting for the strong growth rates of 2000-2004—in large part reflects long-standing difficulties in reaching a political consensus to build the more market-friendly institutions that would allow Ukraine to use its resources more efficiently. They stressed, in particular, the importance of reforms to strengthen public administration, fight corruption, and establish a stable and predictable business environment. In this context, Directors welcomed the Ukraine-EU Action Plan, which commits Ukraine to a wide range of structural policy actions and anchors the authorities' reform drive within the process of closer integration with the EU and global markets. They urged the authorities to launch an aggressive campaign to educate the public on the benefits of these reforms.

Directors encouraged a rapid resolution of the debate on past privatizations. The recent presidential memorandum guaranteeing property rights, the government's efforts to clearly and quickly identify those state enterprises to be privatized, the official commitment to fully comply with privatization legislation, and the transparent re-auction of the Kryvorizhstal steel mill were all seen as important steps in the right direction. Directors noted, however, that a credible legislative proposal that outlines the full scope of possible challenges to past privatizations may still be needed to address lingering investor concerns.

Directors welcomed the government's ambitious trade-policy agenda. While the liberalization achieved so far this year constitutes important and tangible progress, Directors considered that early implementation of the remaining measures needed for WTO membership should remain a priority.

Directors viewed the development of domestic capital markets as key in strengthening the monetary policy transmission mechanism and improving risk management and financial intermediation. In line with Fund and World Bank recommendations, the authorities should establish benchmarks for government securities, set up a coherent debt management strategy, and swiftly adopt a Joint Stock Company Law.

Directors noted that there are continuing fragilities in the financial sector, and encouraged the authorities to strengthen further the supervisory framework. They commended the NBU for tightening regulations, including those pertaining to foreign-currency loan-loss provisioning, open foreign currency positions, limits for related-party lending, and the definition of bank capital. They welcomed the submission to Parliament of revised legislation that would allow limits on early withdrawal of deposits during financial emergencies. However, Directors regretted the delay in amending the Banking Act, and encouraged the authorities to consider short-term measures to shore up the banking system until the new legislation is approved—including raising the minimum capital adequacy ratio to 12 percent. They also encouraged a switch from the highly procedural supervision methods to a more risk-based framework, and a strengthening of the bank resolution process.

Directors welcomed the progress in improving statistics. Although these are broadly adequate for surveillance, shortcomings remain. In particular, stock data on sectoral financial assets and liabilities need to be reconciled with flow data, especially on the external side; and the quality of labor market data, particularly on wages and employment, could be improved.

Directors welcomed the candid Ex Post Assessment (EPA) of Ukraine's longer-term program engagement with the Fund. They welcomed the EPA's findings that Fund–supported programs were quite effective in supporting macroeconomic stability, and that the continuous policy dialogue between the Fund and the authorities influenced important policy decisions and resulted in a beneficial transfer of knowledge to Ukrainian policy makers. At the same time, Directors noted that Fund-supported programs did not succeed in accelerating the pace of reform of more market-friendly institutions, which ultimately explains Ukraine's relatively poor program compliance. In light of this, they concluded that stronger program ownership, rooted in stronger political consensus, would be key to maximize the chances of success of any future program.

Ukraine: Selected Economic Indicators

	2001	2002	2003	2004	2005 Proj.	2006 Proj. 1/
	(Percent change, unless indicated otherwise)					
Production and prices						
Nominal GDP (billions of hryvnia)	204.2	225.8	267.3	344.8	415.5	499.8
Real GDP growth	9.2	5.2	9.6	12.1	4.0	5.5
Consumer price index (period average)	12.0	0.8	5.2	9.0	13.7	12.9
Consumer price index (end of period)	6.1	-0.6	8.2	12.3	12.0	13.0
	(In percent of GDP)					
Public finance						
Consolidated government budget balance, cash basis 2/	-1.6	0.5	-0.9	-4.4	-2.9	-3.2
Primary balance	0.4	1.8	0.1	-3.5	-2.1	-2.1
Revenue	33.5	36.0	35.9	35.0	39.7	38.4
Expenditure	35.1	35.5	36.8	39.4	42.7	41.5
Public debt and arrears (in percent of GDP)	38.6	35.7	27.7	25.1	21.1	18.5
	(Percent change, unless indicated otherwise)					
Money and credit						
Base money	37.4	33.6	30.1	34.1	42.1	24.5
Broad money	41.9	41.8	46.5	32.3	41.0	27.9
Credit to nongovernment	40.5	47.3	63.4	31.2	49.5	28.6
Velocity (annual GDP divided by end of period broad money)	4.46	3.48	2.78	2.75	2.34	2.20
External sector						
Current account balance (in percent of GDP)	3.7	7.5	5.8	10.5	4.8	1.0
External public debt (in percent of GDP)	26.6	24.0	21.6	19.3	15.6	12.5
Debt service (in percent of exports of goods and services)	6.7	5.4	6.2	4.8	4.9	5.1
Terms of trade (annual change in percent)	1.3	1.6	8.6	16.4	-1.4	-5.5
Gross reserves (end of period, in months of next year's imports of goods and services)	1.7	1.9	2.4	2.7	4.7	4.8

Sources: Ukrainian authorities; and IMF staff estimates and projections.

1/ Based on policy intentions and staff's real GDP projections. Assumes that the proceeds from the re-sale of Kryvorizhstal are held in the government account with the NBU.

2/ The consolidated government budget balance includes the central government, local governments and social funds. It excludes US$ 98 million of non-cash property income paid annually by Russia in exchange for amortization of Ukraine's debt to Russia, which are included in the authorities' official figures. Paid VAT refund arrears are reflected as a reduction in total revenues in the consolidated government balance (cash basis).