July 2008
IMF Country Report No. 08/227

Ukraine: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ukraine

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 2008 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 1, 2008, 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 May 9, 2008. 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 statement of June 2, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 2, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Ukraine.

The document listed below has been or will be separately released.

Selected Issues Paper

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
Washington, D.C.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2008 Article IV Consultation

Prepared by the European Department

(In consultation with other departments)

Approved by Juha Kähkönen and Michael T. Hadjimichael

May 9, 2008

Executive Summary

Growth has been very strong and medium-term prospects are good. However, inflation has risen, the current account deficit has deteriorated sharply, and financial sector risks have increased. Sharp rises in public spending have fed domestic demand, although fiscal deficits have been contained and public debt is low. Monetary conditions have tightened somewhat, but the de facto peg to the dollar has limited the ability of monetary policy to combat inflation. Staff projects growth to slow from 7½ percent last year to a more sustainable 5½ percent this year; the authorities project somewhat stronger growth.

It was agreed that fiscal restraint is key to slowing demand growth and easing inflationary pressures. Staff recommends cutting the budget deficit by 1½ percent of GDP in 2008, to 0.5 percent of GDP, by restraining spending. The authorities see less scope for spending restraint, but envisage a deficit below 1 percent of GDP via buoyant revenues.

The authorities have tightened monetary conditions, but monetary policy alone will be insufficient to reduce inflation to acceptable rates. To give monetary policy more scope for action, the authorities should increase exchange rate flexibility, consistent with last year's NBU policy guideline. Recently, the exchange rate has fluctuated more widely. Ultimately, inflation targeting should replace the exchange rate as the nominal anchor, which will require coordinated effort by the government and the central bank.

While the authorities and staff agree that the banking sector as a whole is profitable and well capitalized, the supervisor should continue to strengthen risk management and oversight. Key measures include consolidated supervision, increased transparency, enhanced risk management, relaxed bank secrecy provisions, strengthened prudential requirements, and better mechanisms for bank exit.

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I. INTRODUCTION

1. **Growth has been strong and Ukraine's medium-term potential is enormous**. Real GDP has grown by 7½ percent a year on average since 2000, in line with other CIS countries and higher than in most other transition economies. The economy has been surprisingly resilient in the face of a doubling of imported natural gas prices and an uncertain political climate. The implementation of structural reforms would boost growth potential, allowing Ukraine to close the income gap with neighboring countries (Figure 1).

2. **Since the last Article IV consultation, developments in Ukraine and globally have raised macroeconomic issues to the top of the policy agenda**. High inflation and a widening current account deficit in Ukraine, together with global financial turbulence and slowing world growth, have increased short-term vulnerabilities. Recent progress on macroeconomic and structural reform has been uneven (Table 1), in large part reflecting protracted political uncertainties leading up to parliamentary elections last September. A new Orange coalition government came to power in December 2007, with a paper thin majority, and presidential elections are scheduled for the fall of 2009. The Article IV discussions were held during March 20-April 2, 2008 (Appendix I).

II. BACKGROUND

3. **The economy overheated in 2007**. The economy was pushed beyond its capacity by expansionary fiscal and incomes policies and high steel prices (which fuelled very strong domestic demand growth), and by very rapid money and credit growth (Table 2, Figure 2). These factors, together with rising food and energy prices, lifted CPI inflation to over 25 percent at end-March 2008 (Figure 3). Core inflation has also risen, nominal wage growth is very high, and inflation expectations have drifted up.

4. **Substantial vulnerabilities have built up**:

- Banks' direct and indirect credit risks have increased, reflecting very high lending growth, including in foreign exchange to unhedged borrowers (Figure 4). Greater intermediation is a natural consequence of financial development, but the rapid credit growth may be undermining credit quality. Moreover, house prices are high relative to incomes, raising credit risks on mortgages (Figure 5). The banking system may have to undergo some consolidation, since a number of smaller institutions are unlikely to remain competitive.

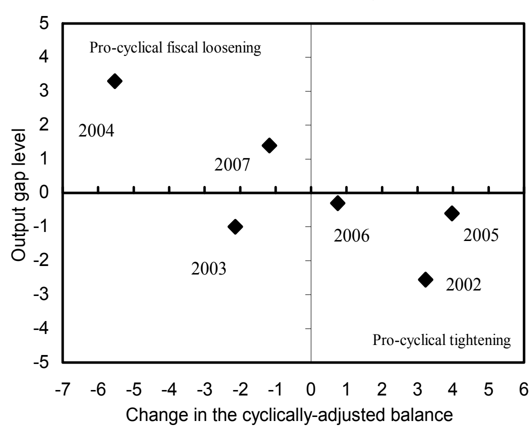
- The current account deficit has deteriorated sharply because of very strong domestic demand growth and, more recently, eroding competitiveness (Table 3, Figure 6). This has occurred despite large terms of trade gains, which may be coming to an end and may even reverse as gas prices rise further and if steel prices revert toward historical trends (Table 4, Figure 7).[1] Capital inflows, including FDI, remain strong, however.

- Private external debt and debt rollover have risen sharply, leaving the economy more sensitive to balance-sheet risks and deteriorating global liquidity conditions. Some debt may be held by Ukrainians (i.e. misrecorded) and some offset by unrecorded foreign exchange assets in Ukraine.

5. **The turbulence on international financial markets has affected Ukraine, but significant financial or corporate sector strains are not yet evident.** Reflecting Ukraine's vulnerabilities, since mid-2007 external spreads have risen by more than in other similar countries and bank and corporate euro-bond issuance has dried up. Banks' funding for their foreign exchange lending has shifted to shorter-term foreign loans, mostly from parent banks, and bank lending to corporates has picked up, keeping problems at bay.[2]

6. **Fiscal policy has been expansionary in the face of rising inflationary pressures and the deteriorating current account position**. Nominal spending has risen by on average over 30 percent a year since 2003, stimulating domestic demand and increasing the size of the government sector (Table 5, Figure 8). This growth reflected rapidly rising public-sector wages and social transfers and, in 2008, partial restitution of Soviet-era deposits that had been wiped out by hyperinflation.[3] Deficits have been moderate, as spending growth has been paid for by inflationary revenue windfalls that fiscal policy itself has helped bring about. Nevertheless, the fiscal stance has been procyclical and Ukraine is one of the few countries in Eastern Europe to have increased its fiscal deficit as capital inflows have surged.

The fiscal stance has a pro-cyclical bias



7. **Monetary conditions have tightened somewhat, but the close control of the exchange rate that characterizes the monetary regime limits what can be done on this front**. As the NBU stepped up sterilization and imposed new reserve requirements on banks' foreign borrowing beginning in late 2007, excess banking system liquidity fell considerably and interest rates rose sharply, notably on the interbank market (Table 6, Figure 9).

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[1] See Selected Issues paper "Two Aspects of the Ukrainian Business Cycle" for a discussion of steel prices.
[2] See Statement by the Staff Representative on Ukraine, for an update of developments through end-May.
[3] See Box 2 in IMF country document 07/05 for background on lost savings. Total remaining claims are estimated at 18 percent of GDP at end-2007.

Nevertheless, real interest rates generally remain negative and credit growth is still very high—76 percent year-on-year in March. Since mid-March, the exchange rate has been allowed to appreciate outside the narrow Hrv/$ 5.00-5.06 band. If this greater fluctuation were to persist, the Fund classification could change, depending on the regime put in place.

8. **Progress has been made on a long structural reform agenda, but much remains undone** (Table 7). Key areas requiring attention are: improving the business climate by updating and strengthening the legal framework, improving accounting standards, and establishing a market for agricultural land; continuing to liberalize trade policy (WTO accession was a significant achievement in this regard), including by abandoning agricultural export restrictions (the recent easing of wheat restrictions was a step forward); improving energy efficiency, including by allowing all domestic prices to reflect full costs; and strengthening tax administration.

III. Discussions with the Authorities

9. **In light of Ukraine's high inflation rate and vulnerabilities, discussions focused on near-term (2008-09) macroeconomic stability-related issues:** policies to reduce inflation, including key steps toward robust fiscal and monetary regimes, and to contain financial sector vulnerabilities (an FSAP update was concluded). Selected structural issues important to short-term macro performance (including gas pricing and tax reform), as well as the consequences of WTO accession, were also covered. The broader structural agenda, which the authorities and staff broadly support and which has been discussed extensively in previous Article IV consultations and by other international agencies, was not taken up in detail.

A. Outlook

10. **Real GDP growth is set to slow in 2008-09, from 7½ percent last year, although the authorities projected higher growth than staff**. Weaker export-market growth, slowing real wage increases, moderating terms of trade gains (due to steep rises in gas import prices), and higher financing costs are expected to reduce demand. Staff projects growth at 5½ percent in 2008, notwithstanding an anticipated rebound in agricultural production after last year's disappointing harvest. The current account deficit is projected to widen to 7.1 percent of GDP, reflecting terms of trade developments, weaker competitiveness, and domestic demand growth that still exceeds output growth. The authorities argued growth would slow less and the current account would widen less than projected by staff, pointing to the harvest and more optimistic projections of steel prices. Slower growth and the improved

harvest should gradually ease inflationary pressures,[4] although in light of the very high CPI increases so far in 2008 the authorities were revising up their official (budget) projection.

Staff's, Authorities' and Consensus 2008 Macroeconomic Forecasts

	Government	Staff (baseline)	Consensus Forecast
Nominal GDP (Hrv bln)	921	939	…
Real GDP growth (percent change)	6.8	5.6	6.3
CPI inflation (percent change), eop	9.6	18.5	19.2 2/
Current account balance (USD bn)	-9.2 1/	-13.4	-10.1

Source: Staff, Ukrainian authorities and April 2008 Consensus Forecast.
1/ Trade balance; the current account balance is typically $3 bn higher.
2/ Average yearly increase in 2008 instead of end-of-period change.

11. **Staff saw risks to its projection as largely balanced, but conceded that uncertainty is high**. A key issue is the development of world steel prices, which have been very closely linked to growth. World growth and the impact of global financial turbulence may also have important ramifications for Ukraine in the coming several quarters. Given the large risks on both sides, the mission discussed two alternative short-term scenarios, emphasizing the macroeconomic tensions: continued high inflation in an upside scenario, and significant reserve losses, contracting credit, and sharply declining real GDP growth in a downside scenario (Table 8, Figure 10).

12. **In the medium term, staff projects growth to fall temporarily below potential, which would eliminate inflationary pressures.** (Table 9). Gas import prices are assumed to rise to transit-adjusted international levels in 2009, and steel export prices to fall gradually

[4] See selected issues paper "Two Aspects of the Ukrainian Business Cycle" for a discussion of inflation dynamics.

toward their long-term trend. The baseline assumes some easing of growth in fiscal transfers and, consistent with the authorities' stated policy, greater exchange rate flexibility; these policy adjustments are critical to ensure a soft landing. The less favorable terms of trade and cumulative loss in competitiveness lead to a depreciation, which weakens domestic demand via balance-sheet effects on households holding dollar liabilities. Under this scenario, external debt stabilizes, though at a higher level; however, adverse shocks could increase it to uncomfortably high levels (Table 10, Figure 11). Public debt is sustainable under a wide range of scenarios (Table 11, Figure 12).

13. **Structural reforms were seen as crucial to medium-term growth prospects**. The authorities noted that WTO accession and the Euro 2012 Cup would spur considerable investment, and viewed trade negotiations with the EU (formal negotiations have recently begun) as another important step forward. Apart from tariffs and agricultural subsidies, Ukraine committed under the WTO to: allow capital flows associated with provision of lending and deposit-taking services; a schedule of export tax reductions, eliminating trade taxes (other than customs tariffs), among others. The authorities characterized WTO commitments as completing a series of gradual legislative changes, and therefore did not anticipate an economic shock upon accession.

B. Fiscal Policy

14. **It was agreed that fiscal restraint was key to reducing inflationary pressures**. The authorities felt that the 2008 deficit could be held below 1 percent of GDP, compared to 2 percent of GDP in 2007. Although spending pressures, including to raise minimum wages and restore the lost savings, remained very strong, they also expected revenues to be quite strong, noting that customs receipts in particular had jumped sharply this year owing to better administration. They judged that privatization receipts in excess of those already in the 2008 budget could be saved. The mission suggested a slightly larger deficit cut of 1½ percent of GDP to restrain domestic demand growth and insure against inflation risks.

15. **The mission argued that spending should be contained, to reduce fiscal pressure and prevent a further increase in government spending in relation to GDP**. This could be implemented by reining in growth in transfers and delaying further restitution of lost savings until demand pressures eased. [5] Also, restraining increases in minimum wages and public sector wages would be vital to break the wage-price spiral that seemed to be developing. The mission stressed the need to strengthen tax administration and broaden the tax base to shore up revenues (Table 12). In particular, staff opposed replacing the VAT with a sales tax, which would only aggravate collection problems, and the authorities indicated that this was fading as a policy issue. The authorities, in a recently formulated inflation plan,

[5] See "Resolving a Large Contingent Fiscal Liability: Eastern European Experiences", IMF Working Paper 08/xx.

while containing many good initiatives, also suggested administrative price control measures, which the mission argued would not reduce inflation and would distort incentives.

16. **The mission argued that fiscal policy should adjust to economic developments, given the uncertainties in the projection**. Ukraine's low fiscal deficit and public debt allow scope for flexibility on both sides. Relative to staff advice to hold the 2008 deficit to ½ percent of GDP, if upside risks materialize the deficit should be allowed to shrink further; but if growth slows significantly a larger deficit, via the automatic stabilizers, may be appropriate, although only if inflation is clearly abating and financing remains ample.

17. **The authorities saw merit in the mission's suggested changes to the fiscal framework**.[6] Staff argued that better integrating macro-fiscal analysis into budget preparation and presentation, in particular cyclically adjusted balances, would convey a clearer picture of the fiscal policy stance; a medium-term expenditure framework would enhance fiscal-monetary coordination and help to guide the annual budget process toward medium-term policy goals; full integration into the budget of quasi-fiscal subsidies would improve transparency and reduce fiscal risks; and liberalizing prices would reduce fiscal risks and improve economic efficiency. The authorities agreed that the fiscal framework could usefully be strengthened, and recently announced a gradual increase in gas prices to households and energy producers (public and private enterprises already pay full cost). However, they judged that in recent years governments had been too short lived and economic developments too variable for medium-term budgeting to be effective.

C. Monetary and Exchange Rate Policy

18. **The NBU emphasized the measures already taken to tighten monetary conditions, and indicated more would be done as needed**. The NBU judged that excess banking system liquidity had been eliminated, but also that monetary policy alone could not contain inflation. They also argued that the effective nominal depreciation of the hryvnia, which had fallen with the dollar, had contributed to inflationary pressures. The mission agreed, noting that the tight management of the exchange rate had made it difficult for the NBU to control inflows and the money supply during 2007 and obscured the risks undertaken by unhedged dollar borrowers. The mission also noted that, under the de facto exchange rate peg, still-tighter conditions might only attract speculative capital inflows, notwithstanding capital controls on non-resident holdings of hryvnia. The authorities shared this concern and were considering additional reserve requirements on short-term capital.

19. **Staff repeated its call for a gradual transition to a more flexible exchange rate and, eventually, inflation targeting**. Such a shift would provide more scope for monetary policy to use control of money and credit growth as a nominal anchor, thereby easing

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[6] Selected Issues Paper, "Strengthening Ukraine's Fiscal Framework."

inflation pressures. Moreover, it would allow the nominal exchange rate to bear some of the burden of needed real exchange rate adjustment to shocks, especially terms of trade shocks to which Ukraine is highly exposed. To implement this policy change, the exchange rate band should progressively widen. Eventually, the exchange rate should be freely floated, with inflation targeting (IT) providing the nominal anchor.

20. **The authorities concurred with staff analysis implying that the value of the hryvnia is broadly consistent with fundamentals, although staff emphasized that the situation could deteriorate** (Box 1). In particular, if domestic demand and inflation were not contained further erosion of cost competitiveness would, at an unchanged dollar exchange rate, move the hryvnia toward overvaluation. In light of this possibility, staff argued that the time was now propitious to increase exchange rate flexibility. Slightly further out, the 2009 monetary policy guidelines should indicate that the band will be progressively widened as circumstances permit and policy needs require, without specifying bands or timing in advance.

21. **The NBU had taken steps to prepare for more flexibility and was considering further moves** (Table 13). Although no announcement has been made of a change in policy, notwithstanding the recent larger fluctuations in the exchange rate, the NBU indicated that the band might be widened and a new mechanism for setting the official rate (now Hrv/$5.05) introduced to bring it closer to interbank rates. Overall, the NBU reported that it could soon be fully capable of executing an IT policy if the decision were made to go this route, but worried that the very open structure of the Ukraine economy, the lack of developed domestic debt and capital markets, and extensive use of administered prices could limit the effectiveness monetary policy.

22. **The mission stressed the need for strong political backing for the change in the monetary policy framework, and the government indicated that it supported the NBU's exchange rate strategy**. The NBU recently issued the Green Paper, a public document for discussion laying out options for strengthening monetary policy and NBU independence, and has argued for securitization of outstanding government debt to the NBU and more flexibility in the transfer of NBU profits to the government. Staff argued that a clear government mandate to the NBU would bolster credibility and that, as the IT framework was being put in place, NBU independence would need to be ensured.

Box 1: Exchange Rate Evaluation

The weight of evidence suggests that the exchange rate in 2007 was broadly consistent with fundamentals (Figure 4). On the CGER macroeconomic balance approach, adjusting for temporary factors the current account deficit was 5½ percent of GDP in 2007, below the norm of about 3 percent of GDP but within the broad margin of error.* Other approaches yield mixed results. The CGER equilibrium real effective exchange rate approach suggests that the CPI-based REER remains significantly undervalued, as does a model of regional income convergence that was recently explored in the April 2008 European Regional Economic Outlook. Purchasing-power-parity and dollar-wage based measures show the hryvnia undervalued and overvalued, respectively. And the CGER external sustainability approach indicates that the underlying current account deficit would stabilize net foreign liabilities at their current (official) level of about 50 percent of GDP, implying broad equilibrium.

Ukraine: Estimating the Underlying Current Account 1/
(in percent of GDP)

Current account balance (2007)		-4.2
Business cycle Ukraine		0.4
Business cycle trading partners		-0.2
Gas price subsidy		-2.0
on imports	-3.6	
on transit	1.6	
Temporary export ban on grain		0.3
Temporary closure of oil refineries		0.6
Lagged effect real exchange rate		-0.4
Underlying current account balance		-5.5

Source: Fund staff calculations

1/ The underlying current account balance is the actual balance corrected for cyclical and temporary factors.

However, uncertainties are large and trends in key variables unfavorable. The exchange rate assessment is surrounded by sizable margins of uncertainty. For example, the evolution of natural gas and steel prices is uncertain, and balance of payments data may be distorted by significant unrecorded economic activity. Also, the rapid deterioration in the current account balance and the high price and wage growth imply a risk of overvaluation in the years ahead.

Real Exchange Rate Valuation Relative to Fundamentals (in percent) 1/

Macro-Balance Approach (CGER)	9.8
Equilibrium REER Approach (CGER)	
Regressing on lagged NFA	-5.9
Regressing on current NFA	-7.9
External Sustainability Approach (CGER)	-0.4
Regional Convergence Approach	-7.2
PPP-Approach	-6.9
Dollar Wage Approach (2006)	31.2

1/ A minus sign denotes undervaluation

* For a description of CGER methodologies see: http://www.imf.org/external/np/pp/eng/2006/110806.pdf. For application to Ukraine, see IMF Country Report 07/47.

23. **The authorities and the mission also discussed a number of more technical reforms to ensure the success of the transition to IT.** It was agreed that needed financial market development would be fostered by greater reliance on domestic-currency government debt issuance, a measure already announced by the government, and early elimination of the foreign exchange transactions tax, rather than in 2010 as scheduled. The NBU noted that it had strengthened analytical capacity and communications strategy, although the mission argued for still better integration of analytics into decision making and for publication of inflation-report-type documents

D. Financial Sector Policy

24. **While the banking sector as a whole seemed profitable and well capitalized, the FSAP update identified a number of vulnerabilities** (Table 14). These include rising credit risks stemming from very high credit growth, balance sheet mismatches as unhedged households have borrowed heavily in dollars, liquidity risk as banks have become increasingly dependent on foreign funding, and banking supervision weaknesses aggravated by increasing complexity of the financial sector, and the existence of a number of small, apparently uncompetitive banks. To strengthen the system, based on the FSAP update the mission called for a number of measures to address credit risks, enhance supervision, and improve the bank resolution framework to facilitate bank mergers (notably by increasing incentives of owners of weak banks to agree to mergers) if, as seems likely, the sector undergoes consolidation (Table 15).

25. **The authorities judged the banking sector to be sound overall, but acknowledged risks**. They noted that the growing presence of foreign-owned banks, which account for some 37 percent of banking system capital, had strengthened the sector, even though these banks also accounted for a great deal of the increase in credit (including in dollar loans). They also emphasized that transparency had improved; the NBU had recently published a list of ownership of most banks and required that banks publish information quarterly on their finances. They felt that conversion of banks to open-joint-stock companies, now underway, held the promise of further transparency. And they pointed to the increase in minimum bank capital requirements, to a level twice that in Europe, as encouraging bank consolidation. The supervisor agreed that, nonetheless, the scale of dollar lending and potential problems with the quality of household loans were matters of concern.

26. **The supervisor had taken measures to address credit risks, and was considering others**. On-site inspection had been stepped up. In 2008, as maturities on foreign borrowing shortened and with no sign of slowing credit growth, new capital requirements were imposed on banks' maturity gap and higher risk weights were attached to riskier asset classes. More measures, for instance new limits on banks' net external borrowing to capital and tighter definitions of non-performing loans, could be taken as necessary, but also with due

consideration to the stress that monetary tightening was already placing on the financial system.

27. **The authorities and the mission discussed contingency planning in light of the evolving challenges facing the Ukrainian economy**. The authorities noted that they had successfully dealt with a crisis in 2004, including by tightening capital controls and that their reserve position is much stronger now than it had been then (Figure 14). The mission agreed that in many respects Ukraine was in a stronger position now, and also that the strategy adopted in 2004 would still be appropriate and could still be effective. But it also noted that the world and, especially, the Ukrainian financial sector had changed remarkably since then, posing new risks. Ukraine has become more dependent on external financing and the banking sector has become much larger and significantly more sophisticated. Moreover, the planned gradual relaxation of capital controls—an initiative supported by staff (subject to the continuation of narrowly defined safeguards) as a way to improve the business environment—would remove one tool that had been used in the past. The authorities expressed considerable interest in pursuing contingency planning, including via simulations of responses by the relevant government bodies to unexpected adverse events.

Ukraine: Adequacy of Gross International Reserves (GIR)

	2004	2005	2006	2007	2008
GIR (in mos. of next years' imports)	2.6	4.4	3.9	4.2	4.1
GIR (in percent of ST debt at remaining maturity)	87	161	156	174	137
GIR (in percent of ST debt at RM and banks' FX deposits)	57	92	79	89	71
		(as a ratio to GDP)			
Reserves	14.4	22.2	20.2	23.1	20.0
Three-months of imports	14.0	12.7	12.4	12.8	12.5
Greenspan-Guidotti rule	16.8	14.0	13.3	13.2	14.6
Jeanne-Ranciere rule (middle income country calibration)	19.5	16.6	15.9	15.9	17.2
Jeanne-Ranciere rule (Ukraine specific term premium)	16.7	13.0	12.9	12.9	14.2

Source: Country authorities; and Fund staff calculations based on Jeanne-Rancière (2006)

IV. Staff Appraisal

28. **The Ukrainian economy has grown strongly since 2000, and medium-term potential is enormous**. A robust international environment, stabilizing macroeconomic policies, including the de facto currency peg to the dollar and low fiscal deficits, and significant structural reforms all sustained growth since 2000. By many measures, Ukraine has also become better insulated against shocks: reserves have increased substantially; the underlying fiscal position is strong and sustainable under a wide range of economic scenarios; the financial sector as a whole appears to be well capitalized and profitable; and WTO accession, the negotiations on an EU trade agreement, and Euro 2012 should spur structural reform efforts. A comprehensive structural reform program would increase economic capacity in the medium term, helping to ensure rapidly rising living standards.

29. **Amidst turmoil in global financial markets and volatility in world commodity prices, however, measures will be needed to deal with heightened vulnerabilities**. Very strong domestic demand growth has resulted in a deteriorating current account and, along with rising food and energy prices, unacceptably high inflation. The real exchange rate is broadly consistent with fundamentals, but it could become overvalued if strong domestic demand growth and inflation persist. Global turbulence has heightened external financing risks. Very high domestic lending growth, including in foreign exchange to unhedged borrowers, and high house prices point to increased credit risks. In view of the near-term challenges, measures will be needed to strengthen fiscal, monetary, and financial policies. In this connection, calls in the authorities' recent anti-inflation program for greater fiscal prudence and better use of the exchange rate band are welcome; administrative measures, by contrast, will be ineffective and distorting.

30. **The fiscal stance should be tightened to contain domestic demand**. A general government deficit reduction of 1½ percent of GDP in 2008, bringing it to near balance, would ease pressures significantly. Given the substantial uncertainties regarding economic prospects, the authorities should stand ready to adjust the fiscal deficit, via automatic stabilizers, as needed: higher growth than expected would increase inflationary risks and call for a smaller deficit, while if growth fell significantly more than projected and inflation abated there would be scope for a larger deficit. Excess privatization receipts should be saved and further restitution of lost savings should be spread over a number of years or offset by spending cuts elsewhere. Incomes policies and increases in minimum wages and public sector wages should be scaled back, to be consistent with single-digit inflation. Tax cuts, which are desirable as part of an overall reduction in the size of government, should be fully offset with spending cuts or base broadening. Strengthening tax administration is a priority, and in this context the VAT should be retained because the alternative of a sales tax would be harder to enforce.

31. **The fiscal framework should be strengthened**. Fiscal policy formulation and assessment would be significantly improved by using structural fiscal balances, broadening fiscal coverage, and adopting a medium-term fiscal framework. Gas prices should be fully passed through to final consumers, with vulnerable groups protected by better targeted social programs.

32. **Recent and welcome NBU policies to tighten monetary conditions should be continued, but the exchange rate should be made more flexible and, in the medium term, inflation targeting introduced**. Sterilization and reduction of excess banking-system liquidity have been helpful, but the de facto exchange rate peg is no longer adequate, as the rise in inflation illustrates. Therefore, as anticipated in the 2008 monetary guidelines, the current monetary framework should be replaced as soon as possible by, first, a more flexible exchange rate to allow more scope for active monetary policy, and ultimately by inflation targeting as a nominal anchor. Since the exchange rate is now broadly consistent with

fundamentals, this is an opportune time to introduce this policy change. To retain flexibility, the bands and the dates at which they change should not be specified in advance, but care should be taken to use control of money and credit growth, via monetary instruments, as the interim nominal anchor during the transition to inflation targeting. The NBU should continue its welcome efforts to strengthen its analytical capacity and integrate macroeconomic analysis into its policy decisions. Communication with the public and the markets can be improved through publication of inflation reports and regular, transparent announcements of policy intentions and actions.

33. **Public and decisive government support for inflation targeting is fundamental**. The government should provide the monetary authorities with a clear inflation-targeting mandate. As the new regime is put in place, the NBU's operational independence needs to be ensured, including by being more flexible on profit transfers to the government and by securitizing outstanding NBU debt. To prepare for inflation targeting, the government should abolish the tax on foreign exchange transactions, securitize its liabilities to the NBU by mid-year, issue more public debt in hryvnia, and liberalize domestic prices to provide monetary policy maximum leverage over inflation.

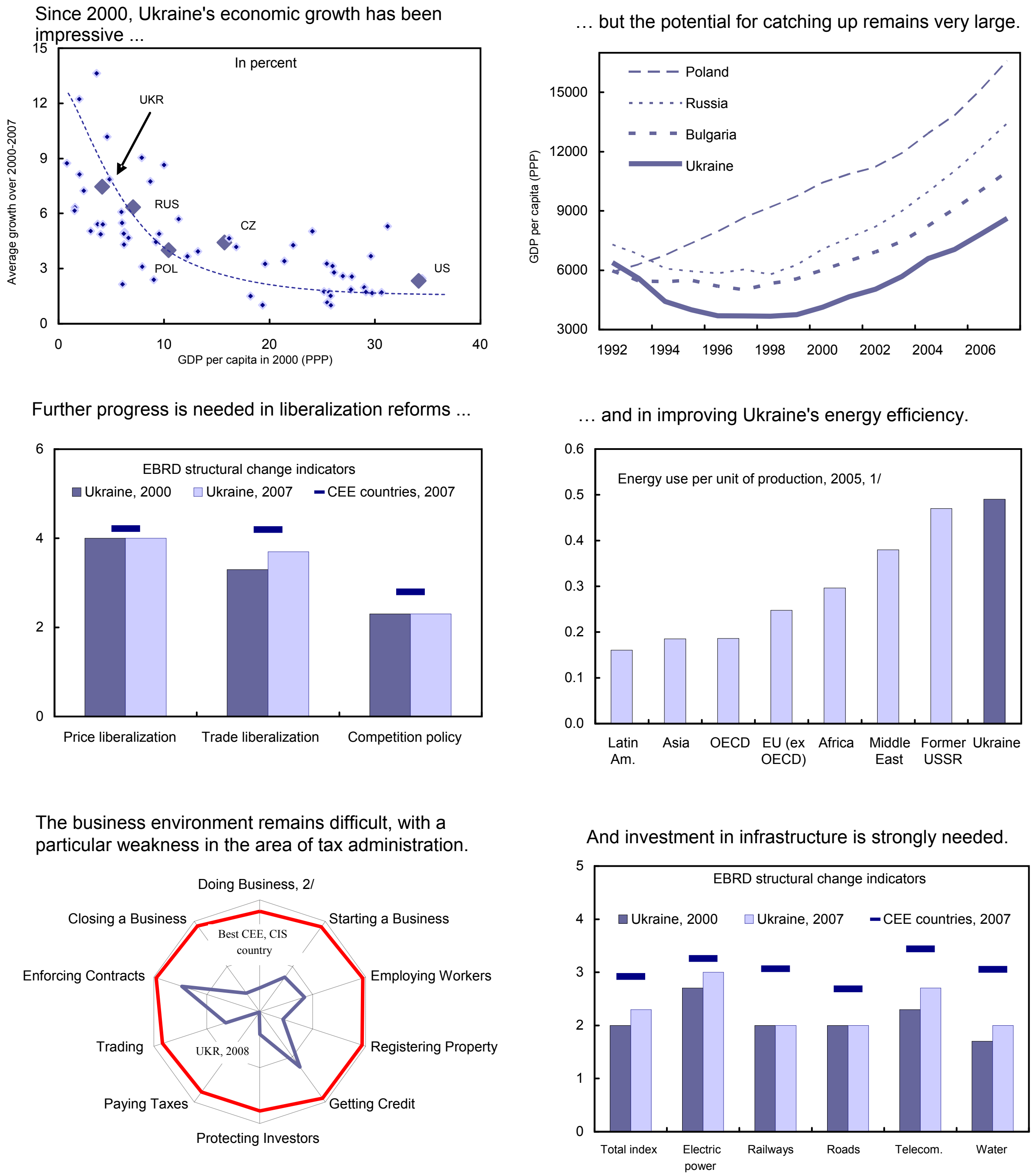
34. **Although the banking sector as a whole seems profitable and well capitalized, it will be crucial to address the growing vulnerabilities identified in the FSAP update**. Key measures to strengthen supervision are consolidated supervision, increased transparency of bank ownership (the recent publication by the NBU of bank ownership is welcome in this regard), encouragement to banks to enhance their risk management capabilities, strong guidance to banks regarding stress testing, and intensified on-site examinations. Prudential measures might include, in addition to the recent welcome increase in minimum statutory capital, greater risk weights for assets that pose higher credit risk (notably unhedged foreign currency denominated lending) and stronger prudential requirements for banks with deteriorating liquidity positions. Problem banks need to be identified earlier and bank exit options expanded to encourage mergers. Finally, to foster the development of capital markets, non-bank supervision should be strengthened.

35. **Contingency planning should be further developed and refined, to ensure an effective response in the event of unforeseen turbulence**. Close cooperation across relevant governmental agencies will be critical in such circumstances, and simulations would help foster this. The authorities' intention to implement a sequenced liberalization of capital controls, including through a new foreign exchange law, is welcome, although safeguards should be retained to be used only in clearly specified and exceptional circumstances

36. **Ukrainian statistics have improved significantly and are adequate for surveillance**. However, heightened risks underscore the need to improve data on foreign trade, notably trade prices, and on external assets, liabilities, and investment flows.

37. It is recommended that the next consultation occur on the standard 12-month cycle.

Figure 1. Ukraine: Potential Output and Structural Reforms



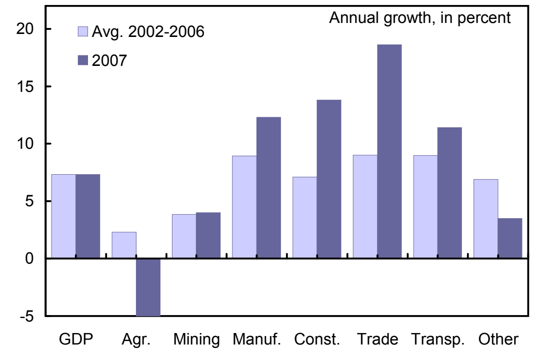
Sources: Ukrainian authorities; IMF *World Economic Outlook;* International Energy Agency; EBRD; and staff estimates.

1/ Measured in kilotonnes of oil equivalent per unit of purchasing-power-parity-adjusted GDP.
2/ World Bank Doing Business indicators (2008). Ukraine's rank was transformed into an index, with 10 as the best and 0 the lowest value.

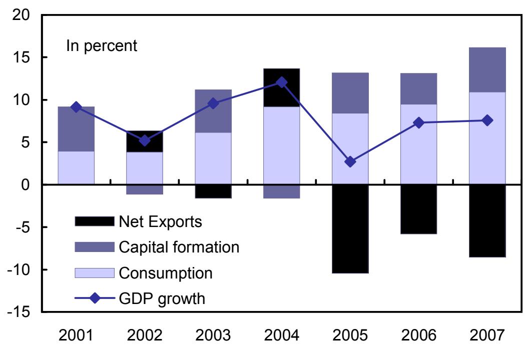
Figure 2. Ukraine: Real Economy Indicators

In 2007 real GDP growth remained robust ...

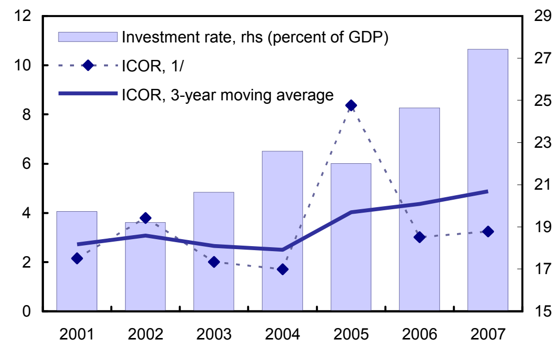
… despite a supply-side disturbance in the agriculture sector.



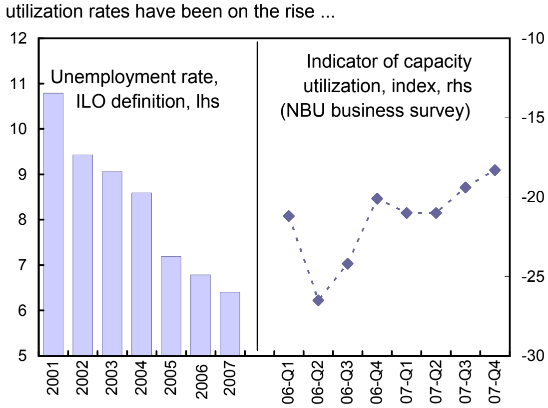
GDP growth has been driven by domestic demand.



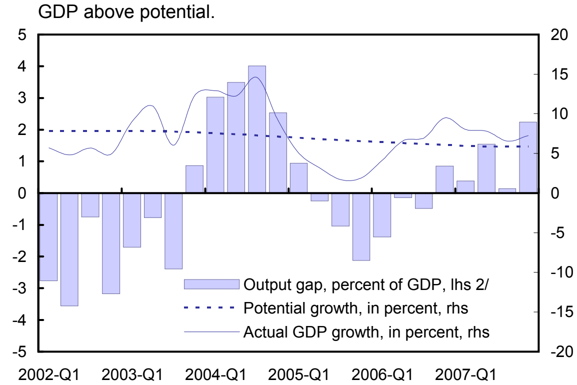
But booming investment growth has been less efficient in realizing production gains.



Easy to activate spare capacity has disappeared: capacity utilization rates have been on the rise ...



… and high domestic demand growth has translated into GDP above potential.

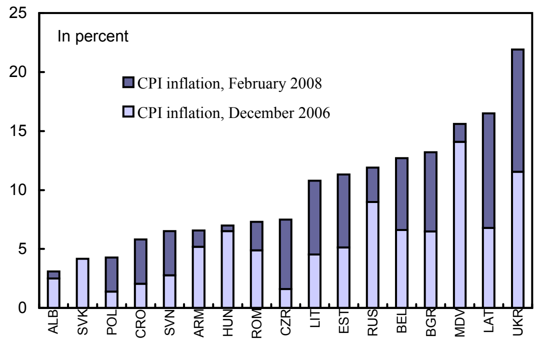


Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.

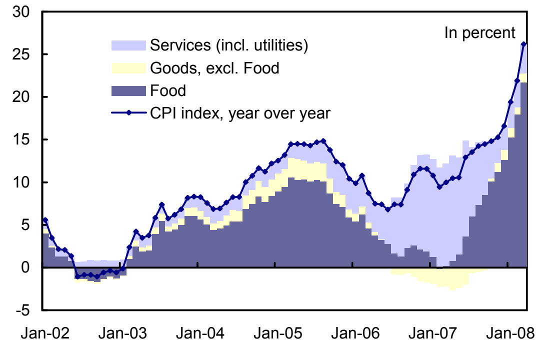
1/ Incremental capital-output ratio (an increase indicates a declining output response to investment).
2/ Output gap calculated using a HP filter over the period 1998-2009.

Figure 3. Ukraine: Indicators of Inflation

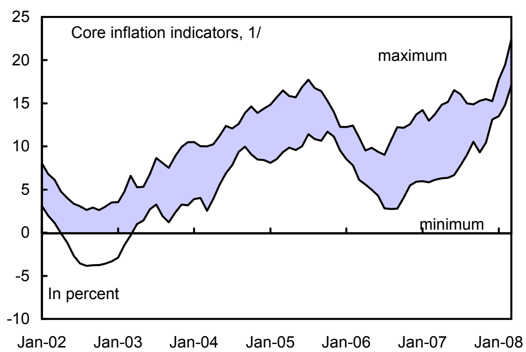
Since end 2006 CPI inflation has increased more in Ukraine than in neighboring countries, starting from a higher level.



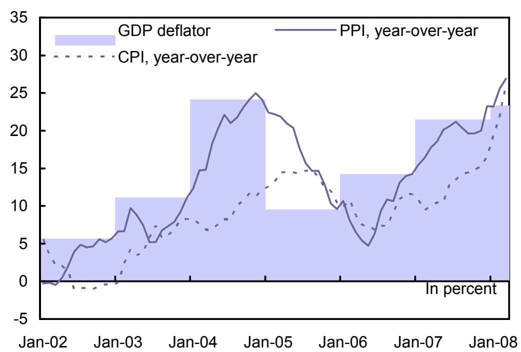
This is partly explained by international and domestic disturbances in food markets.



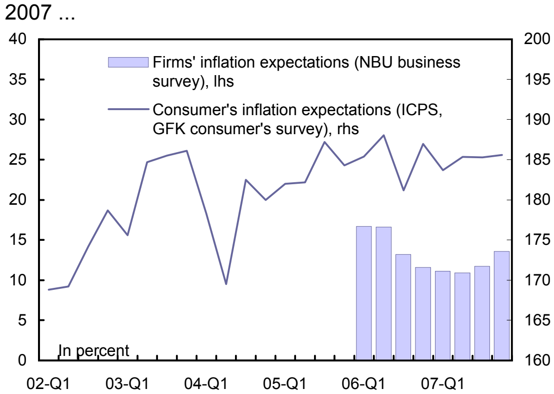
But underlying inflation is also rising rapidly ...



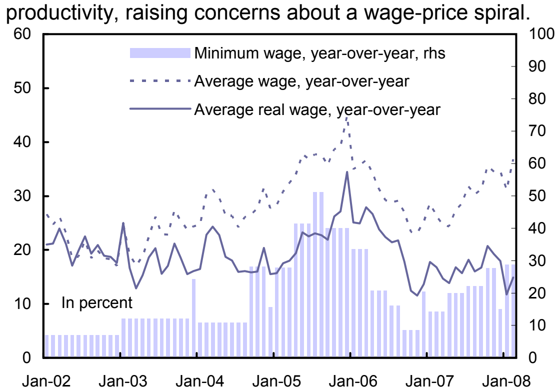
… and other price indicators also point to an increase in inflation since mid-2006.



As a consequence, firms' inflation expectations rose at end-2007 ...



… and wage growth has picked up to a level well above productivity, raising concerns about a wage-price spiral.

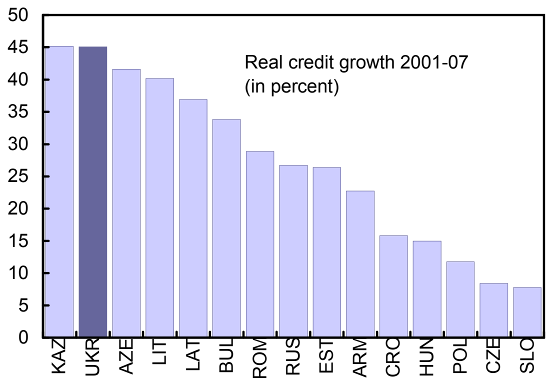


Sources: Ukrainian authorities; IMF *World Economic Outlook*, and staff estimates.

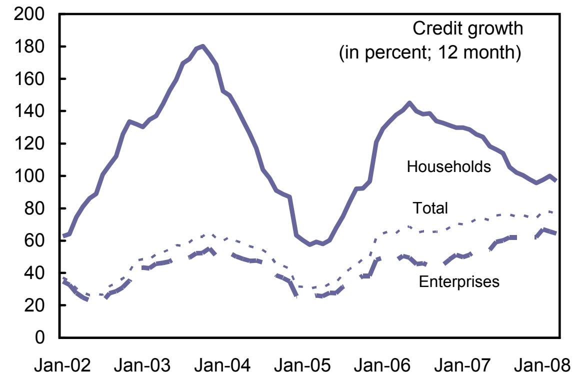
1/ The chart shows, for each period, maximum and minimum values of core inflation indicators calculated using different approaches.

Figure 4. Ukraine: Banking Sector Developments

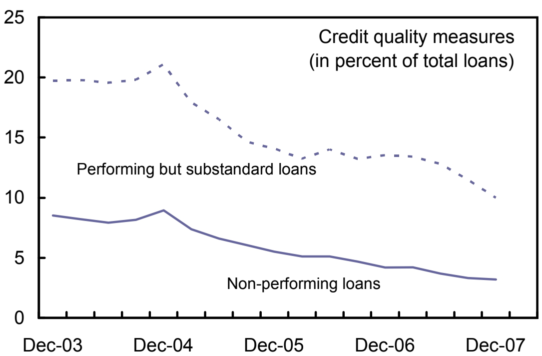
The credit boom has been particularly pronounced in Ukraine...



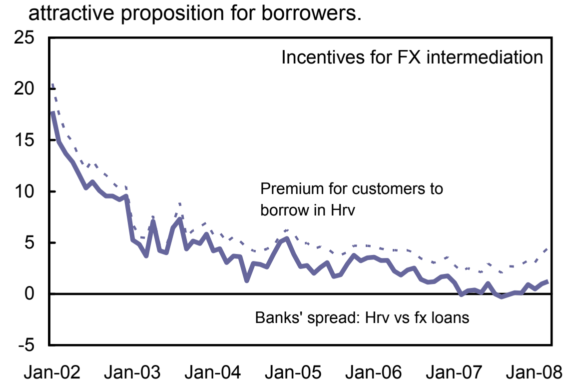
...and credit continues to expand at a very rapid pace.



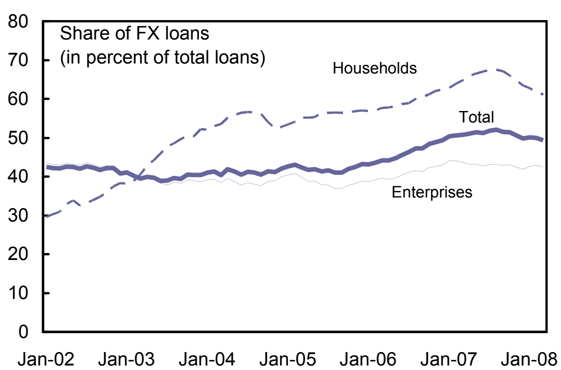
High credit growth has driven down the NPL ratio.



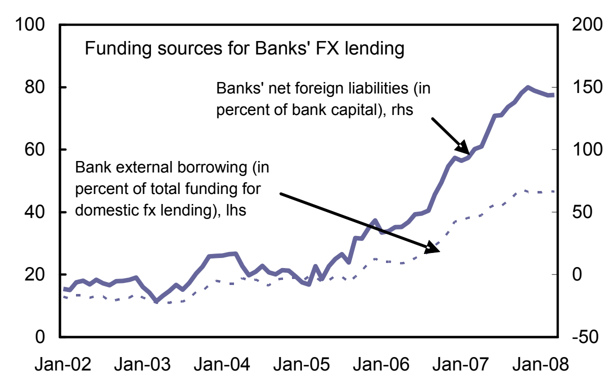
The interest spread is one reason why fx loans are an attractive proposition for borrowers.



A relatively high and rising share of fx in total loans has increased indirect credit risks.



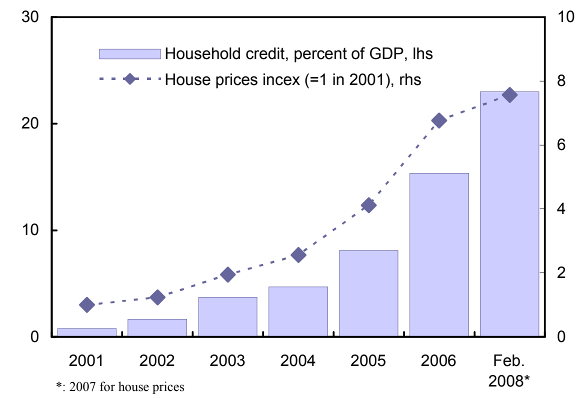
With banks increasingly turning to external loans for funding, liquidity risks have also grown.



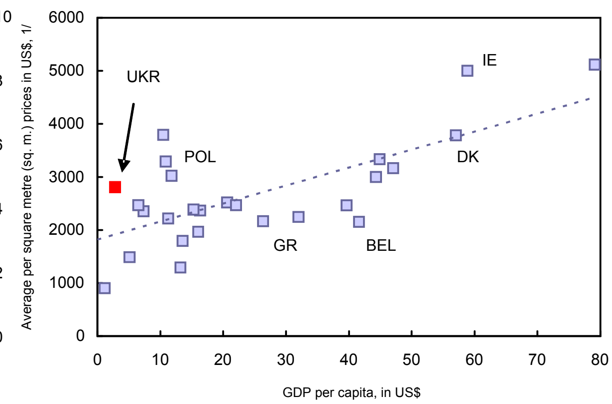
Sources: Ukrainian authorities and Fund staff estimates.

Figure 5. Ukraine: Asset Markets Developments

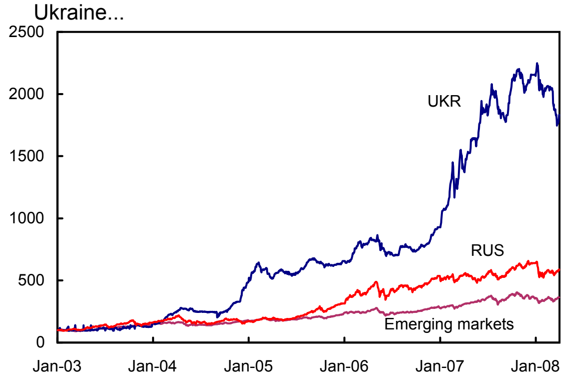
Growing mortgage lending has fueled a house prices boom ...



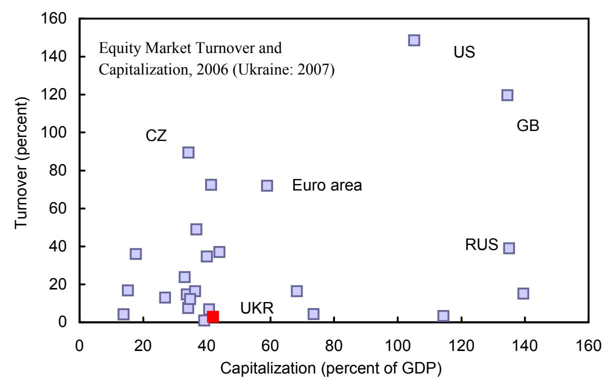
… and prices are now well above expected levels, given income.



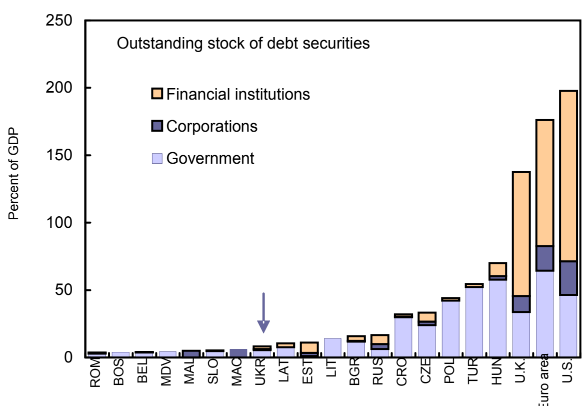
The equity market boom has also been impressive in Ukraine...



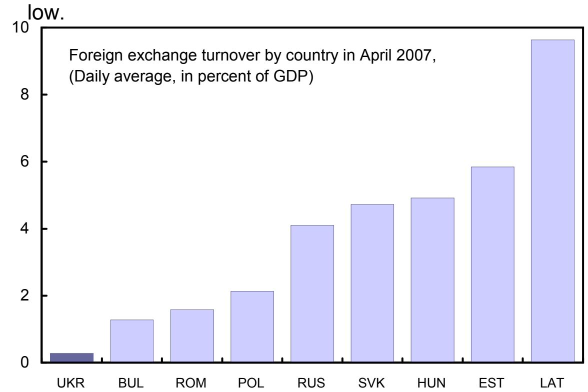
...but while Ukrainian equity markets appear to have significant capitalization, they remain concentrated and illiquid.



Underdevelopment persists in debt markets as well...



...and activity on the foreign-exchange market remains very low.

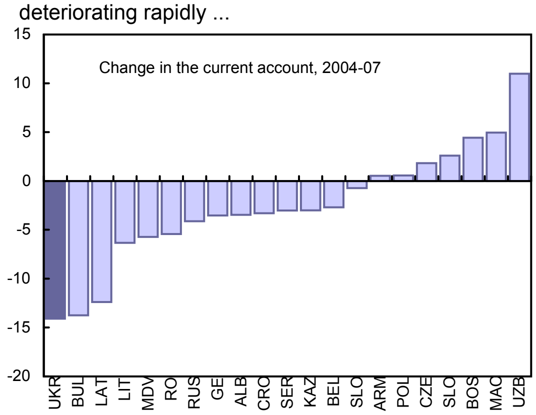


Sources: Ukrainian authorities; IMF *World Economic Outlook*; BIS; Freedom House and International Country Risk Guide, 2006; Global Property Guide Research; and staff estimates.

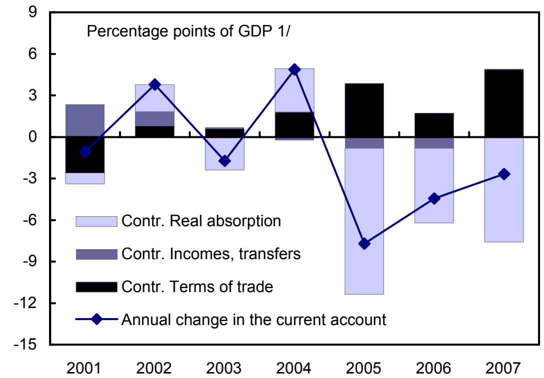
1/ Average per square metre prices in US$ of apartments located in the centre of the most important city of each country.

Figure 6. Ukraine: Balance of Payments Indicators

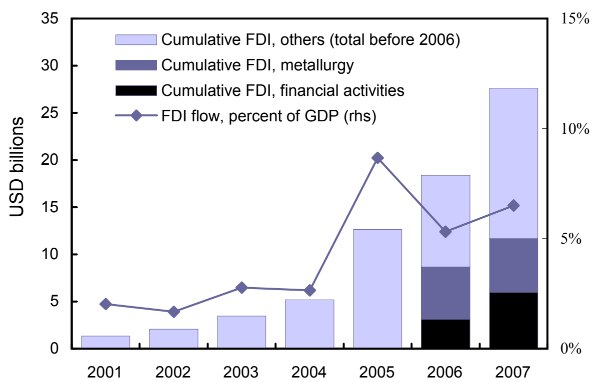
Ukraine's current account deficit remains contained but is deteriorating rapidly ...



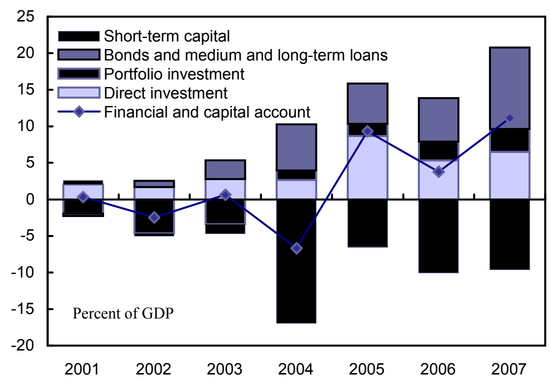
… reflecting strong domestic demand growth.



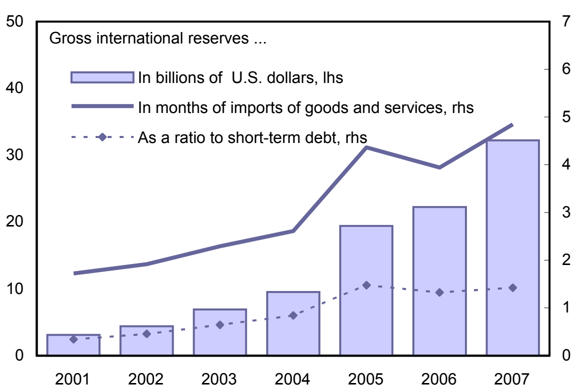
FDI has also picked up sharply of late, notably in the banking sector ...



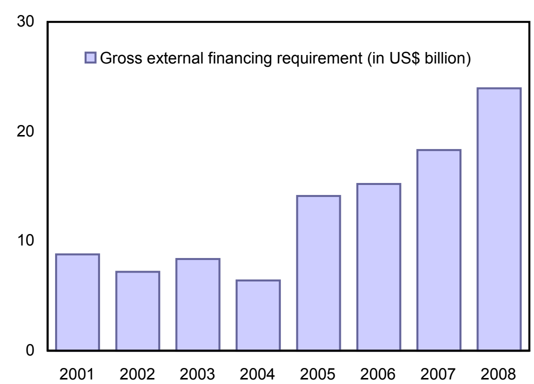
… contributing, together with other capital inflows, to a sharp improvement in the capital account.



As a consequence, NBU international reserves have continued growing, and reached more comfortable levels.



But gross external financing requirements have increased considerably in recent years.

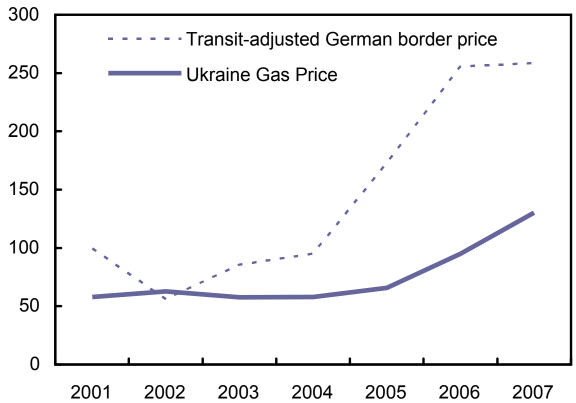


Sources: Ukrainian authorities; IMF *World Economic Outlook;* and staff estimates.

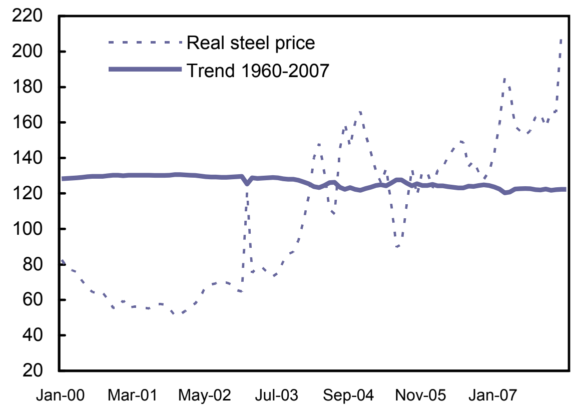
1/ The change in the current account is decomposed as the sum of changes in absorption (with minus sign) and in the ratio of incomes and transfers. The change in absorption is written as the sum of a 'real' absorption effect and a price effect. The latter is the difference between the GDP deflator and the domestic demand deflator, and is labeled here as the contribution of the terms of trade.

Figure 7. Ukraine: Vulnerability Indicators, Selected Periods

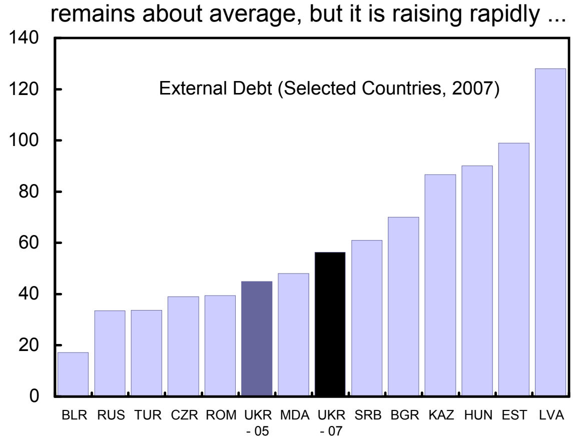
Terms-of-trade developments have been positive, but gas import prices remain below world levels...



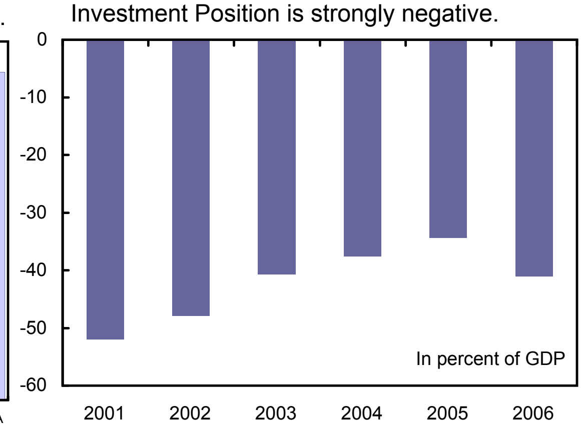
… and steel prices are some 70 percent above their real long-term average.



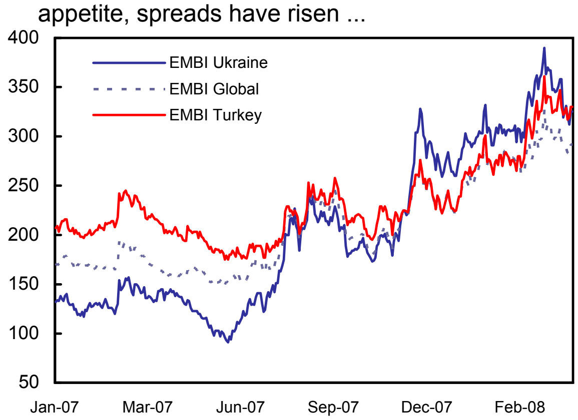
From a regional perspective, external debt remains about average, but it is raising rapidly ...



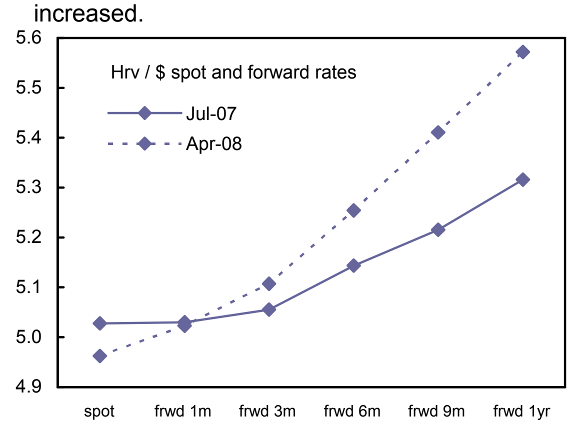
… and Ukraine's reported International Investment Position is strongly negative.



Amid political turmoil and a retrenchment of risk appetite, spreads have risen ...

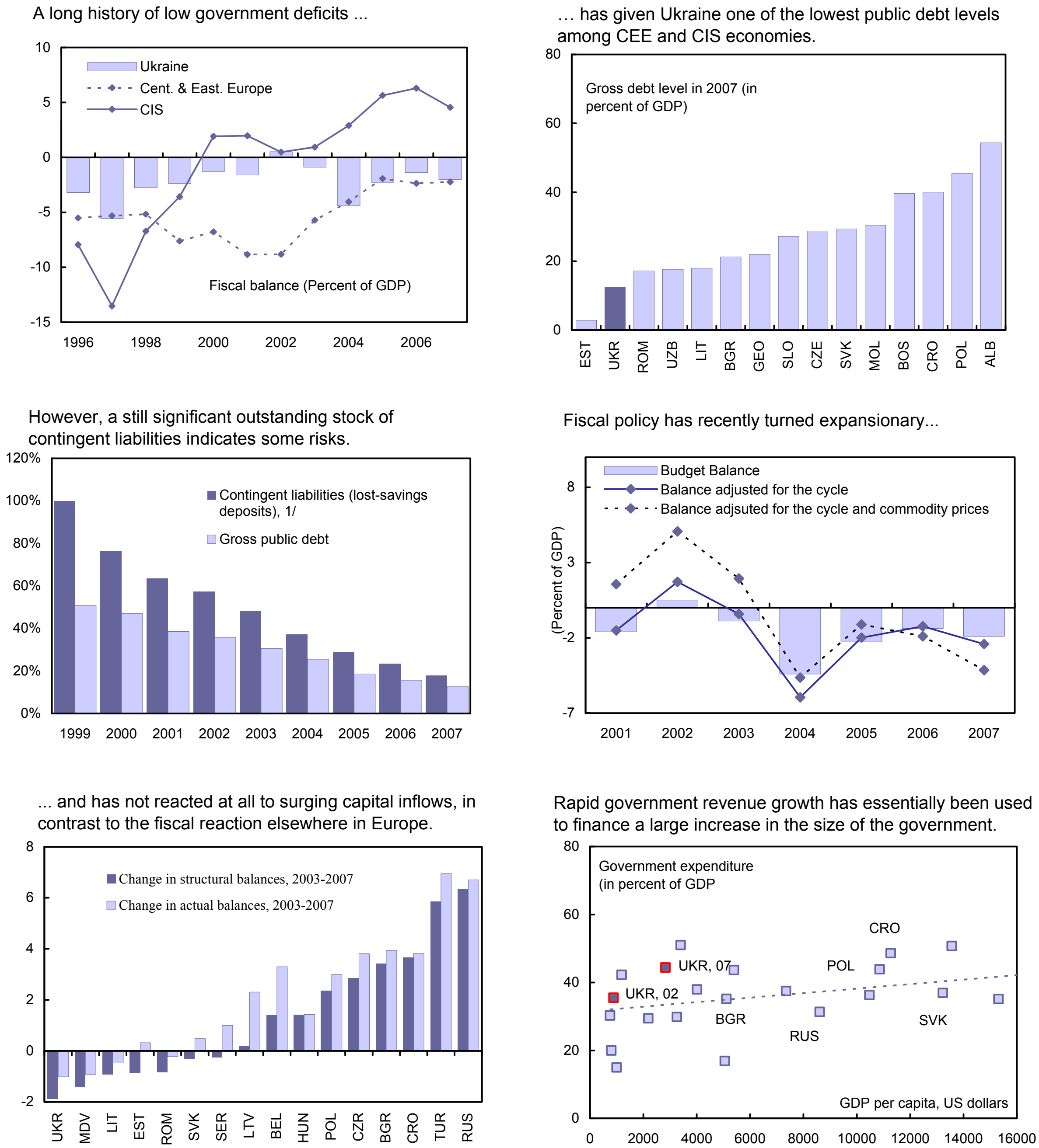


… and markets concerns about the Hyrvnia have increased.



Sources: WEO, Bloomberg, and Fund Staff calculations.

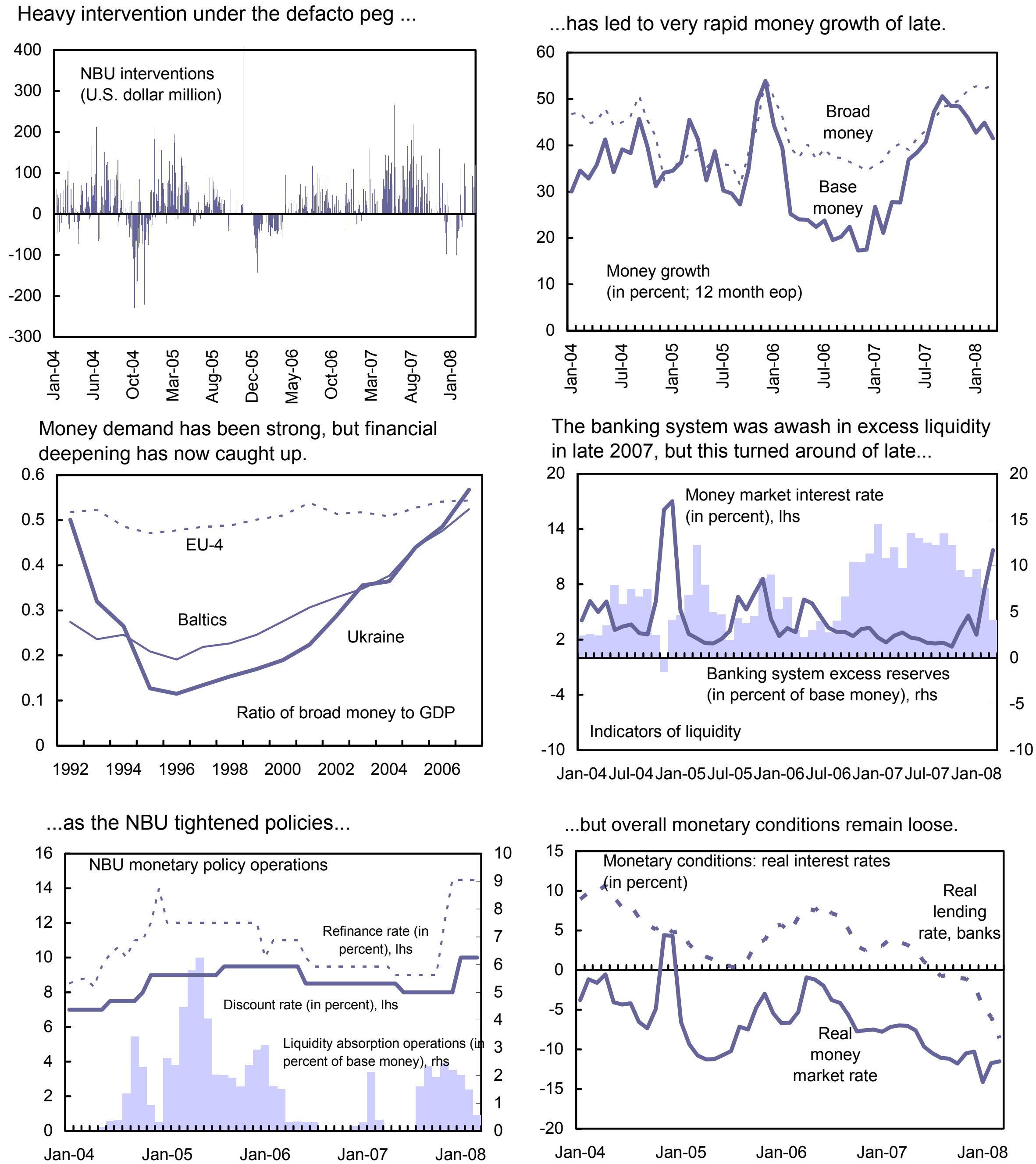
Figure 8. Ukraine: Fiscal Policy Indicators



Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.

1/ Estimated contingent liabilities from the so-called lost-savings deposits.

Figure 9. Ukraine: Monetary Developments

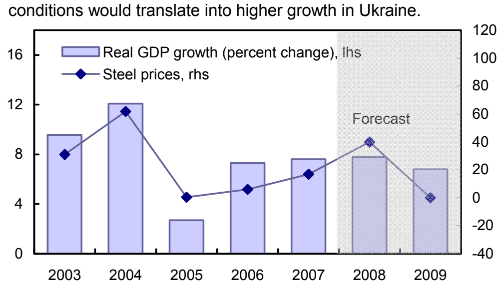


Sources: Ukrainian authorities and Fund staff estimates.

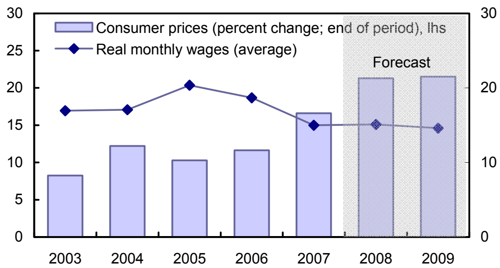
Figure 10. Ukraine: Short-Term Macroeconomic Prospects Under Alternative Scenarios 1/

Upside scenario 2/

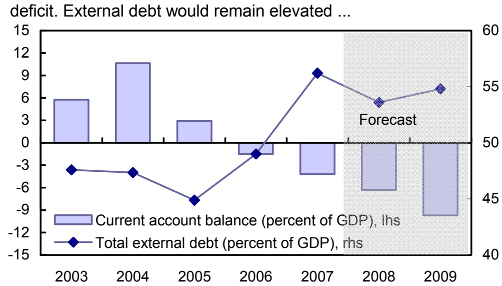
Stronger world growth and steel prices and better financial conditions would translate into higher growth in Ukraine.



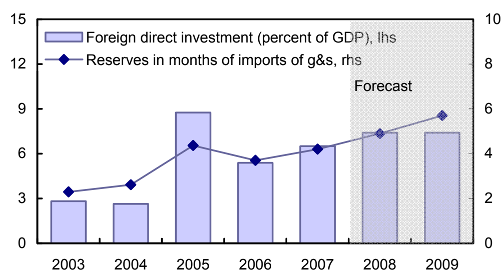
This would exacerbate wage and inflationary pressures …



… and lead to a sharp increase in the current account deficit. External debt would remain elevated ...

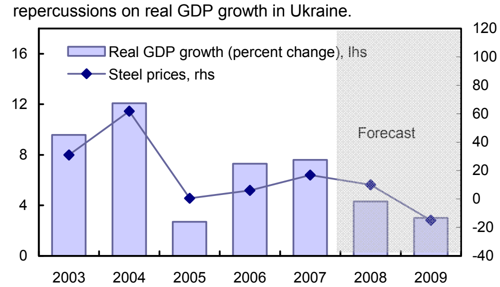


… but financing would remain available.

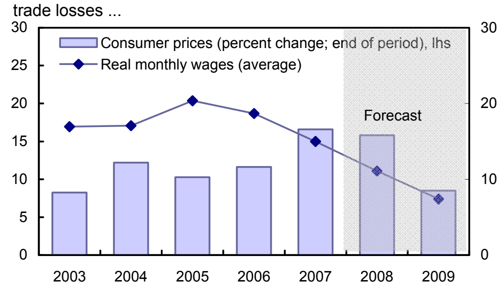


Downside scenario 3/

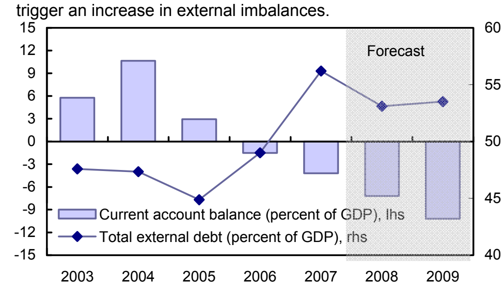
A slowdown in the world economy could have severe repercussions on real GDP growth in Ukraine.



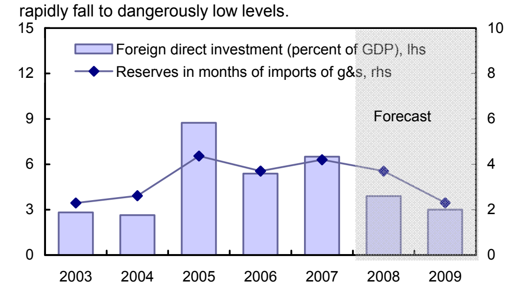
Wage and price inflation would gradually abate but terms of trade losses ...



… and expansionary fiscal and incomes policies would trigger an increase in external imbalances.

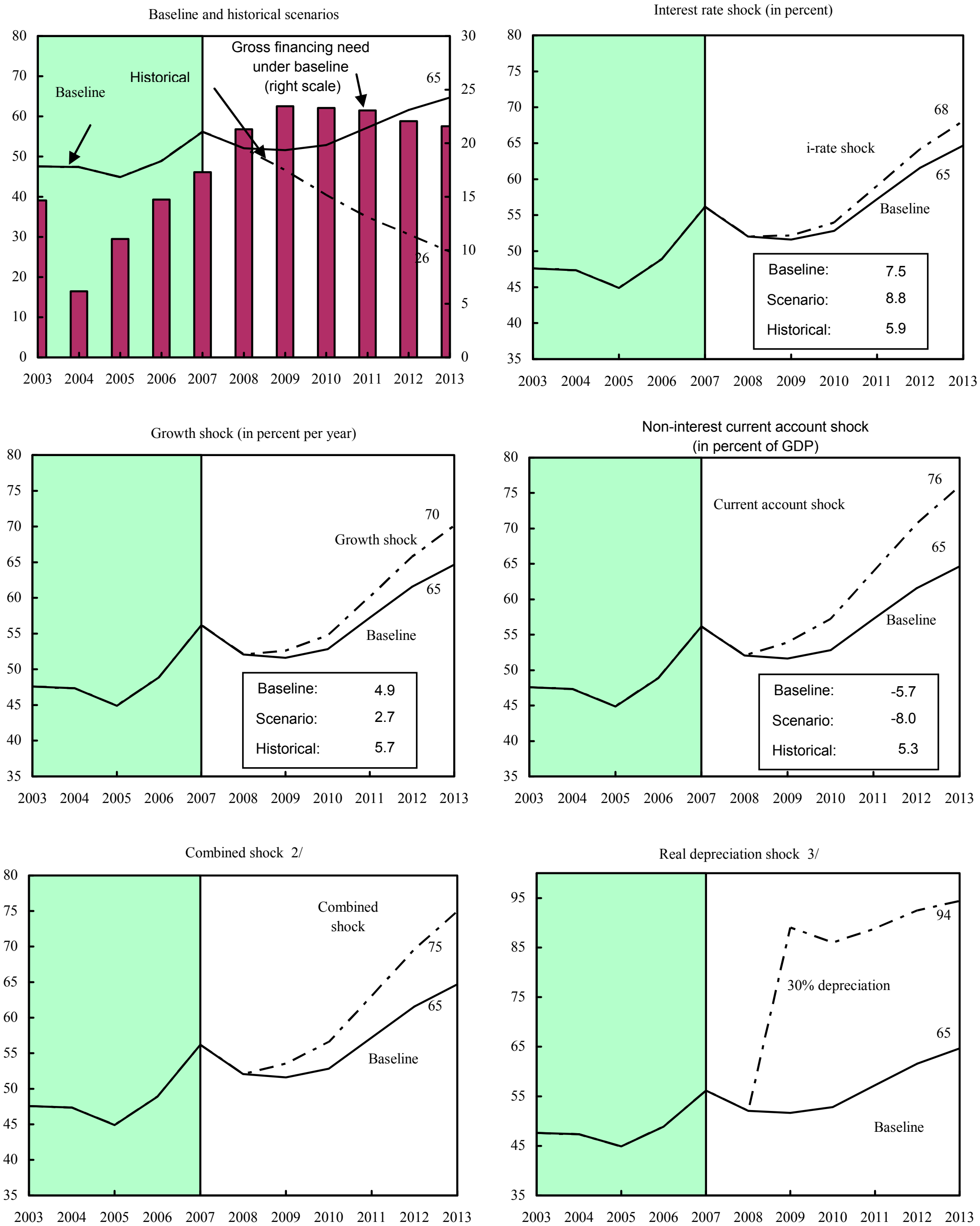


Financing would become difficult, and official reserves could rapidly fall to dangerously low levels.



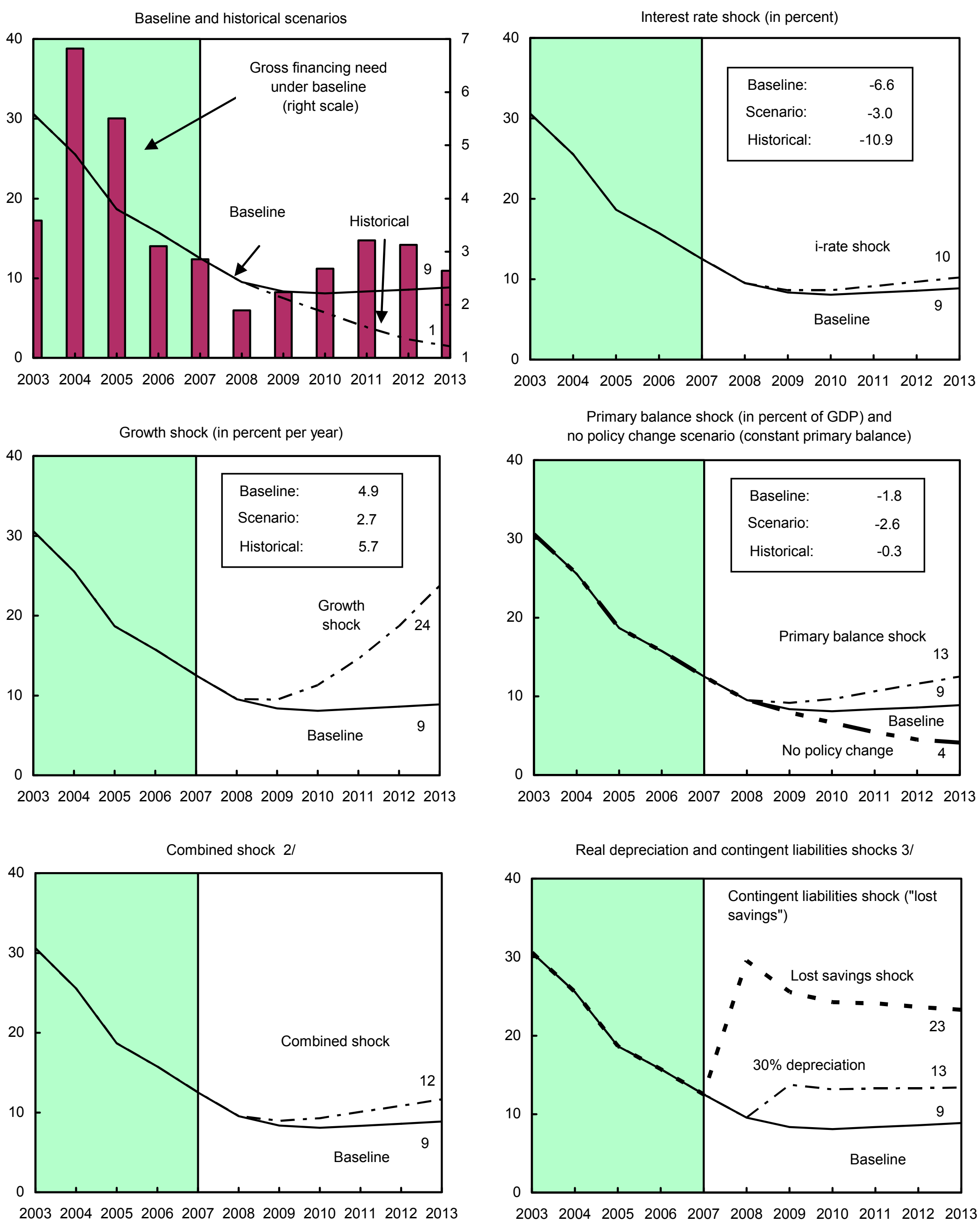
Sources: Ukrainian authorities; IMF *World Economic Outlook;* and staff estimates.
1/ Each scenario assumes: (i) a de facto exchange rate peg through 2009; (ii) full pass-through of rising energy import prices; (iii) the free-play of automatic stabilizers in 2008 and a general government fiscal deficit of 1.5 percent of GDP in 2009; (iv) alignment of the minimum wage with the minimum subsistence level by end-2009; and (v) convergence of natural gas prices to Western European levels (adjusted for transit) by 2009.
2/ The upside scenario assumes an increase in steel prices by 40 percent in 2008 and a stabilization in 2009, more favorable financing conditions and significantly higher FDI relative to the baseline.
3/ The downside scenario assumes an increase in steel prices by 10 in 2008, followed by a decline by 15 percent in 2009; it also assumes significantly lower FDI relative to the baseline, and much more difficult financing conditions.

Figure 11: 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 2009.

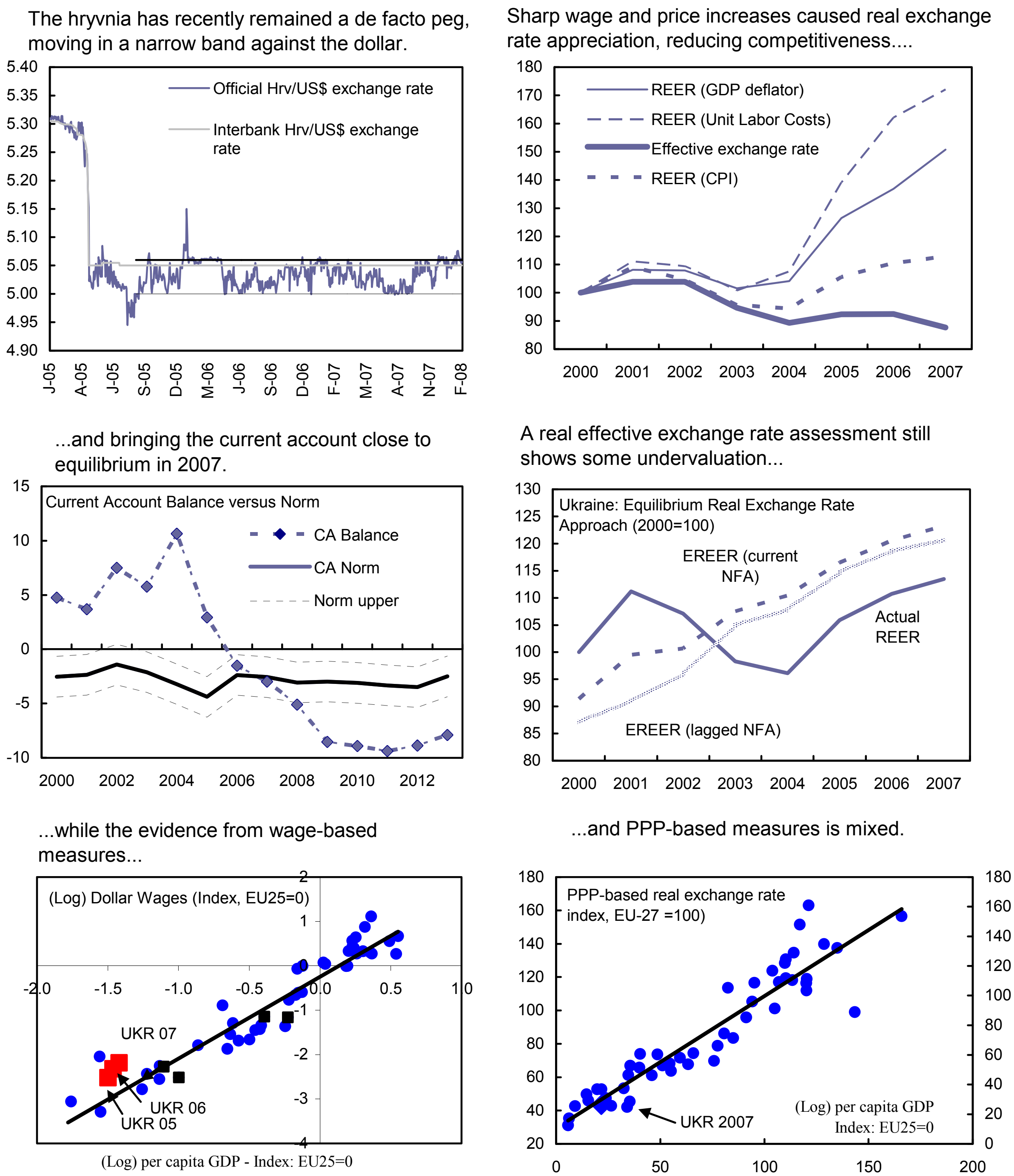
Figure 12: Ukraine: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

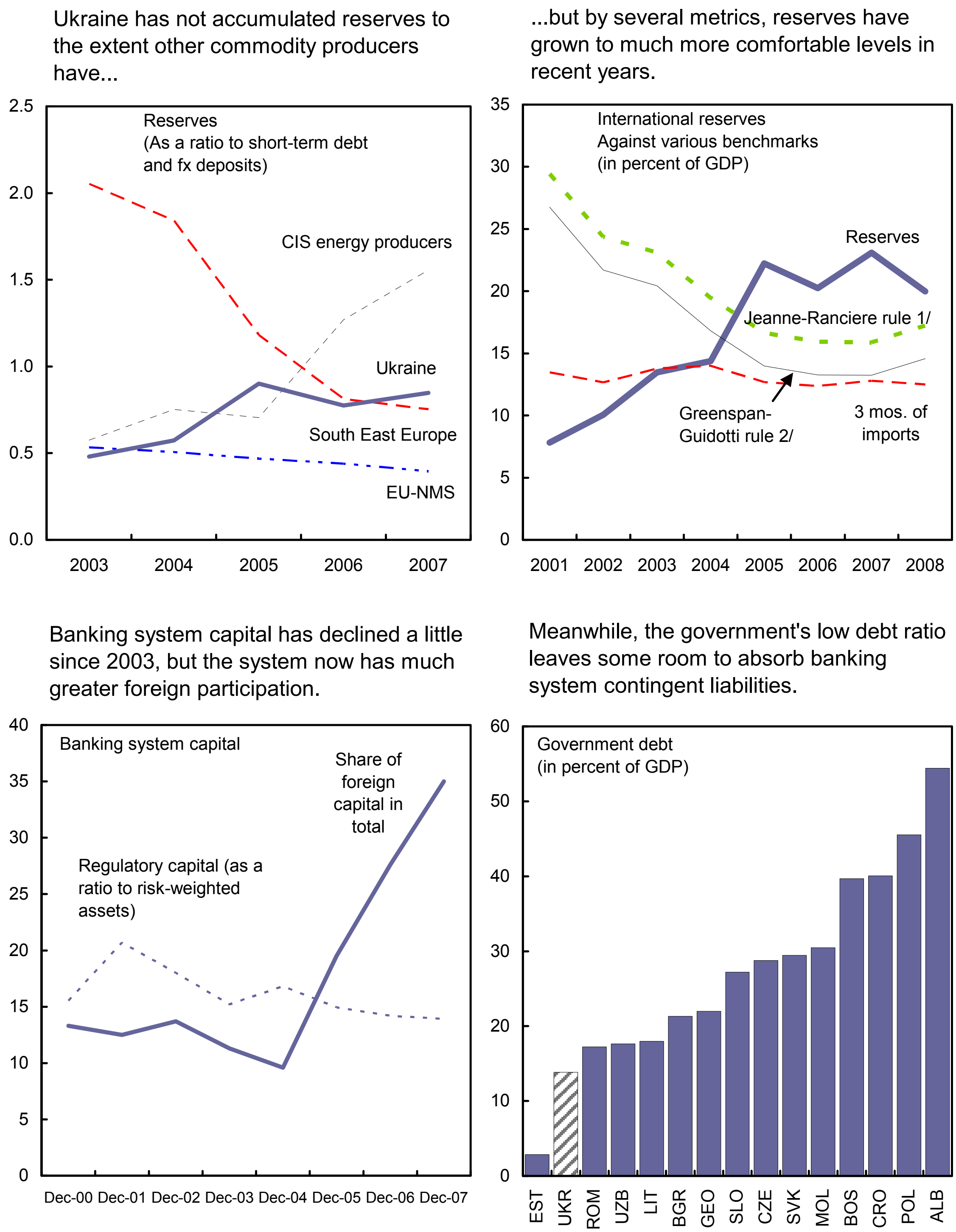
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 20 percent of GDP shock to contingent liabilities occur in 2008 associated with lost savings in USSR's Savings Bank, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 13. Ukraine: Competitiveness and Exchange Rate Assessment, 2000-2007



Sources: NBU, ILO, World Bank, Eurostat, and Fund staff calculations.

Figure 14. Ukraine: Buffers Against Turbulence



Source: IMF WEO and IFS databases; and Fund staff calculations.
1/ See Jeanne and Rancière (2006).
2/ Full coverage of short-term debt, by residual maturity

Table 1. Reactions to IMF Advice

Policy area	IMF advice	Authorities' reaction
Fiscal policy	Maintain a general government deficit of about 2 percent of GDP, and save excess revenues; over time reduce the ratio of recurrent spending to GDP through a restrained incomes policy.	The deficit has been kept below 2 percent of GDP, but excess revenues have for the most part been spent. Wages and social transfers have grown at very rapid rates.
Monetary and exchange rate policy	Shift gradually to a flexible exchange rate regime, and ultimately, inflation targeting.	NBU agrees in principle, but change has been slow. TA has helped build up capacity in the NBU for such a move (see Table 13).
Financial sector policy	Raise capital and provisioning requirements for banks; amend legislation to increase sector transparency and to provide a stronger legal basis for crisis management.	Provisioning and minimum capital requirements have been raised, but the overall capital adequacy ratio has remained at 10 percent. Legal amendments have been stalled in parliament for several years.
Structural reforms	Accelerate implementation of the long list of measures highlighted by various IFIs. Recent Fund emphasis has been on trade reform; energy sector reform (price pass-through); tax system reform (VAT administration, base broadening and rate reductions); and financial sector development.	Strong consensus on trade reform has produced results (WTO accession), but progress in other areas has been limited, with a consensus on how to proceed yet to emerge.

1/ See Ukraine: Ex-post Assessment of Long-Term Use of Fund Resources (2005), available at www.imf.org, for a discussion of the effectiveness of IMF advice over 1995-2005.

Table 2. Ukraine: Selected Economic and Social Indicators, 2003-09

	2003	2004	2005	2006	2007 Est.	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)							
Nominal GDP (billions of hryvnias)	267	345	441	544	713	939	1139
Real GDP	9.6	12.1	2.7	7.3	7.6	5.6	4.2
Domestic demand (contribution)	11.4	9.1	13.2	13.1	16.1	11.6	6.9
Net exports (contribution)	-1.8	3.0	-10.5	-5.8	-8.5	-6.0	-2.7
Output gap	-1.0	3.3	-0.6	-0.3	1.4	1.1	-0.4
Unemployment rate (ILO definition; percent)	9.1	8.6	7.2	6.8	6.4	5.5	5.7
Consumer prices (period average)	5.2	9.0	13.5	9.1	12.8	23.2	16.4
Consumer prices (end of period)	8.2	12.3	10.3	11.6	16.6	18.5	13.2
Core inflation (end of period) 2/	8.7	12.0	13.8	7.2	13.4	17.3	12.3
Nominal monthly wages (average)	23.0	27.5	36.7	29.2	29.7	39.3	27.0
Real monthly wages (average)	16.9	17.0	20.5	18.6	15.0	13.1	9.1
Public finance (percent of GDP) 3/							
Cash balance	-0.9	-4.4	-2.3	-1.4	-2.0	-1.2	-1.5
Revenue 4/	38.0	37.1	41.8	43.7	42.3	43.9	43.7
Expenditure (cash basis)	38.9	41.5	44.1	45.1	44.3	45.1	45.2
Primary balance (cash basis)	0.1	-3.5	-1.5	-0.7	-1.5	-0.8	-1.2
Cyclically adjusted balance 5/	-0.4	-6.0	-2.0	-1.2	-2.7	-1.7	-1.4
Privatization proceeds	1.1	3.1	5.0	0.4	0.6	1.1	0.8
Net domestic financing	-1.2	-0.1	-3.3	-0.4	0.3	-0.1	0.4
Net external financing	1.0	1.4	0.6	1.3	1.0	0.1	0.3
Public debt 6/	30.6	25.5	18.7	15.7	12.5	9.5	8.4
Of which: external debt	21.6	19.2	14.1	12.5	9.8	7.2	6.2
Money and credit (end of period, percent change)							
Base money	30.1	34.1	53.9	17.5	46.0	37.3	26.4
Broad money	46.5	32.3	54.4	34.5	51.7	38.9	27.1
Credit to nongovernment	61.5	31.6	61.9	70.7	74.0	40.1	31.1
Velocity 7/	2.8	2.7	2.3	2.1	1.8	1.7	1.6
Interbank overnight rate (annual average, percent)	6.8	5.7	3.5	2.9	1.5	...	...
Balance of payments (percent of GDP)							
Current account balance	5.8	10.6	2.9	-1.5	-4.2	-7.1	-9.8
Foreign direct investment	2.8	2.6	8.7	5.3	6.5	6.8	6.5
Gross reserves (end of period, billions of U.S. dollars)	6.9	9.5	19.4	22.3	32.5	36.5	35.6
In months of next year's imports of goods and services	2.3	2.6	4.4	3.7	4.2	4.1	3.7
Debt service (in percent of exports of goods and services) 5/	6.2	5.3	4.9	5.1	3.9	3.0	3.1
Goods exports (annual volume change in percent)	14.2	18.2	-8.5	2.7	6.9	4.0	3.3
Goods imports (annual volume change in percent)	30.4	13.8	13.0	12.5	20.3	13.9	8.9
Goods exports	47.4	51.5	40.7	36.1	35.2	32.1	28.5
Goods imports	47.9	45.8	42.0	40.9	42.7	41.5	40.7
Share of metals in merchandise exports (percent)	35.8	39.0	40.1	42.2	37.4	35.6	36.1
Net imports of energy (billions of U.S. dollars)	5.1	6.0	6.1	8.1	10.0	15.3	18.1
Goods terms of trade (percent change)	8.7	9.6	6.2	-0.2	5.2	1.7	-5.1
Goods and services terms of trade (percent change)	7.3	7.8	4.9	1.5	4.3	1.4	-4.1
Exchange rate							
Exchange rate regime			*de facto peg*			...	
Hryvnia per U.S. dollar, end of period	5.33	5.31	5.05	5.06	5.05	…	…
Hryvnia per U.S. dollar, period average	5.33	5.32	5.11	5.04	5.03	…	…
Real effective rate, CPI-based (percent change) 8/	-8.6	-1.4	12.0	4.8	2.6	16.8	9.4

Social indicators

Per capita GDP: US$ 3,056 (2007); Poverty (percent of population): 8.0 (2006; World Bank estimate);
Life expectancy at birth: 68.2 years (2006); Infant mortality (per 1,000): 14.0 (2004); Net primary enrollment (percent net): 86 (2004)

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Policies assumed here include: (i) a de facto exchange rate peg through 2009 and passive monetary policy in support of this; (ii) convergence of gas prices to European levels (adjusted for transit) by 2009; (iii) full pass-through of rising energy import prices; (iv) the free-play of automatic stabilizers in 2008 and a general government fiscal deficit of 1.5 percent of GDP in 2009; and (v) alignment of the minimum wage with the minimum subsistence level by end-2009.
2/ Inflation excluding extreme price movements in the CPI components. The concept used here is the 65th percentile of the distribution of the monthly price changes.
3/The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
4/ From 2003 onward, 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 0.1 percent of GDP relative to previous years.
5/ The cyclically-adjusted balance estimates the government fiscal balance if output were at its potential level.
6/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
7/ Annual GDP divided by end-period broad money (M3).
8/ Period averages; (+) represents real appreciation; based on CPI inflation and IMF INS trade weights (1999-2001).

Table 3. Ukraine: Medium-Term Balance of Payments, 2005-13
(In million of U.S. dollars, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
			Est.			Projection 1/			
Current account balance	2,531	-1,617	-5,918	-13,376	-21,887	-25,453	-26,297	-25,467	-26,752
Merchandise trade balance	-1,135	-5,194	-10,572	-17,618	-27,258	-30,325	-31,538	-33,318	-33,634
Exports	35,024	38,949	49,840	60,251	63,563	68,158	74,298	81,508	89,946
Imports	-36,159	-44,143	-60,412	-77,869	-90,821	-98,483	-105,836	-114,826	-123,580
Services (net)	1,806	2,126	2,696	2,327	3,909	4,362	5,590	8,805	8,299
Receipts 2/	9,354	11,290	14,161	16,148	19,105	20,315	21,454	25,151	24,576
Payments	-7,548	-9,164	-11,465	-13,821	-15,196	-15,953	-15,864	-16,346	-16,277
Income (net)	-985	-1,722	-2,117	-2,843	-3,708	-5,110	-6,552	-7,884	-8,927
o/w: Interest on public debt 3/	-623	-892	-1,001	-1,104	-1,105	-1,108	-1,212	-1,350	-1,705
Current transfers (net)	2,845	3,173	4,075	4,758	5,170	5,620	6,203	6,930	7,511
Financial and capital account	8,038	4,088	15,776	18,171	21,519	24,974	28,165	31,692	34,564
Direct investment and capital transfers (net)	7,468	5,740	9,221	12,724	14,573	16,336	17,413	18,435	19,294
Portfolio investment (excluding government bonds)	1,437	2,822	4,423	3,114	3,214	3,314	3,514	4,214	4,814
Bonds and medium and long-term loans (net)	4,736	6,406	15,763	12,799	12,749	13,428	14,520	15,667	16,744
Private sector loans	3,323	5,797	13,931	12,434	12,154	12,193	12,672	13,132	13,727
Bonds and loans (official)	1,413	609	1,832	365	595	1,235	1,848	2,535	3,017
o/w: Disbursements	3,384	3,239	4,244	1,227	1,953	2,811	3,185	3,338	3,564
Repayments 2/ 3/	-1,971	-2,630	-2,412	-862	-1,358	-1,576	-1,337	-802	-547
o/w: Foreign-currency	162	1,158	1,654	126	287	738	1,340	1,971	2,352
Domestic -currency	1,251	-549	178	239	308	497	508	564	665
Short-term capital (net)	-5,603	-10,880	-13,631	-10,467	-9,017	-8,104	-7,283	-6,625	-6,288
Errors and omissions	152	-42	-463	-463	-463	-463	-463	-463	-463
Overall balance	10,721	2,429	9,395	4,331	-832	-942	1,404	5,761	7,349
Gross official reserves (- is increase)	-10,425	-1,999	-8,980	-4,011	917	942	-1,404	-5,761	-7,349
Net use of IMF resources	-296	-430	-415	-320	-85	0	0	0	0
Memorandum items:									
Total external debt 3/	38,657	52,803	79,550	97,749	115,294	133,326	152,993	174,551	197,209
Total external debt (In percent of GDP)	44.9	48.9	56.2	52.1	51.6	52.8	57.2	61.6	64.7
Public external debt 3/	13,526	14,838	15,559	15,605	16,115	17,350	19,198	21,733	24,750
Public external debt (in percent of GDP) 3/	15.7	13.7	11.0	8.3	7.2	6.9	7.2	7.7	8.1
Current account (in percent of GDP)	2.9	-1.5	-4.2	-7.1	-9.8	-10.1	-9.8	-9.0	-8.8
Excluding transfers	-0.4	-4.4	-7.1	-9.7	-12.1	-12.3	-12.2	-11.4	-11.2
Debt service (in percent of exports of goods and services) 2/ 3/	4.9	5.1	3.9	3.0	3.1	3.0	2.7	2.0	2.0
o/w: Interest payments	1.4	1.8	1.6	1.4	1.3	1.3	1.3	1.3	1.5
Gross international reserves (end of period)	19,391	22,256	32,462	36,473	35,556	34,614	36,018	41,779	49,128
In months of next year's imports of goods and services	4.4	3.7	4.2	4.1	3.7	3.4	3.3	3.6	4.0
Over next year's official debt service	4.9	5.8	14.2	14.3	13.2	13.6	16.7	18.6	...
Merchandise export values (percent change)	4.8	11.2	28.0	20.9	5.5	7.2	9.0	9.7	10.4
Merchandise import values (percent change)	21.8	22.1	36.9	28.9	16.6	8.4	7.5	8.5	7.6
Merchandise export volume (percent change)	-8.5	2.7	6.9	4.0	3.3	5.4	7.1	7.7	8.5
Merchandise import volume (percent change)	13.0	12.5	20.3	13.9	8.9	6.1	6.2	7.2	6.7
Goods terms of trade (percent change)	6.2	-0.2	5.2	1.7	-5.1	-0.6	0.6	0.7	0.9
Goods and services terms of trade (percent change)	4.9	1.5	4.3	1.4	-4.1	-0.6	0.5	0.5	0.7

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

1/ Policies assumed here include: (i) a de facto exchange rate peg through 2009, followed by a gradually widening exchange rate corridor; (ii) passive monetary policy through 2009 as a result of foreign exchange interventions to defend the peg; (iii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2009; (iv) full pass-through of rising energy import prices; and (v) alignment of the minimum wage with the minimum subsistence level by end-2009.

2/ Includes lease receipts and offsetting repayments under the Black Sea Fleet debt swap agreement.

3/ Public and publicly-guaranteed debt, on a residency basis.

Table 4. Ukraine: Selected Vulnerability Indicators, 2003-08

	2003	2004	2005	2006	2007	2008	Latest observation
Financial Market Indicators							
Short-term (ST) interest rate (in percent) 1/	9.3	16.3	2.9	2.1	3.8	14.5	29-Apr-08
EMBI secondary market spread (bps, end of period)	275	264	184	172	303	333	30-Apr-08
Foreign currency debt rating 2/	B1	B1	B1	B1	B1	B1	30-Apr-08
Exchange rate NC/US$ (end of period)	5.33	5.31	5.05	5.06	5.05	4.79	30-Apr-08
Stock market index (PFTS)	85.4	260.1	353.0	498.9	1,174.0	855.2	25-Apr-08
Broad money to gross reserves (percent)	256.9	249.1	199.1	234.9	247.4	250.5	31-Mar-08
External Sector							
Exchange rate regime			de facto peg to U.S. dollar				
Current account balance (percent of GDP)	5.8	10.6	2.9	-1.5	-4.2	-7.1	Proj
Net FDI inflows (percent of GDP)	2.8	2.6	8.7	5.4	6.5	6.8	Proj
Exports (percentage change of US$ value, GNFS)	24.0	42.6	7.5	13.2	27.4	19.4	Proj
Real effective exchange rate, GDP deflator based (percent change) 3/	-5.9	2.5	21.4	8.3	10.8	13.0	Proj
Gross international reserves (GIR) in US$ billion	6.9	9.5	19.4	22.3	32.5	33.6	22-Apr-08
GIR in percent of ST debt at remaining maturity (RM)	67.7	87.4	161.0	155.7	174.7	137.0	Proj
GIR in percent of ST debt at RM and banks' FX deposits	49.8	57.3	92.0	79.0	89.2	70.8	Proj
Net international reserves (NIR) in US$ billion	5.1	8.0	18.2	21.4	32.1	33.1	31-Mar-08
Total gross external debt (ED) in percent of GDP	47.6	47.3	44.9	49.6	56.2	52.1	Proj
o/w ST external debt (original maturity, in percent of total ED)	38.5	34.2	32.6	32.3	32.0	29.7	Proj
ED of domestic private sector (in percent of total ED)	54.5	58.1	65.0	71.9	80.4	84.0	Proj
ED to foreign official sector (in percent of total ED)	22.7	17.8	16.2	11.1	7.5	5.8	Proj
Total public external debt (in percent of GDP) 4/	21.6	19.8	15.7	13.9	11.0	8.3	Proj
Domestically issued public debt held by non-residents (in percent of GDP)	0.1	0.6	1.5	0.7	0.6	0.6	Proj
Total gross external debt in percent of exports of GNFS	82.4	74.4	87.1	105.1	124.3	127.9	Proj
Gross external financing requirement (in US$ billion)	8.4	6.4	14.1	15.2	18.3	23.9	Proj
Public Sector (PS) 5/							
Overall balance (percent of GDP)	-0.9	-4.4	-2.3	-1.4	-2.0	-1.2	Proj
Primary balance (percent of GDP)	0.1	-3.5	-1.5	-0.7	-1.5	-0.8	Proj
Debt-stabilizing primary balance (percent of GDP) 4/	-4.4	-5.9	-4.6	-3.8	-3.4	-1.6	Proj
Gross PS financing requirement (in percent of GDP) 6/	4.4	7.6	3.6	2.4	3.0	2.3	Proj
Public sector gross debt (PSGD, in percent of GDP)	30.6	25.5	18.7	15.7	12.5	9.5	Proj
o/w Exposed to rollover risk (in percent of total PSGD) 7/	10.9	10.2	16.2	9.2	5.5	5.8	Proj
Exposed to exchange rate risk (in percent of total PSGD)	70.7	75.2	75.6	79.1	78.4	75.8	Proj
Public sector net debt (in percent of GDP)	27.1	23.3	13.9	11.9	10.3	7.8	Proj

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

1/ Overnight interbank rate. Monthly average for December or month of latest observation.
2/ Moody's Investors Service. Note that Fitch and Standard & Poor's upgraded Ukraine from B+ to BB- in January and May 2005, respectively.
3/ Period averages; (+) represents real appreciation; based on GDP deflator and IMF INS trade weights (1999-2001).
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 5. Ukraine: General Government Finances, 2004-09 1/

	2004	2005	2006	2007	2008		2009	
				Prel.	Proj		Proj	
	General Gov't	General Gov't	General Gov't	General Gov't	General Gov't	State Budget	General Gov't	State Budget
	(in millions of Hrv)							
Revenue 2/	**128,122**	**184,642**	**235,225**	**301,618**	**412,131**	**231,245**	**497,569**	**278,279**
Tax revenue	108,000	159,707	204,721	263,394	361,623	191,821	438,679	231,290
Personal income tax	13,213	17,325	22,791	34,782	45,963	0	56,369	0
Enterprise profit tax	16,162	23,464	26,172	34,407	45,505	45,422	55,211	55,109
Payroll tax	36,220	49,477	61,919	82,733	111,626	0	135,886	0
Property tax	2,293	2,718	3,122	3,889	4,108	0	4,281	0
VAT	14,808	33,804	50,397	59,383	86,792	86,792	107,103	107,103
Gross collections	28,701	47,110	65,438	78,252	115,037	115,037	141,373	141,373
Refunds	-13,894	-13,306	-15,041	-18,869	-28,245	-28,245	-34,270	-34,270
Other taxes on goods and services	14,961	18,580	22,731	25,844	34,245	31,407	41,796	37,136
Taxes on international trade	5,067	6,722	7,373	10,038	15,226	15,226	17,906	18,906
Other taxes	5,276	7,617	10,216	12,317	18,159	12,975	20,127	13,035
Nontax, capital revenue, and grants	20,123	24,935	30,504	38,224	50,508	39,424	58,889	46,989
State enterprise and NBU dividends	2,243	5,410	4,580	3,217	5,862	5,734	7,113	6,957
Ministry special resources	11,579	10,797	15,247	18,712	20,978	14,600	24,452	16,714
Other nontax	6,300	8,729	10,677	16,296	23,668	19,090	27,325	23,318
Expenditure	**143,327**	**194,672**	**242,652**	**315,852**	**423,145**	**240,766**	**514,967**	**293,609**
Current expenditures	120,868	176,334	217,888	275,594	376,591	210,673	450,927	250,195
Wages	32,775	42,700	55,049	72,677	94,425	42,822	116,147	52,057
Goods and services	19,646	28,442	35,783	45,991	60,955	38,451	75,706	46,757
Subsidies	7,468	9,720	17,081	19,921	27,741	21,428	33,772	27,204
Transfers	57,768	92,159	106,535	133,326	189,720	102,970	221,413	119,021
Pensions 3/ 4/	41,810	72,620	83,031	108,614	141,188	38,641	171,641	48,870
Other	15,958	19,539	23,504	24,712	48,532	64,329	49,772	70,151
Interest	3,210	3,312	3,440	3,679	3,750	5,003	3,890	5,155
Domestic	1,021	1,012	963	811	885	1,039	994	1,185
Foreign	2,189	2,300	2,477	2,868	2,865	3,963	2,895	3,970
Capital spending	20,665	18,111	24,536	38,683	44,481	28,093	61,524	40,987
Net lending	1,102	228	228	1,575	2,074	2,000	2,516	2,426
Unallocated spending	692	0	0	0	0	0	0	0
Overall balance (cash basis)	**-15,205**	**-10,030**	**-7,427**	**-14,233**	**-11,014**	**-9,521**	**-17,398**	**-15,329**
Overall balance (commitment basis)	**-14,188**	**-7,899**	**-8,332**	**-14,041**	**-10,509**	**-9,016**	-16,883	-14,814
Financing	**14,980**	**10,052**	**6,947**	**13,450**	**11,014**	**9,521**	**17,398**	**15,329**
External	4,738	2,729	6,950	7,007	901	439	3,379	2,907
Disbursements	10,222	8,487	12,290	10,640	4,939	4,439	8,391	7,881
Amortization 2/	-5,484	-5,759	-5,340	-3,633	-4,037	-4,000	-5,012	-4,974
Domestic	-327	-14,546	-2,074	2,235	-537	182	4,478	4,450
Net Borrowing	483	-978	-2,332	1,385	2,389	2,698	3,141	3,469
Borrowing	3,334	7,546	1,572	3,881	5,110	5,371	6,200	6,516
Amortization	-2,851	-8,524	-3,904	-2,496	-2,721	-2,672	-3,059	-3,047
Other, incl. deposit finance	-810	-13,567	258	850	-2,926	-2,517	1,337	980
Privatization	10,569	21,869	2,071	4,209	10,649	8,900	9,540	7,973
Statistical discrepancy/financing gap	**225**	**-22**	**480**	**783**	**0**	**0**	**0**	**0**

Sources: Ministry of Finance; NBU; 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. The aggregates for the general government cover the whole of the general government sector, including local authorities and the social funds. The differences between staff's and the authorities' public finances numbers and projections also reflect accounting treatments to ensure consistency with international accounting rules.
2/ Excludes US$ 100 million of non-cash property income paid annually by Russia in exchange for amortization of Ukraine's debt to Russia.
3/ In 2005-06, adjusted for Hrv 2.3 billion in advanced pension payments paid in December 2005, and due in January 2006.
4/ In 2004-06, includes pensions on army, interior, emergency services, penitentiary, tax police and security paid directly by the State budget. Administration of these payments was transferred to the Pension Fund in 2007.

Table 5 (concluded). Ukraine: General Government Finances, 2004-09 1/

	2004	2005	2006	2007	2008		2009	
				Prel.	Proj		Proj	
	General Gov't	General Gov't	General Gov't	General Gov't	General Gov't	State Budget	General Gov't	State Budget
	(in percent of GDP)							
Revenue	**37.1**	**41.8**	**43.7**	**42.3**	**43.9**	**24.6**	**43.7**	**24.4**
Tax revenue	31.3	36.2	38.1	36.9	38.5	20.4	38.5	20.3
Personal income tax	3.8	3.9	4.2	4.9	4.9	0.0	4.9	0.0
Enterprise profit tax	4.7	5.3	4.9	4.8	4.8	4.8	4.8	4.8
Payroll tax	10.5	11.2	11.5	11.6	11.9	0.0	11.9	0.0
Property tax	0.7	0.6	0.6	0.5	0.4	0.0	0.4	0.0
VAT	4.3	7.7	9.4	8.3	9.2	9.2	9.4	9.4
Gross collections	8.3	10.7	12.2	11.0	12.3	12.3	12.4	12.4
Refunds	-4.0	-3.0	-2.8	-2.6	-3.0	-3.0	-3.0	-3.0
Other taxes on goods and services	4.3	4.2	4.2	3.6	3.6	3.3	3.7	3.3
Taxes on international trade	1.5	1.5	1.4	1.4	1.6	1.6	1.6	1.7
Other taxes	1.5	1.7	1.9	1.7	1.9	1.4	1.8	1.1
Nontax, capital revenue, and grants	5.8	5.6	5.7	5.4	5.4	4.2	5.2	4.1
State enterprise and NBU dividends	0.7	1.2	0.9	0.5	0.6	0.6	0.6	0.6
Ministry special resources	3.4	2.4	2.8	2.6	2.2	1.6	2.1	1.5
Other nontax 2/	1.8	2.0	2.0	2.3	2.5	2.0	2.4	2.0
Expenditure	**41.5**	**44.1**	**45.1**	**44.3**	**45.1**	**25.6**	**45.2**	**25.8**
Current expenditures	35.0	39.9	40.5	38.7	40.1	22.4	39.6	22.0
Wages	9.5	9.7	10.2	10.2	10.1	4.6	10.1	4.6
Goods and services	5.7	6.4	6.7	6.5	6.5	4.1	6.6	4.1
Subsidies	2.2	2.2	3.2	2.8	3.0	2.3	2.9	2.4
Transfers	16.7	20.9	19.8	18.7	20.2	11.0	19.4	10.4
Pensions 3/ 4/	12.1	16.5	15.4	15.2	15.0	4.1	15.1	4.3
Other	4.6	4.4	4.4	3.5	5.2	6.9	4.4	6.2
Interest	0.9	0.8	0.6	0.5	0.4	0.5	0.3	0.5
Domestic	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Foreign	0.6	0.5	0.5	0.4	0.3	0.4	0.3	0.3
Capital spending	6.0	4.1	4.6	5.4	4.7	3.0	5.4	3.6
Net lending	0.3	0.1	0.0	0.2	0.2	0.2	0.2	0.2
Unallocated spending	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis)	**-4.4**	**-2.3**	**-1.4**	**-2.0**	**-1.2**	**-1.0**	**-1.5**	**-1.3**
Overall balance (commitment basis)	**-4.1**	**-1.8**	**-1.5**	**-2.0**	**-1.1**	**-1.0**	**-1.5**	**-1.3**
Financing	**4.3**	**2.3**	**1.3**	**1.9**	**1.2**	**1.0**	**1.5**	**1.3**
External	1.4	0.6	1.3	1.0	0.1	0.0	0.3	0.3
Disbursements	3.0	1.9	2.3	1.5	0.5	0.5	0.7	0.7
Amortization 2/	-1.6	-1.3	-1.0	-0.5	-0.4	-0.4	-0.4	-0.4
Domestic	-0.1	-3.3	-0.4	0.3	-0.1	0.0	0.4	0.4
Net Borrowing	0.1	-0.2	-0.4	0.2	0.3	0.3	0.3	0.3
Borrowing	1.0	1.7	0.3	0.5	0.5	0.6	0.5	0.6
Amortization	-0.8	-1.9	-0.7	-0.4	-0.3	-0.3	-0.3	-0.3
Other, incl. deposit finance	-0.2	-3.1	0.0	0.1	-0.3	-0.3	0.1	0.1
Privatization	3.1	5.0	0.4	0.6	1.1	0.9	0.8	0.7
Statistical discrepancy/financing gap	**0.1**	**0.0**	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:								
Nominal GDP (Hrv million)	345,113	441,452	544,153	712,945	938,762	938,762	1,138,986	1,138,986

Sources: Ministry of Finance; NBU; 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. The aggregates for the general government cover the whole of the general government sector, including local authorities and the social funds. The differences between staff's and the authorities' public finances numbers and projections also reflect accounting treatments to ensure consistency with international accounting rules.
2/ Excludes US$ 100 million of non-cash property income paid annually by Russia in exchange for amortization of Ukraine's debt to Russia.
3/ In 2005-06, adjusted for Hrv 2.3 billion in advanced pension payments paid in December 2005, and due in January 2006.
4/ In 2004-06, includes pensions on army, interior, emergency services, penitentiary, tax police and security paid directly by the State budget. Administration of these payments was transferred to the Pension Fund in 2007.

Table 6. Ukraine: Monetary Accounts, 2003-09

	2003	2004	2005	2006	2007	2008	2009
	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.
						Projection 1/	
	(In millions of hryvnias)						
Monetary Survey							
Net foreign assets	26,886	43,877	81,842	66,717	50,978	27,655	-11,979
(In millions of US dollars)	5,043	8,270	16,206	13,211	10,095	5,423	-2,349
Net domestic assets	68,448	81,828	112,229	194,346	345,179	522,662	711,164
Domestic credit	87,912	107,923	144,892	247,037	436,285	612,044	808,000
Net claims on government	15,692	13,509	-7,180	-7,821	-6,658	-8,389	-5,482
Credit to the economy	68,520	89,195	144,277	246,156	428,347	599,988	786,674
Other claims on the economy	3,700	5,220	7,796	8,702	14,597	20,446	26,807
Other items, net	-19,464	-26,095	-32,663	-52,691	-91,107	-89,382	-96,836
Broad money	95,334	125,705	194,071	261,063	396,156	550,317	699,185
Currency in circulation	33,119	42,345	60,231	74,984	111,119	154,359	194,708
Total deposits	61,484	83,138	132,914	184,430	280,154	389,173	495,858
Domestic currency deposits	41,836	52,835	87,296	114,274	190,287	262,127	330,858
Foreign currency deposits	19,648	30,303	45,617	70,155	89,867	127,047	165,001
Money market instruments	731	222	925	1,650	4,884	6,784	8,619
Accounts of the National Bank of Ukraine							
Net foreign assets	28,336	43,573	94,016	110,916	164,859	191,114	187,690
Net international reserves 2/	27,516	43,127	91,472	106,938	157,948	183,114	178,890
(In millions of U.S. dollars)	5,161	8,129	18,113	21,176	31,277	35,905	35,076
Net domestic assets	11,753	10,190	-11,256	-13,702	-22,958	11,735	67,382
Net domestic credit	16,089	15,089	-10,266	-8,127	-7,856	-2,846	27,492
Net claims on government	14,106	12,736	-8,149	-8,949	-6,274	-9,200	-7,862
Claims on government	19,079	18,001	10,315	9,676	9,058	9,058	9,058
Liabilities government	4,973	5,264	18,464	18,625	15,332	18,258	16,920
Net claims on the economy	-40	41	76	169	165	165	165
Net claims on banks	2,023	2,312	-2,193	653	-1,748	7,189	35,189
Other items, net	-4,336	-4,899	-991	-5,575	-15,102	14,580	39,890
of which: revaluation						-1,795	-1,754
Base money	40,089	53,763	82,760	97,214	141,901	194,849	246,272
Currency in circulation	33,119	42,345	60,231	74,984	111,119	154,359	194,708
Banks' reserves	6,970	11,418	22,528	22,231	30,782	40,489	51,564
Cash in vault	2,929	3,324	5,178	7,150	11,352	15,296	19,489
Required reserves	4,364	5,862	9,853	4,080	9,683	15,008	19,122
Excess reserves	-322	2,232	7,498	11,001	9,748	10,185	12,953
Deposit Money Banks							
Net foreign assets	-1,450	303	-12,175	-44,199	-113,882	-163,459	-199,669
Net domestic assets	62,815	82,656	144,919	228,433	393,620	552,632	695,527
Domestic credit	74,819	97,564	169,322	268,275	459,600	650,954	822,892
Net claims on government	1,586	773	969	1,128	-384	810	2,381
Credit to the economy	68,482	89,050	144,129	245,973	428,146	599,788	786,474
Other claims on the economy	3,700	5,220	7,796	8,702	14,597	16,056	17,662
Banks' reserves	6,970	11,418	22,528	22,231	30,782	40,489	51,564
Other items, net	-12,004 0	-14,908 0	-24,402 0	-39,842	-65,981	-98,322	-127,365
Banks' liabilities	61,365	82,959	132,745	184,234	279,738	389,173	495,858
Demand deposits	25,467	31,593	48,115	61,136	90,364	...	...
Time deposits	35,898	51,366	84,629	123,098	189,374	...	...
Memorandum items:							
	(Percentage change year-over-year)						
Base money	30.1	34.1	53.9	17.5	46.0	37.3	26.4
Broad money	47.0	31.9	54.4	34.5	51.7	38.9	27.1
Credit to the economy	63.4	30.0	61.9	70.7	74.0	40.1	31.1
	(Ratio)						
Velocity of broad money 3/	2.80	2.75	2.27	2.08	1.80	1.71	1.63
Money multiplier	2.38	2.34	2.34	2.69	2.79	2.82	2.84
	(In percent)						
Foreign currency loans to total loans	41.4	42.1	43.2	49.4	49.8	50.8	48.8
Foreign currency deposits to total depo	32.0	36.4	34.3	38.0	32.1	32.6	33.3

Sources: National Bank of Ukraine; and IMF staff aggregations, estimates, and projections.

1/ See assumptions in footnote 1 of Selected economic Indicators Table.
2/ Projected NIR are at projected exchange rates.
3/ Based on nominal GDP over the last four quarters.

Table 7. Ukraine: Structural Reforms

Areas	Main Achievements since 2000	Key Outstanding Reforms 1/
Business climate	• Leveled playing field by eliminating tax preferences (2004-05). • Reviewed over 9,000 business regulations and repealed and amended nearly 5,000 (2005-06)	• Abolish anachronistic Economic Code and improve the market-oriented Civil Code. • Adopt Joint Stock Company Law and Limited Liability Company Law. • Amend legislation on protection from unfair competition. • Adopt International Accounting Standards (IAS) for large corporates. • Lift the moratorium for the resale of agricultural land; remove current restrictions in Land Code on non-agricultural land ownership; establish registries for real estate and agricultural land property rights. • Implement reform of the court system to ensure independence and impartiality. • Re-launch transparent privatization program.
Trade policy	• Received market economy status from the EU and the United States (2006). • Slashed average import tariffs from 7.7 to 5.1 percent (2005). • Completed the main steps leading to WTO accession (2007-08).	• Progress in the negotiations of a EU-Ukraine trade agreement.
Energy sector	• Eliminated the culture of non-payment in the energy sector (2000-2002) • Adopted legislation to mutually offset and restructure debts in the energy sector (2005) • Adopted cash payments for gas transits through Ukraine, rather than payments in kind (2005).	• Implement strategy to make Naftogaz internationally competitive. • Implement Ukraine's coal mine restructuring plan. • Enhance independence of National Electricity Regulatory Commission. • Stimulate energy savings by allowing prices to reflect costs.
Fiscal-structural reforms	• Adopted a budget code establishing a solid legal framework for budget management and many of the budget execution and reporting functions (2001)	• Implement comprehensive reform for State Tax Administration. • Bring the State Tax Administration and Customs under the control of the Ministry of Finance.* • Implement a medium-term budget framework. • Bring public procurement legislation in line with EU legislation. • Set up a monitoring and oversight system for financial risks in state-owned enterprises. • Reform the system of unfunded social mandates and replace it with a targeted social protection system. • Reduce tax rates over time, but subject to expansion of the tax base and/or reductions in government spending.

1/ Measures include those listed in the Ukraine-EU Action Plan, and World Bank, OECD, and Fund recommendations. The table does not include measures on the financial sector, which are covered separately.

* denotes measures which are not part of the government programme.

Table 8. Ukraine: Alternative Macro Scenarios

	2004	2005	2006	2007	2008	2009	2008	2009	2008	2009
				Prel.	Baseline		High growth 3/		Low growth 4/	
Output and prices										
Nominal GDP (billions of hryvnias)	345	441	544	713	939	1,139	983	1,263	916	1,066
Real GDP growth (percent change)	12.1	2.7	7.3	7.6	5.6	4.2	7.8	6.8	4.3	3.0
Output gap	3.3	-0.6	-0.3	1.4	1.1	-0.4	3.3	4.4	-0.2	-2.9
Real domestic demand growth (percent change)	8.8	15.3	13.8	15.5	10.5	6.2	13.8	10.9	8.0	3.9
Consumer prices (percent change; end of period)	12.3	10.3	11.6	16.6	18.5	13.2	21.3	21.5	15.8	8.5
Consumer prices (percent change; average)	9.0	13.5	9.1	12.8	23.2	16.4	25.2	21.4	21.7	12.9
Core inflation (trimmmed mean, end of period)	12.0	13.8	7.2	13.4	17.3	12.3	19.6	22.0	16.2	7.9
Wages										
Minimum wage (percent change; average)	15.5	39.3	21.4	17.9	23.8	23.0	23.8	23.0	23.8	23.0
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	39.3	27.0	44.1	39.2	35.1	21.2
Real monthly wages (average)	17.0	20.5	18.6	15.0	13.1	9.1	15.1	14.6	11.1	7.4
Public finance (percent of GDP)										
Cash balance 2/	-4.4	-2.3	-1.4	-2.0	-1.2	-1.5	0.0	-1.5	-2.0	-1.5
Revenue and grants	37.1	41.8	43.7	42.3	43.9	43.7	43.8	43.8	43.9	43.7
Expenditure and net lending (cash basis)	41.5	44.1	45.1	44.3	45.1	45.2	43.8	45.3	45.9	45.2
Of which: currrent expenditure	35.0	39.9	40.5	38.7	40.1	39.6	38.9	39.7	40.9	39.5
Of which: interest payments	0.9	0.8	0.6	0.5	0.4	0.3	0.4	0.3	0.4	0.4
Privatization receipts	3.1	5.0	0.4	0.6	1.1	0.8	1.6	1.6	0.7	0.7
Net domestic financing	-0.1	-3.3	-0.4	0.3	-0.1	0.4	-1.7	-0.2	0.7	0.0
Net external financing	1.4	0.6	1.3	1.0	0.1	0.3	0.1	0.1	0.6	0.8
Public debt (end of period) 3/	25.5	18.7	15.7	12.5	9.5	8.4	9.1	7.4	10.2	9.8
Domestic	6.3	4.6	3.3	2.7	2.3	2.2	2.2	2.0	2.3	2.3
External	19.2	14.1	12.5	9.8	7.2	6.2	6.9	5.4	7.9	7.5
Cyclically-adjusted balance	-6.0	-2.0	-1.2	-2.7	-1.7	-1.4	-1.6	-3.6	-1.8	-0.1
Money and credit										
Base money (percent change, eop)	34.1	53.9	17.5	46.0	37.3	26.4	54.6	37.4	31.2	15.8
Credit to nongovernment (percent change, eop)	31.6	61.9	70.7	74.0	40.1	31.1	55.4	44.9	32.7	18.6
Share of fx credit in total credit	42.1	43.2	49.4	49.8	50.8	48.8	52.5	52.7	49.2	46.5
External sector										
Current account balance (percent of GDP)	10.6	2.9	-1.5	-4.2	-7.1	-9.8	-6.3	-9.7	-7.2	-10.2
Total external debt (percent of GDP)	47.3	44.9	48.9	56.2	52.1	51.6	53.6	54.8	53.1	53.5
Goods exports, value (percent change)	40.8	4.8	11.2	28.0	20.9	5.5	27.5	7.5	17.6	2.4
Goods imports, value (percent change)	23.7	21.8	22.1	36.9	28.9	16.6	32.6	21.3	26.8	14.1
Foreign direct investment (percent of GDP)	2.6	8.7	5.3	6.5	6.8	6.5	7.4	7.4	3.9	3.0
Gross official reserves (end of period)										
In billions of U.S. dollars	9.5	19.4	22.3	32.5	36.5	35.6	46.3	58.9	31.4	20.5
In months of imports of goods and services	2.6	4.4	3.7	4.2	4.1	3.7	4.9	5.7	3.7	2.3
External debt service (percent of exports of g&s)	5.3	4.9	5.1	3.9	3.0	3.1	2.9	2.9	3.1	3.3
Hryvnia per U.S. dollar (end of period)	5.31	5.05	5.06	5.05	...	...	...	...	...	...
Goods terms of trade (percent change)	9.6	6.2	-0.2	5.2	1.7	-5.1	6.9	-3.7	-0.9	-7.8
Goods and services terms of trade (percent change)	7.8	4.9	1.5	4.3	1.4	-4.1	5.7	-3.0	-0.8	-6.2
Savings-Investment Balance (percent of GDP)										
Foreign savings	-10.6	-2.9	1.5	4.2	7.2	9.9	6.3	9.7	7.2	10.2
Gross national savings	31.8	25.6	23.3	22.8	19.5	17.1	21.1	18.8	18.7	15.1
Nongovernment	33.2	25.8	22.4	22.1	18.1	15.8	20.1	18.1	17.6	14.3
Government	-1.4	-0.3	0.9	0.7	1.4	1.3	1.0	0.7	1.1	0.8
Gross investment	21.2	22.6	24.8	26.9	26.8	26.9	27.4	28.5	25.9	25.4
Nongovernment	18.2	20.6	22.5	24.3	24.2	24.1	25.0	26.0	23.3	22.4
Government	3.0	2.0	2.2	2.7	2.6	2.8	2.4	2.5	2.6	3.0

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Each scenario assumes: (i) a de facto exchange rate peg through 2009 and passive monetary policy in support of this; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2009; (iii) full pass-through of rising energy import prices; (iii) the free-play of automatic stabilizers in 2008 and a general government fiscal deficit of 1.5 percent of GDP in 2009; and (iv) alignment of the minimum wage with the minimum subsistence level by end-2009. The upside scenario assumes an increase in steel prices by 40 percent in 2008 and a stabilization in 2009, more favorable financing conditions and significantly higher FDI relative to the baseline. The downside scenario assumes an increase in steel prices by 10 in 2008, followed by a 10 percent decline in 2009; it also assumes significantly lower FDI relative to the baseline, and more difficult financing conditions.
2/ The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
3/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

Table 9. Ukraine: Medium Term Macroeconomic Framework

	2004	2005	2006	2007 Prel.	2008	2009	2010 baseline	2011	2012	2013	Cumulative Change 2008-13
Output and prices											
Nominal GDP (billions of hryvnias)	345	441	544	713	939	1139	1332	1532	1761	2027	…
Real GDP growth (percent change)	12.1	2.7	7.3	7.6	5.6	4.2	3.5	4.6	5.8	6.5	34.4
Output gap	3.3	-0.6	-0.3	1.4	1.1	-0.4	-2.4	-3.2	-2.9	-1.9	…
Real domestic demand growth (percent change)	8.8	15.3	13.8	15.5	10.5	6.2	3.9	4.2	4.8	6.5	41.7
Consumer prices (percent change; end of period)	12.3	10.3	11.6	16.6	18.5	13.2	9.7	8.5	7.1	5.9	81.2
Consumer prices (percent change; average)	9.0	13.5	9.1	12.8	23.2	16.4	11.8	9.2	7.9	6.6	…
Core inflation (end of period) 2/	12.0	13.8	7.2	13.4	17.3	12.3	9.4	7.8	6.7	5.7	75.2
Wages											
Minimum wage (percent change; average)	15.5	39.3	21.4	17.9	23.8	23.0	23.6	14.8	14.2	12.9	178.7
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	39.3	27.0	19.9	14.3	14.3	13.7	214.9
Real monthly wages (average)	17.0	20.5	18.6	15.0	13.1	9.1	7.2	4.6	5.9	6.6	56.2
Public finance (percent of GDP)											
Cash balance 3/	-4.4	-2.3	-1.4	-2.0	-1.2	-1.5	-2.0	-2.5	-2.5	-2.0	…
Revenue and grants	37.1	41.8	43.7	42.3	43.9	43.7	43.4	42.8	42.6	42.5	…
Expenditure and net lending (cash basis)	41.5	44.1	45.1	44.3	45.1	45.2	45.4	45.4	45.0	44.5	…
Of which: currrent expenditure	35.0	39.9	40.5	38.7	40.1	39.6	39.5	39.1	38.8	38.8	…
Of which: interest payments	0.9	0.8	0.6	0.5	0.4	0.3	0.3	0.3	0.3	0.4	…
Cyclically-adjusted fiscal balance	-6.0	-2.0	-1.5	-2.0	-1.1	-1.5	-2.0	-2.5	-2.4	-2.0	…
Privatization receipts	3.1	5.0	0.4	0.6	1.1	0.8	0.6	0.6	0.5	0.5	…
Net domestic financing	-0.1	-3.3	-0.4	0.3	-0.1	0.4	0.9	1.3	1.4	0.9	…
Net external financing	1.4	0.6	1.3	1.0	0.1	0.3	0.5	0.6	0.6	0.6	…
Public debt (end of period) 4/	25.5	18.7	15.7	12.5	9.5	8.4	8.1	8.3	8.6	8.9	…
Domestic	6.3	4.6	3.3	2.7	2.3	2.2	2.3	2.3	2.4	2.5	…
External	19.2	14.1	12.5	9.8	7.2	6.2	5.8	6.0	6.1	6.3	…
Cyclically-adjusted balance	-6.0	-2.0	-1.2	-2.7	-1.7	-1.4	-0.9	-1.0	-1.1	-1.1	…
Money and credit											
Base money (percent change, eop)	34.1	53.9	17.5	46.0	37.3	26.4	18.0	16.5	17.4	17.5	228.7
Credit to nongovernment (percent change, eop)	31.6	61.9	70.7	74.0	40.1	31.1	18.6	15.2	15.5	16.7	238.3
Share of fx credit in total credit	42.1	43.2	49.4	49.8	50.8	48.8	48.4	46.5	44.1	43.8	…
External sector											
Current account balance (percent of GDP)	10.6	2.9	-1.5	-4.2	-7.1	-9.8	-10.1	-9.8	-9.0	-8.8	…
Total external debt (percent of GDP)	47.3	44.9	48.9	56.2	52.1	51.6	52.8	57.2	61.6	64.7	…
Goods exports, value (percent change)	40.8	4.8	11.2	28.0	20.9	5.5	7.2	9.0	9.7	10.4	80.5
Goods imports, value (percent change)	23.7	21.8	22.1	36.9	28.9	16.6	8.4	7.5	8.5	7.6	104.6
Foreign direct investment (percent of GDP)	2.6	8.7	5.3	6.5	6.8	6.5	6.5	6.5	6.5	6.3	…
Gross official reserves (end of period)											…
In billions of U.S. dollars	9.5	19.4	22.3	32.5	36.5	35.6	34.6	36.0	41.8	49.1	…
In months of imports of goods and services	2.6	4.4	3.7	4.2	4.1	3.7	3.4	3.3	3.6	4.0	…
External debt service (percent of exports of goods and services) 2/	5.3	4.9	5.1	3.9	3.0	3.1	3.0	2.7	2.0	2.0	…
Hryvnia per U.S. dollar (end of period)	5.31	5.05	5.06	5.05	...	...	...	...	...	...	…
Goods terms of trade (percent change)	9.6	6.2	-0.2	5.2	1.7	-5.1	-0.6	0.6	0.7	0.9	-1.6
Goods and services terms of trade (percent change)	7.8	4.9	1.5	4.3	1.4	-4.1	-0.6	0.5	0.5	0.7	0.0
Savings-Investment Balance (percent of GDP)											
Foreign savings	-10.6	-2.9	1.5	4.2	7.2	9.9	10.1	9.8	8.9	8.7	
Gross national savings	31.8	25.6	23.3	22.8	19.5	17.1	16.6	17.0	18.0	18.4	
Nongovernment	33.2	25.8	22.4	22.1	18.1	15.8	15.6	16.2	17.1	17.5	
Government	-1.4	-0.3	0.9	0.7	1.4	1.3	1.0	0.9	1.0	0.9	
Gross investment	21.2	22.6	24.8	26.9	26.8	26.9	26.7	26.8	27.0	27.1	
Nongovernment	18.2	20.6	22.5	24.3	24.2	24.1	23.7	23.4	23.5	24.3	
Government	3.0	2.0	2.2	2.7	2.6	2.8	3.0	3.4	3.4	2.9	

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Policies assumed here include: (i) a de facto exchange rate peg through 2009, followed by a gradually widening exchange rate corridor; (ii) passive monetary policy through 2009 as a result of foreign exchange interventions to defend the peg; (iii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2009; (iv) full pass-through of rising energy import prices; and (v) alignment of the minimum wage with the minimum subsistence level by end-2009.
2/ Inflation excluding extreme price movements in the CPI components. The concept used here is the 65th percentile of the distribution of the monthly price changes.
3/ The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
4/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

Table 10. Ukraine: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	47.6	47.3	44.9	48.9	56.2	**52.1**	**51.6**	**52.8**	**57.2**	**61.6**	**64.7**	**-8.9**
2	Change in external debt	-4.5	-0.2	-2.5	4.0	7.3	-4.1	-0.4	1.2	4.4	4.3	3.1	
3	Identified external debt-creating flows (4+8+9)	-14.8	-27.3	-26.6	-16.2	-18.0	-4.2	-0.6	0.0	-1.2	-3.2	-3.8	
4	Current account deficit, excluding interest payments	-7.2	-11.9	-4.6	-0.8	1.7	3.9	6.5	6.7	6.1	4.9	4.5	
5	Deficit in balance of goods and services	-2.6	-7.7	-0.8	2.8	5.6	8.2	10.5	10.4	9.8	8.7	8.4	
6	Exports	57.8	63.6	51.5	46.5	45.2	40.6	36.9	35.0	35.7	37.5	37.5	
7	Imports	55.2	56.0	50.7	49.4	50.7	48.8	47.5	45.4	45.5	46.3	45.9	
8	Net non-debt creating capital inflows (negative)	-1.0	-5.8	-11.9	-8.6	-10.6	-8.9	-8.5	-8.5	-8.7	-9.0	-8.9	
9	Automatic debt dynamics 1/	-6.7	-9.6	-10.1	-6.7	-9.1	0.8	1.4	1.8	1.4	0.9	0.6	
10	Contribution from nominal interest rate	1.4	1.3	1.6	2.3	2.5	3.2	3.3	3.4	3.7	4.0	4.3	
11	Contribution from real GDP growth	-4.2	-4.4	-0.9	-2.6	-2.8	-2.4	-1.8	-1.6	-2.3	-3.1	-3.7	
12	Contribution from price and exchange rate changes 2/	-3.8	-6.4	-10.8	-6.5	-8.8	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	10.3	27.0	24.1	20.2	25.3	0.1	0.1	1.2	5.6	7.5	6.9	
	External debt-to-exports ratio (in percent)	82.4	74.4	87.1	105.1	124.3	128.3	139.8	151.1	160.1	164.1	172.6	
	Gross external financing need (in billions of US dollars) 4/	7.3	4.0	9.5	15.9	24.5	40.0	52.4	58.7	61.6	62.5	65.9	
	in percent of GDP	14.7	6.2	11.0	14.7	17.3	21.3	23.4	23.3	23.0	22.0	21.6	
	Scenario with key variables at their historical averages 5/						**52.1**	**46.6**	**40.4**	**34.9**	**30.7**	**26.3**	**-5.6**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	9.6	12.1	2.6	7.3	7.6	5.6	4.2	3.5	4.6	5.8	6.5	
	GDP deflator in US dollars (change in percent)	7.9	15.5	29.4	16.9	21.9	25.5	14.1	9.2	1.3	0.2	1.0	
	Nominal external interest rate (in percent)	3.1	3.4	4.5	6.5	6.8	7.6	7.5	7.5	7.5	7.5	7.5	
	Growth of exports (US dollar terms, in percent)	24.0	42.6	7.5	13.2	27.4	19.1	8.2	7.0	8.2	11.4	7.4	
	Growth of imports (US dollar terms, in percent)	28.7	31.3	20.4	22.0	34.8	27.6	15.6	7.9	6.3	7.8	6.7	
	Current account balance, excluding interest payments	7.2	11.9	4.6	0.8	-1.7	-3.9	-6.5	-6.7	-6.1	-4.9	-4.5	
	Net non-debt creating capital inflows	1.0	5.8	11.9	8.6	10.6	8.9	8.5	8.5	8.7	9.0	8.9	

1/ 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 growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ 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).

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ 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.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 11. Ukraine: Public Sector Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	30.6	25.5	18.7	15.7	12.5	**9.5**	**8.4**	**8.1**	**8.3**	**8.6**	**8.9**	**-0.9**
	o/w foreign-currency denominated	21.6	19.2	14.1	12.5	9.8	7.2	6.2	5.8	6.0	6.1	6.3	
2	Change in public sector debt	-5.1	-5.1	-6.9	-2.9	-3.2	-3.0	-1.2	-0.3	0.2	0.2	0.3	
3	Identified debt-creating flows (4+7+12)	-5.7	-5.6	-9.0	-2.3	-2.5	-3.0	-1.0	0.2	0.9	0.9	0.4	
4	Primary deficit	-0.1	3.5	1.5	0.7	1.5	0.8	1.2	1.7	2.2	2.1	1.6	
5	Revenue and grants	38.0	37.1	41.8	43.7	42.3	43.9	43.7	43.4	42.8	42.6	42.5	
6	Primary (noninterest) expenditure	37.9	40.6	43.3	44.5	43.8	44.7	44.9	45.1	45.0	44.7	44.1	
7	Automatic debt dynamics 2/	-4.6	-6.0	-5.6	-2.7	-3.3	-2.6	-1.3	-0.9	-0.7	-0.7	-0.8	
8	Contribution from interest rate/growth differential 3/	-4.6	-6.0	-4.8	-2.7	-3.4	-2.6	-1.3	-0.9	-0.7	-0.7	-0.8	
9	Of which contribution from real interest rate	-1.7	-3.1	-4.3	-1.6	-2.5	-2.1	-1.0	-0.6	-0.4	-0.3	-0.3	
10	Of which contribution from real GDP growth	-2.9	-2.9	-0.5	-1.1	-0.9	-0.5	-0.3	-0.3	-0.3	-0.4	-0.5	
11	Contribution from exchange rate depreciation 4/	0.0	-0.1	-0.7	0.0	0.0	...	...	...	...	...	...	
12	Other identified debt-creating flows	-1.1	-3.1	-5.0	-0.4	-0.6	-1.2	-0.9	-0.6	-0.6	-0.5	-0.5	
13	Privatization receipts (negative)	-1.1	-3.1	-5.0	-0.4	-0.6	-1.1	-0.8	-0.6	-0.6	-0.5	-0.5	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	-0.1	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/	0.6	0.6	2.1	-0.6	-0.8	0.0	-0.1	-0.4	-0.6	-0.6	-0.1	
	Public sector debt-to-revenue ratio 1/	80.6	68.8	44.6	36.0	29.6	21.7	19.1	18.7	19.5	20.2	20.9	
	Gross financing need 6/	3.6	6.8	5.5	3.1	2.9	1.9	2.2	2.7	3.2	3.1	2.6	
	in billions of U.S. dollars	1.8	4.4	4.7	3.3	4.0	3.6	5.0	6.8	8.6	8.9	8.1	
	Scenario with key variables at their historical averages 7/						**9.5**	**7.5**	**5.7**	**3.8**	**2.3**	**1.5**	**-0.6**
	Scenario with no policy change (constant primary balance) in 2008-2013						**9.5**	**8.0**	**6.6**	**5.4**	**4.5**	**4.1**	**-0.7**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	9.6	12.1	2.7	7.1	7.6	5.6	4.2	3.5	4.6	5.8	6.5	
	Average nominal interest rate on public debt (in percent) 8/	3.3	3.9	3.8	4.2	4.3	4.2	4.3	4.5	4.6	4.7	4.9	
	Average real interest rate (nominal rate minus change in GDP deflator, in per	-4.7	-11.2	-20.8	-9.5	-18.9	-20.5	-12.1	-8.5	-5.3	-3.9	-3.2	
	Nominal appreciation (increase in US dollar value of local currency, in percer	0.0	0.5	5.1	-0.1	0.0	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	8.0	15.2	24.6	14.9	21.8	24.7	16.4	13.0	9.9	8.6	8.1	
	Growth of real primary spending (deflated by GDP deflator, in percent)	21.4	20.2	9.6	9.9	5.9	7.8	4.7	3.9	4.6	5.0	5.2	
	Primary deficit	-0.1	3.5	1.5	0.7	1.5	0.8	1.2	1.7	2.2	2.1	1.6	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
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 - π (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 12. Ukraine: Selected Tax Policy and Administration Priorities.

Authorities proposals[7]	Staff recommendation
Tax policy: ➢ Replace the VAT with a retail stage sales tax (BYT election platform). ➢ Maintain different registration thresholds for the VAT and the Simplified Tax System (STS). ➢ Phase out the foreign exchange transactions tax (FETT) over several years.	**Broaden the tax base and reduce distortions**: ➢ Retain the VAT to ensure compliance, but remove the remaining VAT exemptions and introduce the new VAT regime on agriculture. ➢ Keep preferential investment incentives to a minimum to reduce economic distortions and avoid a large-scale risk of fiscal leakage. Exempting exporters from corporate income tax is discriminatory, facilitates tax evasion, and may be incompatible with the WTO's code of subsidies. Instead use accelerated depreciation and capital allowances to stimulate investment. ➢ Align the STS threshold with that of the VAT; reduce the threshold for physical persons; rationalize eligibility criteria for the regime; and set up a graduation rule from the system. ➢ Immediately abolish the FETT to encourage the development of the foreign exchange market.
Tax administration: ➢ Set a 30 day limit on the conduct of large taxpayer audits, which can only be extended by another 30 days. ➢ Require court approval for collecting unpaid debts, for declining registration to fraudulent taxpayers, and for accessing banking information. ➢ Institute high penalties for underreporting of tax (at 50 percent of underreported liability).	**Provide revenue stability and improve compliance**: ➢ Tax administrations should not set timeframes for completing an audit. Instead, fair treatment of taxpayers should be ensured by setting clear audit standards, publishing taxpayer rights, and allowing for appeals and investigation of allegations of harassment or corruption. ➢ The filing of tax lien, authority to seize financial assets (e.g., cash on hand, securities, bank accounts), setting conditions for registration and deregistration, and accessing banking information for audit purposes should be allowed without court approval to ensure effective collection enforcement and to combat fraud. ➢ Introduce a two-tiered penalty for simple and gross negligence and a separate penalty for late filing, in line with international standards.
VAT administration: ➢ No clear deadline for payment of VAT refunds. ➢ Require a full audit of all VAT cash refunds within 30 days. ➢ Require comprehensive documentation for the monetary reimbursement of VAT credit.	**Ensure timely refund provision to eligible taxpayers**: ➢ Establish a clear deadline for the refund based on the expiry of the carry-forward period. Exporters should be reimbursed monthly, in line with international standards. ➢ Repeal the requirement for a full audit of cash refunds and reduce the need for supporting documentation by introducing a risk-based verification system and a dedicated VAT audit program to ensure compliance. ➢ Ensure that interest is paid on late refunds to compensate taxpayers with legitimate refund claims for being deprived of their working capital. ➢ Adequately budget for projected refund claims.

[7] Selected proposals from the "Concept for Tax Reform" paper, Draft Tax Code, and (where noted) the BYT election platform.

Table 13. Ukraine: Moving to Inflation Targeting: Progress Report

Preconditions	Key Achievements in 2007-08	Further Steps Needed 1/
Institutional framework	• Published a draft Green paper, soliciting public input on options for NBU mandate and independence.	• Finalize the Green paper, and translate this into an Action Plan for 2008-09. • Adopt further amendments to the NBU Act that would provide the NBU with a clear mandate to achieve price stability and allow for greater NBU independence.
Exchange rate flexibility	• Allowed the hryvnia/U.S. dollar exchange rate to fluctuate in a 1 percent corridor, and to occasionally move up to 1 percent outside of this corridor.	• Gradually allow greater exchange rate flexibility, within a narrow but, over time, widening exchange rate corridor.
Monetary policy instruments	• Introduced more active use of deposit facility, focused around two week CDs, although at a low interest rate of 1 percent.	• Identify key policy rate; and actively steer the policy rate within a gradually narrowing interest rate corridor. • Apply monetary instruments in a consistent, transparent, and market-oriented manner.
Capacity to model and forecast	• Regular preparation of a macroeconomic survey assessing short term outlook, including under different monetary policy actions. • Developed an exclusion-based core inflation indicator, and began publishing this from January 2008 • Refined quarterly projection model and quarterly business outlook survey.	• Integrate macroeconomic survey into monetary policy decision making. • Develop full range of core inflation indicators.
Communication of monetary policies	• Introduced more frequent public discussion of monetary policy. • Outreach to financial sector and academia on IT	• Issue an Inflation Report. • Further modernize the NBU website. • Conduct press conferences and issue press releases on inflation targeting.
Financial market development	• Foreign exchange turnover tax reduced to 0.5 percent in 2008 budget. • Prepared a concept note, and draft legislation, on foreign exchange market liberalization	• Abolish the foreign exchange turnover tax. • Develop benchmarks for government securities. • Simplify procedures for working in the foreign exchange market.
Banking sector stability		• Gradually implement more risk-based supervision. • Further tighten banking supervision, regulation, and legislation.

1/ Steps identified in the NBU's 2006 Action Plan and Fund recommendations.

Table 14. Ukraine: Financial Soundness Indicators for the Banking Sector, 2004-07
(In percent, unless otherwise indicated)

	2004	2005	2006	2007				2008
				Mar.	Jun.	Sep.	Dec.	Mar.
Ownership								
Number of banks	160	165	170	173	173	174	175	176
Private	158	163	168	171	171	171	173	174
Domestic	139	140	133	131	129	127	126	127
Foreign	19	23	35	40	42	44	47	47
o/w: 100% foreign-owned	7	9	13	18	17	16	17	17
State-owned	2	2	2	2	2	2	2	2
Foreign-owned banks' share in statutory capital	9.6	19.5	27.6	29.8	32.8	35.0	35.0	36.7
Concentration								
Share of assets of largest 10 banks	53.1	53.8	52.4	53.0	52.5	51.6	49.7	...
Share of assets of largest 25 banks	72.0	73.5	74.3	74.6	75.4	75.2	75.2	...
Number of bank with assets less than $150 million	124	121	109	113	100	97	85	...
Capital Adequacy								
Regulatory capital to risk-weighted assets	16.8	15.0	14.2	14.0	14.0	13.9	13.9	13.3
Capital to total assets	12.9	11.8	11.7	11.6	11.8	11.6	11.7	12.4
Asset Quality								
Credit growth (year-over-year)	31.6	61.9	70.7	73.0	75.6	75.1	74.1	76.2
Credit to GDP ratio	25.8	32.6	45.2	47.7	51.6	55.6	60.1	63.1
Change of loan to GDP ratio (percentage points)	-1.3	6.8	12.6	13.3	14.3	14.6	14.9	15.4
NPLs to total loans 1/ 2/	30.0	19.6	17.8	17.6	16.5	14.8	13.2	...
NPLs (excl. part of timely serviced substandard loans) 1/ 3/	8.9	5.5	4.2	4.2	3.7	3.3	3.2	...
NPLs net of provisions to capital	136.8	100.0	93.6	99.1	94.2	82.2	72.9	...
Specific provisions to NPLs 4/	21.1	25.0	23.1	20.8	23.7	25.9	26.3	...
Specific provisions to total loans	6.3	5.6	4.8	4.7	4.7	4.5	4.2	4.1
Foreign Exchange Rate Risk								
Loans in foreign currency to total loans	42.1	43.2	49.4	50.8	51.2	51.5	49.8	49.4
Deposits in foreign currency to total deposits	36.4	34.3	38.1	38.8	36.5	34.6	32.1	33.1
Foreign currency loans to foreign currency deposits	123.6	136.5	173.3	183.7	206.0	220.8	237.2	238.8
Total net open positions in foreign currency to regulatory capital	14.7	8.6	8.4	9.3	9.1	8.7	7.0	7.7
Banks net foreign assets to capital	1.5	-43.4	-93.4	-100.5	-127.1	-137.7	-147.1	-143.8
Total foreign currency assets (incl. loans) to total foreign currency liabilities (incl. deposits)	115.1	106.5	106.3	108.3	106.4	107.6	105.3	106.3
Total short-term foreign currency assets (incl. loans) to total short-term foreign currency liabilities (incl. deposits)	193.1	146.9	158.6	149.7	129.7	131.5	115.6	130.7
Liquidity Risk								
Liquid assets to total assets	16.4	16.1	12.6	11.4	11.8	11.0	10.3	8.9
Customer deposits to total loans to the economy	93.4	92.2	74.9	71.2	67.9	67.2	65.3	62.4
Long-term assets to long-term liabilities	86.0	90.8	89.7	91.0	93.4	94.7	95.3	93.7
Short-term assets to short-term liabilities	119.2	114.9	120.6	118.2	112.9	110.7	110.0	114.2
Earnings and Profitability								
Return on assets (after tax; end-of-period)	1.1	1.3	1.6	1.6	1.4	1.4	1.5	1.4
Return on equity (after tax; end-of-period)	8.4	10.4	13.5	12.7	11.3	11.6	12.7	11.4
Net interest margin to total assets	4.9	4.9	5.3	4.9	4.9	4.9	5.0	4.8
Interest rate spreads (percentage points; end-of-period)								
Between loans and deposits in domestic currency	9.6	8.3	7.2	5.9	6.5	5.4	5.8	6.3
Between loans and deposits in foreign currency	4.2	4.8	5.4	5.6	5.5	5.5	4.9	5.2
Between loans in domestic and foreign currency	6.2	4.7	3.6	2.5	3.0	2.7	3.2	4.4
Between deposits in domestic and foreign currency	0.8	1.2	1.8	2.2	1.9	2.8	2.3	3.3
Number of banks not complying with banking regulations								
Not meeting capital adequacy requirements for Tier I capital	2	1	0	0	0	1	0	...
Not meeting prudential regulations	14	3	1	0	1	1	1	...
Not meeting reserve requirements	11	3	1	0	0	0	1	...

Sources: National Bank of Ukraine; and staff estimates.

1/ NPLs are those classified as substandard, doubtful, and loss.
2/ Increase in nonperforming loans (NPLs) in 2003 partly due to new classification rules.
3/ The NBU estimates that as of end-March 2004, 6.2 percent of loans classified as substandard were being timely serviced.
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 15. Ukraine: FSAP Update Priority Recommendations

Vulnerabilities	Measures	Priority
Bank balance sheet risks		
• Growing indirect credit risk, due to increasing balance sheet currency mismatches. • Growing direct credit risk, due to rapid credit growth. • Growing liquidity risk, due to dependence on foreign financing.	• Reduce incentive for balance sheet mismatches by gradually shifting to a flexible exchange rate within an inflation targeting regime. • Targeted prudential strengthening (e.g. higher risk weights for riskier assets). • Close monitoring of liquidity risk management of banks. • Contingency planning, including enhanced stress testing.	High
Banking sector development		
• Increasing complexity of the financial system • Large remnant of small structurally weak banks	• Deepen consolidated supervision. • Deepen supervisory cooperation. • Increase bank disclosure standards and transparency practices. • Strengthen bank resolution framework to facilitate merger and acquisition.	High
Capital market development		
• Debt market underdevelopment • Inadequate legal, regulatory, and supervisory framework for securities markets	• Issue more Hrv denominated government debt • Greater independence and financial autonomy for securities and NBFI regulators • Increase NBFI disclosure standards and transparency practices.	Medium

Table 16. Ukraine: Millennium Development Goals

	1990	1994	1997	2000	2003	2004	2005
Goal 1. Eradicate extreme poverty and hunger							
Population below minimum level of dietary energy consumption (in percent)	..	..	..	..	3.0	3.0	…
Poverty headcount, national (percent of population)	..	..	..	..	20.0	..	..
Prevalence of underweight in children (under five years of age)	..	..	..	3.0	1.0	..	..
Goal 2. Achieve universal primary education							
Net primary enrollment ratio (percent of relevant age group)	..	..	..	..	85.0	86.0	…
Primary completion rate, total (percent of relevant age group)	100.6	93.5	..	92.0	95.0	..	..
Proportion of pupils starting grade 1 who reach grade 5	..	..	..	..	..	..	..
Youth literacy rate (percent ages 15-24)	100	..	..	..	..	100	…
Goal 3: Promote gender equality and empower women							
Proportion of seats held by women in national parliament (percent)	10.8	..	8.7	9.9	12.7	...	...
Ratio of girls to boys in primary and secondary education (percent)	..	..	..	99.5	99.2	98.5	95.0
Ratio of young literate females to males (percent ages 15-24)	100	..	..	..	..	100.1	...
Share of women employed in the nonagricultural sector (percent)	50.0	51.0	52.0	53.0	54.0	54.0	...
Goal 4: Reduce child mortality							
Immunization, measles (percent of children ages 12-23 months)	..	96.0	97.0	99.0	99.0	99.0	...
Infant mortality rate (per 1,000 live births)	19.0	..	..	18.0	..	14.0	...
Under 5 mortality rate (per 1,000)	26.0	..	..	24.0	..	18.0	...
Goal 5: Improve maternal health							
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	35.0	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases							
Incidence of tuberculosis (per 100,000 people)	41.5	..	..	..	..	100.5	...
Prevalence of HIV, total (percent of population aged 15-49)	..	..	..	..	1.0	1.0	1.0
Goal 7: Ensure environmental sustainability							
Access to an improved water source (percent of population)	..	..	..	..	98.0	..	..
Access to improved sanitation (percent of population)	99.0	..	..	..	99.0	..	..
CO2 emissions (metric tons per capita)	..	..	6.0	6.0	7.0	..	..
Forest area (percent of total land area)	28.9	..	..	26.1	..	15.7	..
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	..	2.0	1.0	2.0	2.0	2.0	...
Nationally protected areas (percent of total land area)	..	..	..	..	3.9	3.9	...
Goal 8: Develop a global partnership for development							
Aid per capita (current US$)	5.6	5.6	5.3	11.0	6.8	7.6	...
Fixed line and mobile phone subscribers (per 1,000 people)	135.4	155.4	187.1	228.5	368.3	545.3	...
Internet users (per 1,000 people)	0.0	0.1	2.0	7.1	52.3	79.0	97.0
Personal computers (per 1,000 people)	1.9	6.9	11.9	18.1	23.5	28.0	...

Source: World Development Indicators database, September 2006.

APPENDIX I: UKRAINE—FUND RELATIONS
(As of March 31, 2008)

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

II. General Resources Account:	**SDR Million**	**Quota**
Quota	1,372.00	100.00
Fund holdings of currency	1,552.95	113.19
Reserve position in Fund	0.00	0.00

III. SDR Department:	**SDR Million**	**%Allocation**
Holdings	7.56	N/A

IV. Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
Extended arrangements	180.95	13.19

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)[8] (SDR million; based on existing use of resources and present holdings of SDRs):

	2008	2009
Principal	123.66	57.28
Charges/Interest	5.15	1.23
Total	128.81	58.51

[8] 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.

VII. Projected Payments to Fund (Obligations basis)[9] (SDR million; based on existing use of resources and present holdings of SDRs):

	2008	2009	2010	2011	2012
Principal	99.43	57.28		24.23	
Charges/Interest	5.25	2.20	0.97	0.87	
Total	169.84	60.76	2.12	49.84	

VIII. 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.

IX. 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. Since March 19, 1999, the exchange rate for the hryvnia has been determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention to allow the free float of the hryvnia, but has intervened regularly to limit fluctuations. The exchange rate arrangement has been reclassified, effective January 1, 2001, as a conventional pegged arrangement. On March 31, 2008 the official hryvnia/U.S. dollar rate has stood at 5.05.

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 on current international transactions were introduced in September 1998, and were removed in March 1999.

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[9] 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.

X. Article IV Consultation:

The discussions for the 2008 Article IV Consultation took place in Kyiv between March 20 and April 1, 2008. The concluding statement of the mission was posted at www.imf.org on April 16, 2008.

The IMF team comprised Messrs. Ford (Head), Flanagan, Moulin (all EUR), Mr. Driessen (MCM), Ms. Zakharova (FAD), Mr. Hofman (PDR), and Mr. Horvath, Resident Representative.

The mission met with NBU Governor Stelmakh, Finance Minister Pynzenyk, Economy Minister Danylyshyn, First Deputy Chief of Staff to the President Shlapak, other senior officials, representatives of parliament, the diplomatic community, financial sector, and think tanks. Mr. Yakusha (OED) attended the discussions.

A separately published *Selected Issues* Paper provides background on two topics: (1) Two Aspects of the Ukrainian's Business Cycle; (2) Strengthening Ukraine's Fiscal Framework. A forthcoming *Working Paper* provides background on Resolving Large Contingent Fiscal Liabilities.

The previous consultation was concluded on January 12, 2007. The conclusions of the Executive Board's discussions and country documents were made available at www.imf.org on February 5, 2007.

XI. FSAP Participation

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. The observance of the following standards and codes was 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 further update mission visited Ukraine between June 11-22, 2007 and July 9-20, 2007. The observance of the following standards and codes was assessed: Basel Core Principles for Effective Banking Supervision; and IOSCO Core Principles of Securities Regulation. An updated Financial Sector Stability Assessment (FSSA) is expected to be considered by the Executive Board as part of the present Article IV consultation.

XII. ROSCS

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).

XII. Fund Technical Assistance Missions, 2003-08 (As of April 16, 2008)

Department	Type of Mission	Timing
FAD	Modernizing the State Tax Service	February 7–21, 2006
	Macro-fiscal Analysis	January 10–18, 2006
	Reform of the State Customs Service	December 2006
	Proposals to Reform the Tax System	October 5–18, 2005
	Customs Administration	June 7–21, 2005
LEG	Workshop on the Use of Cash Couriers and Cross-Border Operations for Money Laundering and the Financing of Terrorism	April 2007
	Workshop on Effective Enforcement of Criminal Justice Measures in Anti-Money Laundering and Combating the Financing of Terrorism	April 2005
MCM	Monetary Policy Operations	March 27-April 4, 2008
	Monetary policy, banking supervision, and other core central bank functions.	November 5-11, 2007
	Operational Preparations for Exchange Rate Flexibility	September 3-10, 2007
	Monetary policy, banking supervision, and other core central bank functions.	July 14-17, 2007
	NBU Internal Audit and Financial Reporting	September 4–12, 2006
	Monetary Policy Communication Strategy	March 6–14, 2006
	Monetary Policy Operations	January 23–February 2, 2006
	Operational Preparations for Exchange Rate Flexibility	December 11–21, 2005
	Action Plan for Transition to Inflation Targeting	October 10–14, 2005
	Foreign Exchange Markets	July 20–28, 2005
	Debt Management Strategy (with ICM)	June 23–July 7, 2005

Department	Type of Mission	Timing
	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
STA	Balance of Payments Statistics	June 29–July 12, 2005
	Real Sector Statistics	March 21–April 1, 2005
ICM	Management of External Debt	May 31-June 3, 2005

XII. Fund Resident Representatives and Advisors, 2003–08 (as of April 1, 2008)

Purpose	Representatives/Advisors	Assignment
Resident Representatives		
Senior Resident Representative	Mr. Franks	September 2004 – August 2007
	Mr. Figliuoli	August 2001–August 2004
Resident Representative	Mr. Horvath	Since October 2007
	Mr. Lissovolik	July 2001–January 2004
Advisors		
Advisor on Inflation Targeting to the National Bank of Ukraine	Mr. Vavra	Since January 2006, bi-monthly visits. November 2004–November 2005
Macro Policy Advisor to the Ministry of Finance	Mr. Marion	2005–06
Banking Supervision Advisor at the NBU	Mr. Livesay	April 2005–October 2005

APPENDIX II: UKRAINE—RELATIONS WITH THE WORLD BANK
(April 2008)

The IMF and World Bank staffs discussed their respective work programs during April 2008 (Table 1):

- The World Bank presently has a lending program with Ukraine, and in the context of a planned DPL III loan for late 2008, requested an updated IMF assessment of the macroeconomic framework, inflation developments, and the alignment of the real exchange rate with fundamentals. The IMF staff agreed to this.
- The IMF staff foresaw surveillance and technical assistance activity in 2008-09, and requested two key inputs from the bank covering targeted budget cuts and regulated pricing reform. World Bank staff noted that they would be able to update previous PER work on expenditure cuts in time for the 2009 budget, and that they could provide inputs on regulated pricing in the energy and, possibly transportation sectors.

Macro critical sectoral issues:

- *Tax system reform*. Both teams expect to be involved, the Bank through an on-going policy dialogue and a review of draft legislation, and the Fund through desk review of any new draft legislation. It was agreed that, as in the past, comments would be shared and coordinated prior to their being forwarded to the government.
- *Expenditure policy reform*. The World Bank has the lead on this issue in light of recent PFR work. The IMF staff agreed to promote cutbacks identified within the PFR, and updated by Bank staff, in the context of needed upcoming budget restraint.
- *Energy sector reform*. The World Bank is expected to take the lead on this issue, including identifying underpricing and near-term reforms to improve the process of tariff setting. The teams agreed to discuss any proposed path for unwinding implicit subsidies before presenting details to the government.
- *Pension reform.* The World Bank is expected to take the lead on this issue, building on its ongoing advice to the government. The teams agreed to discuss the timing of introduction of second pillar against macroeconomic constraints and capital market development conditions.
- *Broader tariff policy*. The World Bank is expected to take the lead on this issue. Analysis would be confined in 2008-09 to the transportation sector (with a focus on the railways). The Bank staff agreed to keep IMF staff informed of tariff policy recommendations arising from this analysis.

Table 1. Details of IMF and World Bank Work Programs

Title	Products	Provisional Timing of Missions	Expected Delivery Date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	Development Policy Loan III	May 2008 September 2008 October 2008	December 2008
	Country Economic Memorandum (CEM)	May 2008 September 2008	December 2008
	Dialogue on Economic and Fiscal issues, including: expenditure policy, tax policy (and tax administration), trade and FTA; other at Government's request	May 2008 June 2008 September 2008 March 2009	June 2009
	TA on capital budgeting and other PFM issues	June 2008 September 2008 March 2009	June 2009
	Trade logistics and facilitation assessment	June 2008 September 2008	December 2008
	Financial sector TA (banking supervision with NBU, non-bank regulatory and supervision reform together with USAID)	June 20008 September 2008 March 2009	June 2009

Table 1 (continued). Details of IMF and World Bank Work Programs

Title	Products	Provisional Timing of Missions	Expected Delivery Date
A. Mutual information on relevant work programs			
IMF work program in next 12 months	Article IV	March/April 2009	May/June 2009
	Staff visit	November 2008	November 2008
	<u>TA to NBU:</u>		
	Monetary operations	May 2008	August 2008
	Macro modeling	May 2008	August 2008
	Business surveys	September 2008	December 2008
	Inflation targeting	October 2008	January 2009
	Stress testing	October 2008	January 2009
	Accounting	October 2008	January 2009
	Monetary operations	October 2008	January 2009
	Inflation targeting	December 2008	March 2009
	Inflation targeting	March 2009	June 2009
	Accounting	March 2009	June 2009
	Business surveys	April 2009	July 2009
	<u>TA to MoF:</u>		
	Macro-fiscal	August 2008	August 2008
	Macro-fiscal	February 2009	February 2009
	Tax system (desk review of new law)	...	...
	<u>TA to SSC:</u>		
	National accounts	April 2009	April 2009

Table 1 (concluded). Details of IMF and World Bank Work Programs

Title	Products	Provisional Timing of Missions	Expected Delivery Date
	B. Request for work program inputs		
Fund request to Bank (with summary justification)	1. Analysis of cost recovery (under-pricing) in the energy sector). *To inform the transition to inflation targeting.* 2. Quantified list of possible targeted recurrent budget spending cuts. *To help steer the economy back to internal stability.*		
Bank request to Fund (with summary justification)	1. Assessment of exchange rate over/under-valuation 2. Assessment of the underlying and temporary factors driving inflation. 3. Evaluation of sustainability of macroeconomic framework.		Sept/Oct 2008
	C. Agreement on joint products and missions		
Joint products in next 12 months	...		

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

APPENDIX III: UKRAINE—RELATIONS WITH THE EBRD
(February 2008)

Ukraine joined the EBRD in 1992 and since then the EBRD has been active in supporting Ukraine's transformation toward a market economy. Successive country strategies have focused on:

- Financing private sector projects, developing the financial sector and rehabilitating existing infrastructure (1992-93).
- Strengthening the financial sector and supporting the needs of SMEs; promoting the commercialization and structural reform of public utilities; and improving energy efficiency and supporting the transition of the enterprise sector, especially in agribusiness (2000).
- 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 commencing funding for the agricultural sector through the provision of working capital (2004).
- Helping to improve the business climate and the competitiveness of the private sector; strengthening the institutional capacity of the financial sector and increasing the level of finance for micro enterprises and SMEs; and supporting the restructuring and modernization of Ukraine's road, railway, harbor, airport infrastructure, power and oil & gas sectors (2005).

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 established between EBRD and the Ministry of Transport.

In 2007 Ukraine rose to become the Bank's 3rd largest exposure (after Russia and Poland), representing approximately 8.3% of the Bank's signed commitments as of 1 July 2007. This is significant in as much as during the two previous strategy periods Ukraine was ranking fifth in terms of exposure. As of 31 December 2007 the Bank had invested in 155 projects with a net cumulative business volume (the "NCBV") of € 3,1 billion, €with private sector projects representing 72% of the NCBV and non sovereign operations representing 67% of the NCBV. In terms of the sector distribution of Bank financing, 31% of the portfolio is in

Infrastructure, some 21% in General Industries, 20% in Specialised Industries (mostly Agribusiness), 20% in Financial Institutions and the balance of 8% in Energy.

The **current country strategy**, approved in September 2007, outlines four main areas of operational focus: (i) promoting higher efficiency, competitiveness and corporate governance standards in the local private sector and assisting foreign direct investment; (ii) promoting the development of the domestic capital markets and providing continued support to micro, small and medium-sized private enterprises through dedicated long-term credit lines with partner banks; (iii) promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy; and (iv) improving efficiency and reliability of key infrastructure, power generation, transmission and distribution and of the oil and gas transport systems of Ukraine.

In terms of **developing the local private sector and encouraging FDI**, the Bank actively participated in financing key foreign investors such as IKEA, but also cross-border transactions with sponsors from countries of operations such as the Polish sanitary ware producer Cersanit and Serbian Agroinvest. In the retail sector the Bank supported the development of the leading local supermarket chain Furshet.

Program promoting the **development of domestic capital markets**, in 2007 the Bank launched its Hryvnia Lending Programme with the successful establishment of KievPrime, a credible local currency interbank index. The Bank completed successful syndications in favor of local commercial banks, such as Kreditprom bank. Provision of mortgage finance for Forum bank and finance for small and medium businesses continued through EBRD credit lines to Mega bank. The EBRD intensified significantly its investments in the property sector with loans to property developer Cantik and participation in two commercial property funds.

The strategic goal of supporting **environmental protection and energy efficiency and security** related projects was pursued in 2007 with the industrial energy efficiency credit line to UkrExim bank. The EBRD continued its support for local private business in the oil and gas sector by financing downstream operator Galnaftogas and the exploration company Cadogan Petroleum. A significant milestone in the activities of the Chernobyl Shelter Fund and the Nuclear Safety Account – two major donor-funded programs administered by the EBRD - was the signing of the contract for the construction of the new safe confinement for Unit 4 and the contract for the completion of the dry fuel storage facility at Chernobyl Nuclear Power Plant.

In the **infrastructure** area, important recent projects include the first municipal transport projects for the Kiev Metropolitan and the Kiev Municipal bus company and the first investment in the media and telecommunications sector in favor of Volia cable operator.

APPENDIX IV: UKRAINE—STATISTICAL ISSUES

Economic and financial data provided to the Fund are broadly adequate for surveillance, but as discussed below there are some shortcomings, particularly in national accounts and balance of payments data. 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, the country became the first CIS country to subscribe to the SDDS. The 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.

Real sector statistics

The *1993 SNA* is the general framework for compiling national accounts. The classifications used are largely in accordance with international standard. Source data are obtained from the extensive survey program of the State Customs Service (SCS), supplemented with data from administrative and other sources. The main survey report forms have been revised significantly in recent years to bring them in line with the definitions, scope, and classifications of the 1993 SNA, and new chart of accounts of enterprises. Significant improvements have been introduced in the compilation and seasonal adjustment of quarterly GDP.

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 agree 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. A STA mission is currently in the field, and it will examine the recent improvements introduced in the compilation of currently available national accounts series, having 200 as new base year, and will assist as needed to further strengthen quality of the annual and quarterly accounts.

Government finance statistics

The Ministry of Finance (MOF) and State Treasury have made considerable progress in compiling fiscal data. The Ministry 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 *GFSM 1986*. From 2002, the functional classification has been consistent with *GFSM 2001*, the current international standard. All central and local government transactions are recorded in the

Treasury Single Account. Starting in 2004, the authorities have provided STA with local government expenditures, with latest data reported for the period through 2006.

The data ROSC report highlighted that government finance statistics are available monthly, but do not provide the recommended coverage. The authorities have since reported central and local government data for 1999-2006 in the *GFSM 2001* format for publication in the *GFS Yearbook*. However, timely publication of data from government extrabudgetary funds such as the pension and insurance funds remains an issue.

Monetary and financial statistics
The data ROSC mission recommended that the timeliness of the analytical accounts of the central bank be improved using the daily accounting records on monetary operations. SDDS flexibility options are used for monetary data: the first for timeliness of the analytical accounts of the banking sector and the second for the timeliness of the analytical accounts of the central bank.

The authorities use the Standardized Report Forms (SRF) for reporting monetary data to STA and EUR. In addition, data beginning from December 2001 have been converted into the SRF framework and published in *IFS Supplement* since September 2006, and are available online.

External sector statistics

The balance of payments statistics are compiled in broad conformity with the fifth edition of the *Balance of Payments Manual* and are reported quarterly to STA with a lag of about ten weeks. The principal data sources are the International Transaction Reporting System (ITRS), surveys of enterprises, and administrative data.

Following the recommendations of the data ROSC mission, the authorities have expanded the survey on inter-enterprise arrears to include information relevant for balance of payments purposes. In July 2003, the NBU lowered the reporting thresholds for banks within the ITRS, which resulted in a considerable increase in the coverage of transactions. A one-off survey of migrant and related remittances is planned to be conducted in June 2008, and it is hoped that this will be the basis for improving the quality of data on shuttle trade, compensation of employees, workers' remittances, and travel. Some weaknesses exist in the identification and classification of financial flows stemming from capital flight. The authorities have made progress in disseminating international reserves data and external debt statistics. The release of monthly data on official reserves, in line with the Fund's reserve template, started in mid-2002, and those on quarterly external debt, in line with the *External Debt Statistics Guide* (2003), started in September 2004.

Though the cooperation between different government agencies has improved in recent years, problems still exist in coordinating the work of the NBU and the State Statistics Committee, particularly regarding the statistics on services. An April 2008 Fund technical assistance mission in external sector statistics focused mainly on the assessment of accuracy and reliability of external sector statistics, specifically the coverage and recording of financial transactions. The mission noted that data on trade in goods remain considerably understated and a detailed study of errors in coverage and valuation of goods need to be conducted. Some classification errors in financial flows were identified and their correction should ensure consistency between financial flows and stocks. With financial support from the World Bank, the NBU undertook a study of foreign exchange cash inflows during the past ten years and used the results to estimate the stock of foreign exchange cash outside the banking system. The data will be incorporated in the IIP for 2007.

UKRAINE: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
APRIL 23, 2008

	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]	Data Quality Accuracy and reliability[8]
Exchange Rates	3/2008	4/7/2008	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	3/2008	4/22/2008	W	W	M		
Reserve/Base Money	2/2008	3/20/2008	W	W	M	O, LO, O, O	O, O, O, O, NA
Broad Money	2/2008	3/20/2008	M	M	M		
Central Bank Balance Sheet	2/2008	3/20/2008	M	M	M		
Consolidated Balance Sheet of the Banking System	2/2008	3/20/2008	M	M	M		
Interest Rates[2]	2/2008	3/20/2008	W	W	M		
Consumer Price Index	2/2008	4/9/2008	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/31/2007	1/28/2008	M	M	M	O, LO, LO, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	1/31/2008	2/15/2008	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	1/31/2008	2/15/2008	M	M	M		
External Current Account Balance	Q3 2007	Dec. 2007	Q	Q	Q	O, LO, LO, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q3 2007	Dec. 2007	Q	Q	Q		
GDP/GNP	Q3 2007	Nov. 2007	Q	Q	Q	O, LO, O, O	O, LO, O, O, LO
Gross External Debt	Q3 2007	Dec. 2007	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.

Statement by the IMF Staff Representative
June 2, 2008

1. Since the issuance of the staff report, more information about 2008 developments has become available, the National Bank of Ukraine (NBU) has continued to take steps toward greater exchange rate flexibility, and the NBU has taken measures to give administrators of problem banks more authority. This information does not change the thrust of the staff appraisal.

2. The economy has been stronger than expected, but imbalances have also grown. In the first four months of 2008, real GDP growth remained robust at 6.2 percent year-on-year. CPI inflation continued to climb, with the 12 month rate exceeding 30 percent in April. The cumulative 12-month current account deficit is estimated to have risen to 5.4 percent of GDP in March 2008, owing to surging imports. Since peaking in late March, eurobond spreads have come down by as much as 50 basis points, while access to longer term external financing has picked up, with some $850 million in direct and syndicated loans and $400 million in eurobonds issued in May. These developments suggest that risks could be tilting towards the high-growth and high-imbalances scenario laid out in the staff report.

3. While the fiscal position has remained in surplus, spending pressures are mounting. As in past years, the general government budget has recorded a surplus through late-May. An inflation-driven surge in revenues has helped to pay for large expenditure increases (50 percent during the first quarter of the year), but this revenue expansion along with indexation requirements for wages and transfers has led to heavy pressure for a supplementary budget. A recent constitutional court ruling which overturned the government's latest strategy for avoiding unfunded social mandates (amounting to some 9 percent of GDP) has placed additional pressure on the government, and new legislation is in process to contain this risk.

4. The NBU has allowed the exchange rate to fluctuate, and appreciate, outside the previous narrow de facto band. In late May, it revalued the official exchange rate by 4 percent, and resumed intervening to bring market rates broadly into line with the new official rate (but without announcing new bands). The NBU supervisory council (comprised of parliamentarians and Presidential appointees) initially objected, but the head of the council later indicated that a wider exchange rate band may soon be sanctioned and a new mechanism would be introduced to keep the official exchange rate in line with market rates. These changes would be in line with staff advice. Needed supporting actions, including public and decisive government support for regime transition, clear NBU communication about policies, and cancellation of the fx tax, remain as enumerated in the staff report.

5. The NBU has amended regulations governing the financial administration of problem banks. Administrators now have broader rights to seek buyers for banks failing to meet minimum liquidity requirements. This is in line with advice in the FSAP update.

INTERNATIONAL MONETARY FUND
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Public Information Notice (PIN) No. 08/68
FOR IMMEDIATE RELEASE
June 12, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation with Ukraine

On June 2, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.[1]

Background

Growth remained strong in 2007. Real GDP growth reached 7.6 percent, on par with the average since 2000, and in line with other CIS countries. Production and investment have been resilient despite an uncertain political climate and supply-side shocks (a doubling of imported natural gas prices since 2005 and a poor 2007 agricultural harvest).

Rapid domestic demand growth pushed the economy beyond its capacity in 2007–08, leading to accelerating inflation. The demand expansion, fed by fiscal and incomes policies and a capital-inflow driven surge in money and credit growth, in combination with rising food and energy prices, gradually lifted CPI inflation to over 30 percent by end-April 2008. Core inflation has also risen, nominal wage growth is very high, and inflation expectations have drifted up.

The current account deficit continued to deteriorate in 2007, due to very strong domestic demand growth, but it remains broadly consistent with fundamentals. The deterioration has occurred despite terms of trade gains, which may reverse as gas prices rise and if steel prices revert toward their historical trend. If domestic demand

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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.

and inflation are not contained, a further erosion of cost competitiveness would move the hryvnia toward real overvaluation.

Capital inflows, including FDI, remain strong, but private external debt and debt rollover have risen sharply. The economy has become more sensitive to balance-sheet risks and deteriorating global liquidity conditions. However, some external debt may be held by Ukrainians (i.e. misrecorded) and some offset by unrecorded foreign exchange assets in Ukraine. International reserves remain at comfortable levels.

Banks' credit risks have increased, reflecting very high lending growth, including in foreign exchange to unhedged borrowers. Surging liabilities to non-residents, although in part reflecting the presence of foreign banks, point to growing liquidity risks. And, with house prices high relative to incomes, credit risks on mortgages have grown.

The effects on Ukraine of international financial market turbulence have begun to recede. Reflecting Ukraine's vulnerabilities, external spreads rose sharply beginning in mid-2007 and euro-bond issuance dried up. However, eurobond spreads have been falling since late-March 2008, while access of banks and corporates to longer term external financing has resumed, facilitating rollover of debt maturities.

The fiscal stance has been procyclical. Nominal spending has risen by over 30 percent a year since 2003, reflecting rapidly rising public-sector wages and social transfers and, in early 2008, partial restitution of Soviet-era deposits that had been wiped out by hyperinflation in the early 1990s. General government deficits have been kept moderate, as spending growth has been paid for by inflationary revenue windfalls. This has allowed the public debt to decline to just over 10 percent of GDP.

Monetary conditions have tightened somewhat of late. The National Bank of Ukraine (NBU) stepped up sterilization and imposed new reserve requirements on banks' foreign borrowing beginning in late 2007, instituted new prudential measures in early 2008, and since March 2008 has allowed the exchange rate to appreciate outside the previous de facto Hrv/$ 5.00-5.06 band. Excess banking system liquidity has fallen considerably, interest rates have risen sharply, notably on the interbank market, and lending in foreign currency has slowed significantly. Nevertheless, real interest rates remain negative and overall credit growth is still very high—76 percent year-on-year in March.

Progress has been made on the structural reform agenda, but much remains to be done. WTO accession was a significant achievement, but compared to other transition economies Ukraine lags in energy efficiency, internal price liberalization and has notable weaknesses in its business environment, especially in the area of tax administration. Development of the high-potential agricultural sector remains constrained by the lack of a market for agricultural land.

Executive Board Assessment

Executive Directors commended Ukraine’s continued strong economic growth and increased overall resilience to shocks. They noted that reserves have increased substantially, the fiscal position is sustainable, the financial sector appears well capitalized and profitable, and foreign direct investment is strong. These developments would support Ukraine’s considerable long-term growth potential, the realization of which will require the steady pursuit of sound macroeconomic policies and growth-enhancing structural reforms.

Directors also expressed concern that some macroeconomic vulnerabilities have increased. Significantly higher inflation and a wider external current account deficit reflect volatility in world commodity prices, but mainly strong domestic demand growth. Directors cautioned that rapid domestic lending growth, including in foreign exchange to unhedged borrowers, and high house prices have increased credit risks. They welcomed the authorities’ efforts to mitigate liquidity risks arising from growing external borrowing and debt rollover needs in the context of the global financial market turbulence.

Directors noted uncertainties regarding growth prospects, but agreed that further tightening of policies will be required to buttress macroeconomic stability. In this context, they welcomed the authorities’ intention to tighten fiscal policy, which will be critical for restraining domestic demand and reducing inflationary pressures. They encouraged the authorities to aim for a near-balanced budget—or tighter—in 2008. At the same time, Directors considered that, should growth slow significantly and inflationary pressures ease, a larger fiscal deficit could be accommodated if financing is available. Directors also saw merit in taking steps to strengthen the fiscal framework more generally to improve fiscal policy formulation and assessment, in particular by broadening fiscal coverage, and adopting a medium-term fiscal framework.

To achieve the desired fiscal tightening, Directors suggested that growth in social transfers will need to be reined in, and increases in minimum wages and public sector wages scaled back. In addition, further restitutions of depreciated Soviet-era bank deposits should be spread over a number of years. To shore up revenues, administration of the value added tax should be strengthened, and the tax itself preserved. Tax cuts, while desirable as part of an overall reduction in the size of government, should be fully offset with spending cuts or tax base broadening. Gas prices should be fully passed through to final consumers, with vulnerable groups protected by better-targeted social programs.

Directors underscored the importance of a tight monetary stance to fight inflation. Directors generally considered that a shift to a more flexible exchange rate would enhance the effectiveness of monetary policy, and welcomed the 2008 monetary guidelines, which call for a gradual transition to a flexible exchange rate and ultimately to inflation targeting. They were encouraged by the authorities' recent actions to allow greater exchange rate flexibility, and encouraged the authorities to communicate clearly and consistently to the markets and the public about the move. Directors generally felt that if recent flexibility were allowed to continue in the context of a wider official trading band, it would help underscore the two-way risk to domestic borrowing in foreign currency. A few Directors were not persuaded of the desirability of exchange rate flexibility leading to inflation targeting. Directors stressed the importance of developing foreign exchange and money markets, in particular noting a weak interest rate channel of monetary policy transmission. While some Directors noted the uncertainties surrounding the assessment of the current level of the real exchange rate, Directors generally agreed that the real exchange rate appears to be broadly consistent with fundamentals.

Directors stressed that decisive government support for a new inflation targeting regime will be fundamental, particularly in the form of a clear inflation-targeting mandate and operational independence for the monetary authorities. It would also be important for the government to abolish the tax on foreign exchange transactions, securitize its debt to the National Bank of Ukraine, issue more public debt in domestic currency, and further liberalize domestic prices to provide monetary policy maximum leverage over inflation.

Directors welcomed the authorities' progress in implementing the FSAP recommendations, noting that financial indicators have improved further. However, they noted that Ukraine's financial sector vulnerabilities remain. In this context, they supported recent measures to identify bank owners, raise minimum capital requirements, improve risk management practices, and curb banks' foreign borrowing. They encouraged efforts to fully develop consolidated supervision, improve banks' stress testing and risk management capabilities, intensify on-site examinations, and impose stronger prudential requirements on banks with deteriorating liquidity positions.

Directors suggested that productivity-enhancing structural reforms should play a significant role in boosting growth and restraining inflation over the medium term. In particular, they looked forward to the positive impact of Ukraine's WTO accession on enhancing market competition and economic efficiency. They encouraged the authorities to push forward in improving the business environment and the legal framework.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Ukraine: Selected Economic and Social Indicators, 2003-09

	2003	2004	2005	2006	2007 Est.	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)							
Nominal GDP (billions of hryvnias)	267	345	441	544	713	939	1139
Real GDP	9.6	12.1	2.7	7.3	7.6	5.6	4.2
Domestic demand (contribution)	11.4	9.1	13.2	13.1	16.1	11.6	6.9
Net exports (contribution)	-1.8	3.0	-10.5	-5.8	-8.5	-6.0	-2.7
Output gap	-1.0	3.3	-0.6	-0.3	1.4	1.1	-0.4
Unemployment rate (ILO definition; percent)	9.1	8.6	7.2	6.8	6.4	5.5	5.7
Consumer prices (period average)	5.2	9.0	13.5	9.1	12.8	23.2	16.4
Consumer prices (end of period)	8.2	12.3	10.3	11.6	16.6	18.5	13.2
Core inflation (end of period) 2/	8.7	12.0	13.8	7.2	13.4	17.3	12.3
Nominal monthly wages (average)	23.0	27.5	36.7	29.2	29.7	39.3	27.0
Real monthly wages (average)	16.9	17.0	20.5	18.6	15.0	13.1	9.1
Public finance (percent of GDP) 3/							
Cash balance	-0.9	-4.4	-2.3	-1.4	-2.0	-1.2	-1.5
Revenue 4/	38.0	37.1	41.8	43.7	42.3	43.9	43.7
Expenditure (cash basis)	38.9	41.5	44.1	45.1	44.3	45.1	45.2
Primary balance (cash basis)	0.1	-3.5	-1.5	-0.7	-1.5	-0.8	-1.2
Cyclically adjusted balance 5/	-0.4	-6.0	-2.0	-1.2	-2.7	-1.7	-1.4
Privatization proceeds	1.1	3.1	5.0	0.4	0.6	1.1	0.8
Net domestic financing	-1.2	-0.1	-3.3	-0.4	0.3	-0.1	0.4
Net external financing	1.0	1.4	0.6	1.3	1.0	0.1	0.3
Public debt 6/	30.6	25.5	18.7	15.7	12.5	9.5	8.4
Of which: external debt	21.6	19.2	14.1	12.5	9.8	7.2	6.2
Money and credit (end of period, percent change)							
Base money	30.1	34.1	53.9	17.5	46.0	37.3	26.4
Broad money	46.5	32.3	54.4	34.5	51.7	38.9	27.1
Credit to nongovernment	61.5	31.6	61.9	70.7	74.0	40.1	31.1
Velocity 7/	2.8	2.7	2.3	2.1	1.8	1.7	1.6
Interbank overnight rate (annual average, percent)	6.8	5.7	3.5	2.9	1.5	...	...
Balance of payments (percent of GDP)							
Current account balance	5.8	10.6	2.9	-1.5	-4.2	-7.1	-9.8
Foreign direct investment	2.8	2.6	8.7	5.3	6.5	6.8	6.5
Gross reserves (end of period, billions of U.S. dollars)	6.9	9.5	19.4	22.3	32.5	36.5	35.6
In months of next year's imports of goods and services	2.3	2.6	4.4	3.7	4.2	4.1	3.7
Debt service (in percent of exports of goods and services) 5/	6.2	5.3	4.9	5.1	3.9	3.0	3.1
Goods exports (annual volume change in percent)	14.2	18.2	-8.5	2.7	6.9	4.0	3.3
Goods imports (annual volume change in percent)	30.4	13.8	13.0	12.5	20.3	13.9	8.9
Goods exports	47.4	51.5	40.7	36.1	35.2	32.1	28.5
Goods imports	47.9	45.8	42.0	40.9	42.7	41.5	40.7
Share of metals in merchandise exports (percent)	35.8	39.0	40.1	42.2	37.4	35.6	36.1
Net imports of energy (billions of U.S. dollars)	5.1	6.0	6.1	8.1	10.0	15.3	18.1
Goods terms of trade (percent change)	8.7	9.6	6.2	-0.2	5.2	1.7	-5.1
Goods and services terms of trade (percent change)	7.3	7.8	4.9	1.5	4.3	1.4	-4.1
Exchange rate							
Exchange rate regime			*de facto peg*			...	
Hryvnia per U.S. dollar, end of period	5.3	5.3	5.1	5.1	5.1	…	…
Hryvnia per U.S. dollar, period average	5.3	5.3	5.1	5.1	5.0	…	…
Real effective rate (percent change) 8/	-5.9	2.5	21.5	9.6	9.8	14.7	9.3

Social indicators
Per capita GDP: US$ 3,056 (2007); Poverty (percent of population): 8.0 (2006; World Bank estimate); Life expectancy at birth: 68.2 years (2006); Infant mortality (per 1,000): 14.0 (2004); Net primary enrollment (percent net): 86 (2004)

Sources: Ukrainian authorities; and staff estimates and projections.
1/ Policies assumed here include: (i) a de facto exchange rate peg through 2009 and passive monetary policy in support of this; (ii) convergence of gas prices to European levels (adjusted for transit) by 2009; (iii) full pass-through of rising energy import prices; (iv) the free-play of automatic stabilizers in 2008 and a general government fiscal deficit of 1.5 percent of GDP in 2009; and (v) alignment of the minimum wage with the minimum subsistence level by end-2009.
2/ Inflation excluding extreme price movements in the CPI components. The concept used here is the 65th percentile of the distribution of the monthly price changes.
3/ The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
4/ From 2003 onward, 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 0.1 percent of GDP relative to previous years.
5/ The cyclically-adjusted balance estimates the government fiscal balance if output were at its potential level.
6/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.
7/ Annual GDP divided by end-period broad money (M3).
8/ Period averages; (+) represents real appreciation; based on GDP deflator and INS trade weights (1999-2001).

Statement by Mr. Yakusha, Alternate Executive Director for Ukraine
June 2, 2008

My Ukrainian authorities would like to thank staff for the useful discussions. They appreciate the Fund's advice and the presentation of the numerous topics covered in the Selected Issues report. In general, the authorities considered the staff appraisal helpful and the consultations with the Fund productive. Major recommendations are now in the process of implementation. Some nuances in views remain on part of the FSSA text that has not been properly updated, and on the assumptions for external demand used for forecasting the baseline scenario.

Economic growth in 2008 has so far stood at above 6 percent with a trend of acceleration, despite negative contribution of the construction sector, already affected by policy tightening. Increased external demand for Ukrainian exports confirms the validity of the growth assumptions by the authorities. So far industry growth stood at 8 percent with machinery growing at 32.9 percent, reflecting positive changes in the production structure. Profitability of businesses has also increased, while capital investment grew by over 10 percent in the first quarter. Volumes of trade increased substantially. In the first quarter domestic trade grew by 15 percent, exports by 28 percent, and imports by 44.5 percent. The latter figure reflects not only rising prices for imported energy and a genuine growth in consumer imports, but also the still high but now decreasing volume of non-reported activity. Since the beginning of the year revenues from customs increased 1.8-fold, mostly due to modernization of the custom procedures and enforcement of the measures to fight smuggling, which have been strengthened by the new government.

The global financial turmoil has so far affected Ukraine only to a marginal extent. In the first quarter of 2008, compared to the same quarter of 2007, external financing increased substantially for both the corporate and financial sectors despite an almost complete absence of Eurobond issuance by Ukrainian entities. In spite of that, the share of longer-term external financing increased, and as of May 1, 2008 it has exceeded 50 percent, while the share of interbank credit has declined, contrary to the FSSA's description. Since August of 2007 the trend of faster growth of foreign currency denominated consumer loans as compared to loans in national currency, has also reversed. During the first four months of this year, the growth rate of consumer loans in the national currency was twice the growth rate of foreign currency denominated loans. Volatility in the domestic stock market has notably increased, but without a substantial downside trend. There has also been some occasional volatility in the interbank credit market, but this trend of reduced excess liquidity is associated with domestic policy tightening, and notably with substantial accumulation of resources in government accounts. Market players are estimating the prospects for Ukraine with diverging views. One major rating agency has changed the outlook from positive to stable, another announced plans to improve the outlook. Spreads for Ukrainian entities increased to a considerable extent, probably reflecting existing undeniable political uncertainties. At the same time FDIs continued to increase. In the first four months of this year FDIs increased overall by 11.4 percent to a total of over USD 41 billion. At the same time direct investments of Ukrainian companies abroad continue to increase, though at a slower pace, and now total USD 6.1 billion.

The authorities agree with the staff's assessment of inflation acceleration as a major threat to stability, growth, and social standards, and the internal discussion in the country about the reasons behind the high inflation is intense. The culprits frequently mentioned are the continuing global commodity price boom, which affects, in a very open economy, both export and import prices, the substantial increases in prices for imported energy, the growth in social transfers and budgetary wages, which exceed productivity growth. Structural rigidities and weak enforcement of the competition policy hamper the supply response, which is compounded by a bad year for Ukraine's agriculture in 2007. It has also been mentioned that previous governments tried to slow down price increases during the years of three national elections in a row; that food occupies a much higher share in the CPI basket than in neighboring countries; and that the relatively stable nominal exchange rate to the falling US dollar ceased to be helpful. Analysis of the core inflation and aggregate demand pressures as well as a worsening of inflationary expectations according to various surveys conducted by the NBU and the private sector, confirm the staff's diagnosis.

The authorities agree that taming aggregate demand is important for reducing demand pressures and for preventing inflationary expectations from getting entrenched. The joint NBU-Government plan of anti-inflationary measures that is currently being implemented reflects also the Fund's advice. The main emphasis is put on allowing a soft landing of the economy by carefully slowing down aggregate demand through tightening of both fiscal and monetary policy, alongside market interventions from government commodity reserves and other supply side measures. Refinancing rates have been increased, and overall monetary conditions tightened also by more stringent requirements for capital adequacy, increased reserve requirements, and better provisioning against possible losses. The requirements for assessing borrowers' ability to repay credits have also been tightened, as were overall credit standards, collateral valuations, etc. Mortgage financing has been especially affected by these measures, and the previously explosive growth in housing prices has slowed down.

The most important policy change in recent months was the gradual withdrawal of the NBU from the foreign exchange market that allowed the interbank market nominal exchange rate to the US dollar to appreciate by over 10 percent in two months since mid March. Both cash and offshore hryvnia markets demonstrated even stronger appreciation at some point. Most recently, the interbank exchange rate has been fluctuating at around 6-8 percent above its level at the beginning of the year. The NBU also adjusted by about 4 percent (so far) the official rate used for accounting purposes and for a small volume of the NBU transactions with the government. There has been some controversy as well as a parliamentary discussion after the exchange rate sustained its movement outside the indicative band approved by the parliament for 2008, but the NBU continued to exercise its authority over monetary policy quite independently, a stance supported by the government. The government on its part limited budgetary spending to some extent despite substantial growth in revenues - this year's budget has been consistently executed with small surpluses of up to 0.5 percent of GDP so far. Cutting planned social spending increases was not feasible though, also because of court rulings.

It is also worth noting that unlike the measures implemented by some other major agricultural exporters, in Ukraine the authorities have eased and later abolished restrictions and quotas on grain and other food exports, thus contributing, inter allia, to the helpful in a current global situation decline in wheat prices.

Implementation of the anti-inflation agenda is taking place in a not so easy political environment, where parliament had spent a lot of time on disagreements over non-economic issues at the expense of considering and implementing a structural reform agenda. As the authorities indicated during the consultations, success in fighting inflation also requires addressing the rigidities that are hampering supply side and competition. Reforms have been accelerated in areas not requiring parliamentary approval – modernization of the customs and VAT administration accelerated with electronic declarations and greater automation, and VAT arrears have been reduced substantially. The regulatory regime and accounting requirements are being simplified and other investment climate improvements are on their way – public auctions for access to non-agricultural land and for the exploration of natural resources, and privatization procedures also organized in a public auction format with price offered as the exclusive criterion. Budgetary risks stemming from imperfections in the natural gas market have been addressed and the financial situation of the Naftogaz of Ukraine company has improved.

After many years of negotiations Ukraine officially joined the WTO on May 16. The move received unprecedented parliamentary support with 411 out of 450 votes. It is expected that WTO membership will not only accelerate trade, but will increase much needed competition on domestic markets, thus contributing to lower production costs. In line with WTO obligations, certain import duties have been substantially reduced recently. Finally, after approving the new law on the Cabinet of Ministers which clarifies the authority of the executive branches, the parliament has started considering a new labor code, a customs code and other pieces of economic reform legislation. Hopefully, modernization of the banking and corporate legislation will also be considered soon.

The National Bank of Ukraine has tightened policies to a greater extent than reflected in the main staff report based on the end-March data. Since the beginning of 2008, base money had increased by 1.9 percent on May 26 compared with a 7.5 percent increase during the same period of 2007. The NBU also gradually increased, from 10.1 to 15.2 percent, its actual refinancing rate, while average credit rates increased so far to over 17 percent. Prudential measures increased banks' obligatory reserves from HRV 9.7 billion to over HRV 11 billion in January-April alone. All monetary and prudential measures combined had recently slowed credit growth somewhat – at the beginning of the year credit grew by about 4 percent a month, in April its growth slowed to 2.9 percent, while so far in May (as of May 26) it was 1.5 percent. In general the extremely high credit growth rates in Ukraine are better understood if longer term dynamics and an initially low base as well as a substantial volume of non-reported economic activity and incomes are taken into account. As such, the growth rates of consumer loans have reached their maximum of over 100 percent in 2006-2007 and since then have been gradually declining.

As stated in the FSSA, Ukraine implements practically all FSAP recommendations. The authorities do not fully share the description presented in the FSSA, as the trends increasing the risks are emphasized stronger than the measures already implemented to address these risks. In particular, dollarization trends are highlighted, while in practice the opposite has started to happen, also as a result to the measures implemented by the NBU. Not all newly introduced prudential requirements to address the quality of credit operations, especially in the area of consumer loans, are taken into account. In particular, credit classification criteria have been tightened, thus increasing the required provisioning. Adequacy of the regulatory capital is now calculated under more stringent criteria and also taking into account foreign exchange risks and also longer term liquidity risks, thus effectively achieving the same macroeconomic result as the overall increase in capital adequacy would do, but also with positive externalities for risk management. Obligatory reserves were introduced against loans from abroad, and, together with the additionally increased provisioning against loans extended in foreign currency, have started to reduce the share of foreign exchange loans. The NBU enforces these and other stricter prudential norms. Mismatches in over 1-year maturity of assets/liabilities have decreased by 20 percent in the last four months due to the new prudential requirements. The share of long-term deposits has also increased this year (from 24 to 27 percent). Financial sector corporate governance has been improved (all banks are supposed to be open joint-stock companies with regularly reported and published lists of owners). Minimal statutory banking capital has been doubled to Euro 10 mln, twice the EU norm.

Foreign banks which increased their presence in Ukraine to just under 50 percent in regulatory capital, have improved the level of banking services and also the overall level of risk management. At the same time, while competing for a market share, foreign banks have this year generated so far over 62 percent of the total growth in consumer loans. The NBU is carefully monitoring all developments on the external liabilities side, first of all those of a short-term nature – all foreign loans are reported and registered in Ukraine - and the central bank is ready to implement adequate measures in case any of the risks mentioned in the FSSA would start to materialize. Increased flexibility of the exchange rate (in line with staff recommendations) is expected to eventually reduce some financial risks, will definitely contribute to lower inflation, and will likely strengthen the so far relatively weak trends toward de-dollarization. The way the greater flexibility will affect trade and capital flows remains to be seen.

As was clearly stated by the NBU officials, the central bank is not really committed to any particular exchange rate level. It may smooth only temporary fluctuations, and will not resist either strengthening or weakening of the exchange rate if fundamental trends are to change substantially. In particular, NBU has publicly not ruled out the possibility of some weakening of the exchange rate in case terms of trade will change in line with staff expectations described in the SI report. In this light, the de facto exchange rate regime in Ukraine has been more closely aligned to the de-jure exchange rate regime, which remained a managed float (despite smaller fluctuations) in recent years.