August 2010
IMF Country Report No. 10/262

# Ukraine—Request for Stand-By Arrangement and Cancellation of Current Arrangement Staff Report; Staff Supplement; Press Release on the Executive Board Discussion.

In the context of the cancellation of existing stand-by arrangement and request for a new stand-by arrangement, the following documents have been released and are included in this package:

- The staff report for the Request for Stand-By Arrangement and Cancellation of Current Arrangement, prepared by a staff team of the IMF, following discussions that ended on July 3, 2010, 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 July 16, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of July 21, 2010, on the assessment of the risks to the Fund and the Fund's liquidity Position.

- A Press Release summarizing the views of the Executive Board as expressed during its July 28, 2010 discussion of the staff report that completed the request.

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

**Request for Stand-By Arrangement and Cancellation of Current Arrangement**

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and Lorenzo Giorgianni

July 16, 2010

**Stand-By Arrangement**. In the attached letter, the Ukrainian authorities request the cancellation of the 2008 Stand-By Arrangement and describe their economic and financial policies for which they request a new 29-month SDR 10.0 billion (728.9 percent of quota, about US$14.9 billion) Stand-By Arrangement involving exceptional access. An initial purchase of SDR 1.25 billion will become available on approval with the remainder phased, subject to quarterly performance criteria and reviews. The authorities have requested US$2.0 billion to be allocated to the budget in 2010.

**Policies**. Key objectives of the authorities' program are to consolidate public finances, restore banking system soundness, and develop a more robust monetary policy framework focused on domestic price stability, with greater exchange rate flexibility. To help achieve this, the government will implement reforms and institutional changes, including tax and expenditure policies, pension and energy sector reforms, and measures to strengthen central bank independence and rehabilitate the banking system. Strict adherence to these policies will help catalyze private flows and facilitate exit from official financing. A number of key policy steps have been adopted as prior actions (Box 6).

**Discussions**. During March 16–April 2 and June 21-July 3, 2010 the staff team met with the Prime Minister, Mr. Azarov; the Deputy Prime Minister, Mr. Tihipko; the Minister of Finance, Mr. Yaroshenko; the Governor of the National Bank of Ukraine, Mr. Stelmakh; the First Deputy Chief of Staff of the Presidential Administration, Ms. Akimova; and other senior officials; ambassadors; as well as representatives of international financial institutions and private banking and business communities.

**Staff**. The staff team comprised Mr. Arvanitis (head); Messrs. Dohlman, Raczko, Roudet, and Atoyan and Ms. Yang (EUR); Mr. Ljungman (FAD); Mr. Olafsson (MCM); and Mr. Chensavasdijai (SPR). Mr. Alier, resident representative, assisted the mission. The mission cooperated closely with World Bank staff on structural issues. Mr. Yakusha, Alternate Executive Director for Ukraine, attended most meetings.

**Publication**. The Ukrainian authorities intend to publish the staff report.

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# I. INTRODUCTION

1. **With the current Stand-By Arrangement (2008 SBA) set to expire in November 2010, and significant external financing and adjustment needs remaining, the authorities have requested a new Fund arrangement.** While the 2008 SBA was successful in preventing a severe financial disruption and cushioning the impact of the crisis, the foundations for sustainable growth are not firmly established. The new government that took office in March has formulated a medium-term economic reform plan to tackle long-standing structural weaknesses, and has requested support under a new SBA spanning the period to the next parliamentary elections—scheduled for Fall 2012.

**The 2008 SBA—Fallout of the Crisis and Policy Response**

**The global economic financial crisis hit Ukraine hard in late 2008 and 2009.** As a major steel exporter and borrower in international markets, Ukraine's economy was severely hit by the decline in demand for steel products and reduced access to capital markets—the impact of which was magnified by pre-existing economic and financial vulnerabilities. Confidence in the currency and the banks waned, causing a system-wide run on deposits; real GDP collapsed, along with domestic demand; and falling fiscal revenues strained public finances.

**Notwithstanding the toll of the crisis on Ukraine's economy, the 2008 program managed to restore macroeconomic and financial stability.** The sharp adjustment was to an extent unavoidable given the large pre-existing imbalances. However, measures to restore banking system confidence helped stabilize deposits and exchange rate pressures eased over time. By mid-2009, an incipient recovery was under way.

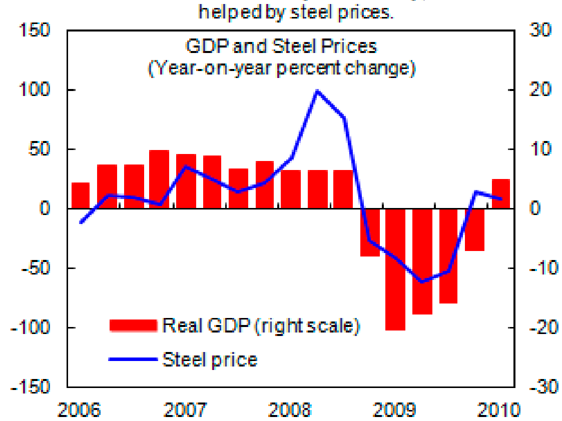
**Weak policy implementation, however, undermined better outcomes.** Against a difficult economic environment and a complex political situation, the program eventually went off track as policies weakened and reforms stalled in the run up to the Presidential elections.

2. **A Fund-supported program would lend credibility to the authorities' policies and help coalesce support from the official sector and markets**. The authorities see a new SBA as providing a strong signal that sound macroeconomic policies and financing are in place to support adjustment and reforms and to ensure that Ukraine will be in a position to deal with risks in the event external conditions worsen. An SBA is expected to catalyze financing from markets and official sector to cover Ukraine's still sizable external financing needs.

## II. Recent Developments and Economic Challenges

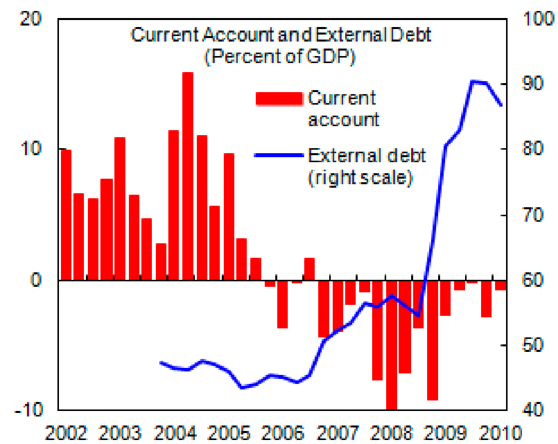
3. **The fallout of the economic crisis continues to reverberate.** Though economic activity has revived in recent months, helped by stronger external demand and higher steel prices, the foundations for a sustainable recovery are not firmly established and a large output gap remains (Box 1). Construction activity and retail sales continue to be subdued and unemployment—currently 9.0 percent—remains historically high (Figure 1).

A weak recovery is underway, helped by steel prices.



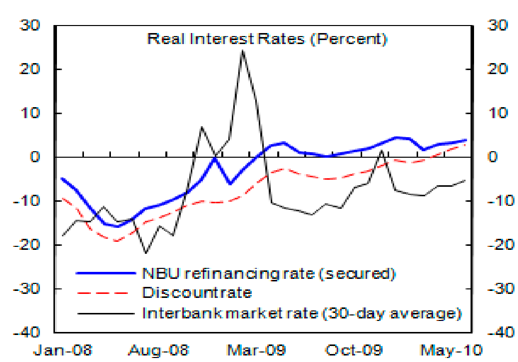

Sources: National Committee of Statistics; Bloomberg; and IMF staff calculations.

4. **External vulnerabilities are still significant.** Ukraine remains exposed to commodity prices shocks given large energy imports and lack of export diversification (steel and agriculture account for 55 percent of exports). External debt-to-GDP ratio increased sharply in 2008–09 as a result of the depreciation and the recession, and reserve cover dropped to around 70 percent, making Ukraine vulnerable to confidence reversals and financial strains in other parts of Europe (Box 2). On the positive side, private debt rollover rates have increased recently to about 86 percent (year-to-date) and the current account deficit is expected to narrow further to around 1 percent of GDP in 2010, compared with 7.1 percent in 2008.




Sources: National Bank of Ukraine; and IMF staff calculations.

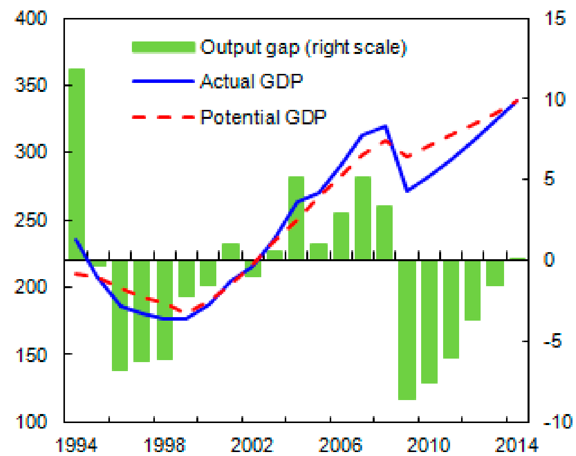
5. **Inflation is coming down, but the authorities' commitment to low inflation could be compromised by the pursuit of multiple objectives**. Domestic price inflation has declined to 6.9 percent y-o-y in June, on the back of lower food prices (Figure 2)—but remains above trading partner levels. With the economy still fragile, the National Bank of Ukraine (NBU) has been reluctant to exit its accommodative stance over concerns about the impact of higher interest rates on the banking system and the availability of credit to the economy. Key policy rates have been kept low or negative in real terms,




Sources: Ukrainian authorities; and IMF staff calculations.

**Box 1: Estimating Potential Growth and Output Gap in Ukraine**

**The crisis is likely to have a durable negative impact on Ukraine's potential growth.** Using the production function approach, staff estimates that the output gap in 2010 remains large at -7.5 percent and the post-crisis potential growth is estimated at about 4 percent, compared with 6.2 percent during the recent growth episode. The output gap is closed by 2015 (see chart). However, estimates of potential output in Ukraine are subject to large degree of uncertainty in view of the short time series, structural breaks, high sensitivity to smoothing parameters, and lack of reliable data on capital stock and capacity utilization.




Source: IMF staff estimates and projections.

Potential Growth and Output Gap (Percent)

| | 2008 | 2009 | 2010 | 2015 |
|---|---|---|---|---|
| **Actual/projected growth** | 2.1 | -15.1 | 3.7 | 4.0 |
| **Potential growth** | 3.9 | -4.0 | 2.6 | 4.0 |
| *Of which*, contribution by: | | | | |
| Labor | 0.0 | -0.2 | -0.1 | 0.2 |
| Capital | 3.6 | -1.3 | 1.2 | 2.7 |
| TFP | 0.4 | -2.5 | 1.5 | 1.1 |
| **Output gap** | 3.4 | -8.6 | -7.5 | 2.7 |

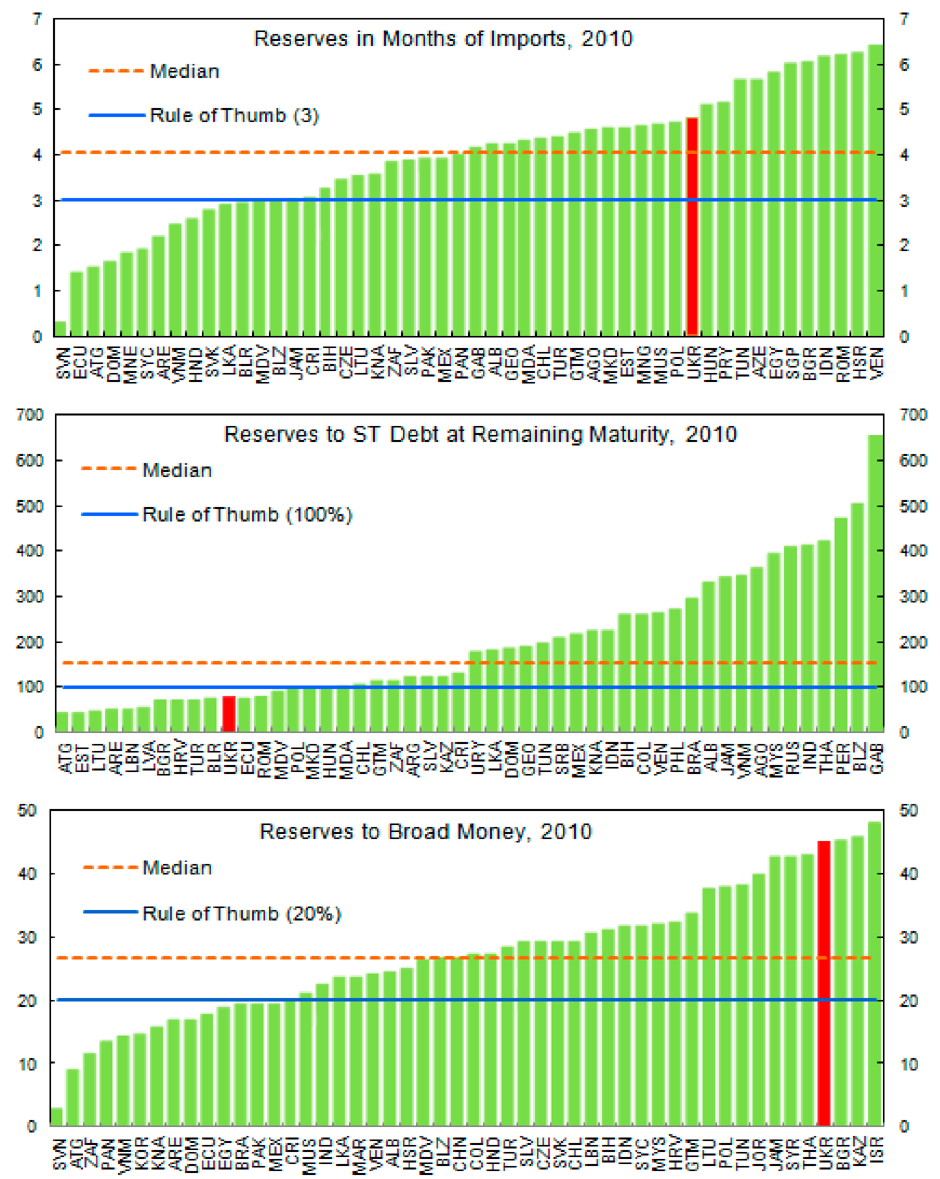
Source: IMF staff estimates and projections.

## Box 2. Ukraine: Assessment of Reserve Adequacy

**Under a new Fund program, Ukraine's foreign exchange reserves would rise to more prudent levels, based on standard metrics and comparisons with other emerging markets.**

***Comparison with generally accepted benchmarks:***

- Calibration results based on Jeanne and Ranciere's (2006) model suggest the "optimal" level of reserve is 25 percent of GDP or about $35 billion. This model accounts for risk aversion, probability of sudden stops and opportunity costs of holding reserves.
- Reserve cover (reserves to short-term debt at remaining maturity), at 75 percent in 2010 and rising to 90 percent by 2011,is below both the Greenspan-Guidotti rule of 100 percent and the emerging market median (153 percent).
- At 45 percent, reserves are above the Kapteyn-Wjinholds threshold coverage of 20 percent of broad money.
- Reserve cover (in months of imports) is nearly 5 months, exceeding the standard benchmark of 3 months.
- Taking into account all these metrics and the composition of the BOP, staff believes that maintaining reserve cover above 85 percent would be sufficient to maintain confidence and provide adequate buffers.




Source: IMF staff projections.

emergency liquidity assistance (stabilization) loans are being converted to longer duration loans that will take longer to unwind, and excess liquidity has been building up in the banking system.

6. **At the same time, since August 2009, the hryvnia has been broadly stable against the U.S. dollar**. Foreign exchange sales by the NBU totaled US$10.5 billion in 2009, while gross reserves declined by about US$5 billion. Exchange rate movements would have been larger had the authorities not tightened the regulatory framework for transactions in the foreign exchange market. With improving market conditions and supported by bilateral loans, most of the reserves loss was recovered in the first half of 2010 and gross reserves currently stand at around US$30 billion. Gains from the 2008 depreciation have been largely eroded due to inflation differentials and the hryvnia is estimated to be broadly in line with fundamentals using standard analysis.

Exchange Rate Assessment 1/

(Percent deviation from equilibrium REER)

| | |
|---|---|
| Equilibrium real exchange rate | -1.7 |
| Macroeconomic balance 2/ | 0.9 |
| External sustainability 3/ | -1.8 |

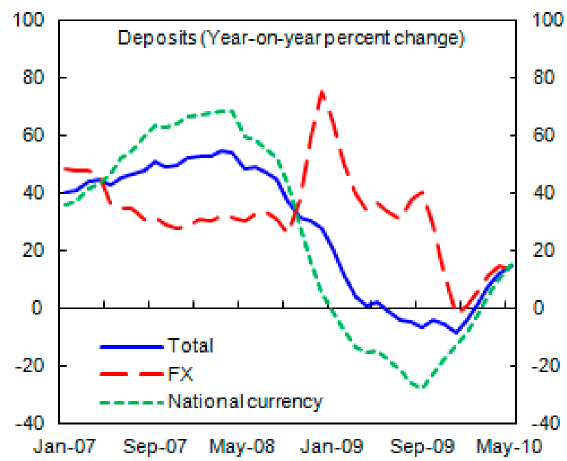
Source: IMF Exchange Rate Assessment Toolkit.

1/ Based on April 2010 WEO.

2/ REER adjustment needed to bring underlying current account to the level of the norm (-3.1 percent of GDP).

3/ REER adjustment needed to stabilize NFA position.

7. **The banking system remains under strain.** Asset quality is still deteriorating and higher provisioning is eroding capital buffers.[1] Recently completed extended audits for all banks revealed that 61 banks (holding 59 percent of assets in the banking system) will need about UAH 40 billion of additional capital. Of this, UAH 12–18 billion will be provided by the government to cover the capital needs of banks under state control. Higher risk aversion by banks has translated into stagnant lending (-3 percent y-o-y), even as funding constraints are gradually easing given a return of deposits in the banking system (Figure 3).




Sources: National Bank of Ukraine; and IMF staff calculations.

8. **Public finances deteriorated sharply in the aftermath of the crisis, while the budget has become more rigid.**

[1] NPLs reached 15 percent (under a stricter definition) and nearly 42 percent (if all substandard loans are included) of total loans in March 2010 (see Table 7).

- The combined general government deficit, including Naftogaz (program definition) reached 8.7 percent of GDP in 2009, reflecting shortfalls in revenues and expansion of spending heading into the elections. The broader deficit, however, was considerably higher given the budgetary cost from bank recapitalization (amounting to about 2.5 percent of GDP) and accumulation of VAT refund arrears (about 1.0 percent of GDP). Government direct and guaranteed debt increased rapidly to 35 percent of GDP at end-2009, from 20 percent at end-2008.

- The 2010 budget approved in late April targets a general government deficit of 5.3 percent of GDP, but underlying weaknesses highlight the need for action. Tax revenues continue to underperform, as the tax base and particularly VAT collections are recovering more slowly than assumed. The cash deficit for the first half of 2010 reached 2.2 percent of GDP. However, VAT arrears continued to accumulate, increasing by UAH 8.5 billion.[2]

- Public sector wages and pension spending are projected to absorb more than 70 percent of total general government expenditure this year. This is driven by nominal spending increases of 24 percent and 22 percent respectively, resulting from the implementation of the Social Standards Law and public wage top-ups (Box 3). Absent reforms of public administration and the pension system, structural fiscal rigidities are set to increase further in the coming years.

- Spending for the Euro 2012 football tournament will increase considerably this year as construction gets into full swing. Overall public spending during the five years leading up to the games is projected to reach the equivalent of 6.5 percent of 2010 GDP, including loan guarantees. The authorities expect that the games will promote private investments of a similar magnitude to upgrade private facilities ahead of the tournament.

Euro 2012: Approved Budget (Billions of Ukrainian hryvnias)

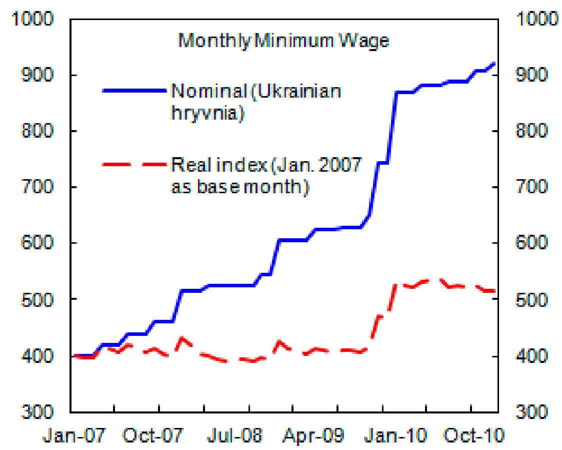
| | 2008 | 2009 | 2010 | 2011 | 2012 | Total |
|---|---|---|---|---|---|---|
| Public projects | 3.6 | 3.7 | 25.2 | 31.1 | 7.5 | 71.1 |
| State budget | 3.1 | 3.1 | 10.1 | 12.0 | 6.9 | 35.3 |
| State guarantees | ... | ... | 13.6 | 16.2 | ... | 29.8 |
| Local budgets | 0.5 | 0.6 | 1.5 | 2.8 | 0.6 | 6.0 |
| Private projects | 6.9 | 10.0 | 23.8 | 28.3 | 2.4 | 71.3 |
| Total | 10.5 | 13.7 | 49.0 | 59.4 | 9.9 | 142.4 |

Source: Cabinet of Ministers Resolution No. 357, April 14, 2010, "On Approval of the State Program for Preparation and Staging of Euro-2012."

[2] The authorities have decided to settle these claims through issuance of VAT bonds. The terms include a 5-year maturity with even semiannual amortizations and a coupon of 5.5 percent. The below-the-market interest rate raised sharp complaints from VAT claimants (mostly exporters).

## Box 3. Adjustment in Social Standards in Ukraine

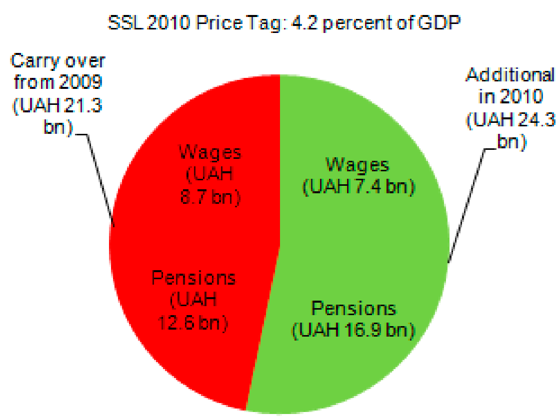
**A new Social Standards Law (SSL) was enacted (October 2009) in the run-up to Presidential elections.** SSL implementation began in late 2009, but was interrupted in early 2010 by court challenges and the absence of a budget. Following a Constitutional Court ruling confirming its validity and adoption of the 2010 budget in April, implementation of the law has resumed, with payments retroactive to January 1, 2010.




Sources: State Committee of Statistics; and IMF staff calculations and projections.

**The SSL has been billed as an effort to compensate low wage earners and pensioners for erosion of their purchasing power during the crisis and remains a priority of the new government.** In practice, however, it has resulted in significant budget pressures due to indexation of wages and pensions to the minimum wage and subsistence levels.

**The government has tried to limit costs by delinking public wages from the minimum wage, but this has led to unsustainable wage compression.** Under this mechanism, by the end of 2010, the lowest 7 grades of the public sector wage scale (out of 25) will be set at—and fully indexed with—the minimum wage level. Salaries for all the other grades are being indexed to a government-set *1st grade tariff*, which will increase by a much smaller extent (8 percent this year compared to 24 percent for the minimum wage).

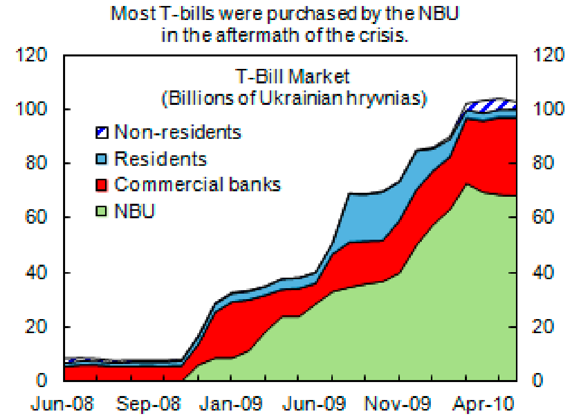



**Staff estimates the gross cost of the SSL at slightly over 4 of GDP in 2010**. Half of this represents carry-over costs from the changes in late 2009. Another one-third of the 2010 cost would come from the increase in the wage bill, and the remainder from higher pension expenditures.

**The government also began implementing public wage "top-ups" (a type of bonus) in November 2009.** Staff estimates this will cost another 0.8 percent of GDP (in addition to the SSL) in 2010.

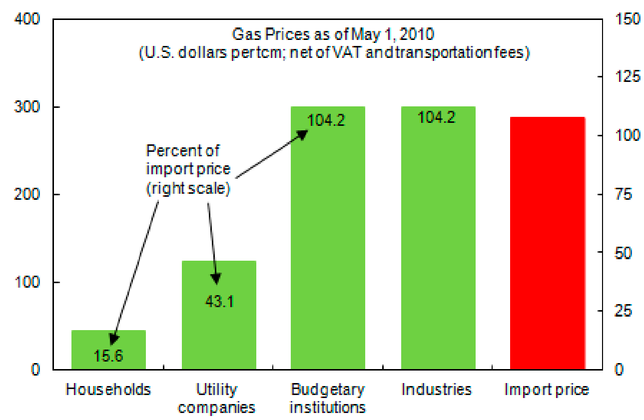
**Current government plans include a significant increase in the *1st grade tariff* at end-2010 that would generate an additional cost in 2011 of about 2.3 percent of GDP.** The wage bill would increase even more with additional changes to social standards and the *1st grade tariff* in 2011—which will likely be decided at the time of the 2011 budget discussions.

9. **The NBU has emerged as a major holder of Treasury bonds (over 60 percent of total stock)**. While the NBU does not participate in the primary T-bond auctions, it has been monetizing government bonds issued for bank recapitalization, in line with the 2009 anti-crisis law. In addition, it has been refinancing bonds purchased by state banks which in recent months have increased their presence in the T-bond market.



Source: National Bank of Ukraine.

10. **Naftogaz's financial viability is at risk without reforms (Box 4).** A combination of below market price sales of gas to households and utility companies, weak payment discipline, and price concessions to specific industries have strained Naftogaz's finances, leading to insufficient investment and large cash deficits. To support Naftogaz's 2009 operations, the government transferred about 2.5 percent of GDP in "recapitalization" bonds to Naftogaz, while in October 2009 Naftogaz restructured US$1.6 billion of Eurobond and bank debt. The current situation undermines Naftogaz's finances and deters needed investment in exploration and extraction of domestic gas and in the gas pipeline networks. Moreover, subsidized consumption has led Ukraine to become one of the least energy-efficient countries in Europe. A new multi-year gas contract with Gazprom signed in April 2010 is expected to offer some relief to Naftogaz as import prices are reduced considerably (by 30 percent of import price, up to a maximum of $100 per thousand cubic meters). For 2010, however, the deficit could reach 1.5 percent of GDP on unchanged policies, as higher import volumes are projected to mostly offset the savings from the lower price.[3]



Source: IMF staff estimates.

[3] This does not include the recent Stockholm arbitration tribunal ruling against Naftogaz in a commercial dispute with RosUkrEnergo, a gas intermediary, that awarded the latter ownership of 11 bcm of gas and a further 1.1 bcm of gas in lieu of damages. At this stage, Naftogaz and the authorities have not decided whether to transfer gas in storage to RosUkrEnergo, or pursue a negotiated solution.

**Box 4. Gas Sector Reforms**

**Gas sector reform is a high priority under the government's new economic plan.**

- Ukraine is one of the least energy-efficient countries worldwide and highly dependent on imported gas.
- Below-market domestic prices and low payment compliance have weakened Naftogaz's finances, generating the need for budgetary financial support.
- Investment in exploration, extraction, and transportation is insufficient, domestic production is well below potential, and gas transit through Ukraine is at risk due to deteriorating gas networks.

**The reforms during the program period aim to complete the agenda initiated under the previous program, including:**

- *Gradually bringing domestic gas prices to import-parity.* 50 percent domestic gas price increases for households and utility companies were implemented on July 13, effective August 1, with the next billing period. A further 50 percent increase is planned on April 1, 2011, with semi-annual increases thereafter until import parity is reached for all categories of consumers (with automatic adjustment mechanism planned thereafter). Industrial prices are already at market levels, and preferential tariffs for various industries have been eliminated.

- *Strengthening social safety nets.* To limit the impact of the large gas price increases on the poorest segments of the population, the government is increasing transfers (affecting approximately 5 percent of households) using established support programs.

- *Strengthening payment discipline.* The authorities intend to address the low compliance rates of district heating companies by (i) creating a central independent regulator for setting heating tariffs, and (ii) creating distribution account into which all utility payments are made, and from which payments to Naftogaz are automatically drafted.

- *Liberalization of the gas sector and unbundling of Naftogaz.* In line with the 2009 Brussels declaration, in July 2010, the authorities enacted a new gas sector law that provides for a gradual liberalization. It will also contribute to harmonization with the relevant EU Directive and has opened the way for Ukraine's Energy Community Treaty membership. The law will also provide for a gradual restructuring of Naftogaz, including by adopting separate cost centers for gas imports, domestic gas production and gas transit.

*Modernizing the gas transit infrastructure.* The authorities are working toward securing a loan from the World Bank, the EBRD, and the EIB to revamp the gas transit infrastructure.

## III. POLICY DISCUSSIONS

### A. Program Objectives

11. **The new government is determined to tackle these challenges and convert the recent economic stabilization into sustained economic growth.** Upon taking office in March, it moved quickly to formulate a five-year plan to advance reforms in the areas of public finances; financial sector development; social security, education, and health care; and infrastructure development and modernization, including in the energy sector.

12. **The proposed program aims to support the authorities' agenda in four key areas**:

- ***restore confidence and fiscal sustainability*** by reducing the general government deficit to 2.5 percent of GDP by 2012 and setting public debt firmly on a downward path below 35 percent by 2015;
- ***initiate reforms to modernize the gas sector and phase out Naftogaz's deficit***, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. A new gas law adopted in early July will improve efficiency through unbundling production, transit, and distribution to end-users, and allowing new entrants into the domestic gas market;
- ***restore and safeguard banks' soundness*** through completion of recapitalization plans by end-2010 and strengthened supervision, and
- ***develop a more robust monetary policy framework*** focused on domestic price stability with greater exchange rate flexibility under a more independent NBU.

### B. Macroeconomic Framework

13. **Policies and reforms under the program are expected to support higher and more durable growth, lower inflation, and reduce vulnerabilities.**

- *Real GDP growth is expected to reach 3.7 percent in 2010 and an average of 4.6 percent in 2011–12.* In 2010, growth is hindered by a slow recovery in private consumption, a still-weak banking sector, and the implementation of corrective fiscal measures. Industrial and agricultural production, however, will continue to provide positive contributions, benefiting from the year-over-year recovery in commodity prices, particularly steel. Inventory restocking and infrastructure spending for the Euro 2012 football tournament is expected to lift investment. Growth will gain momentum in 2011–12, led by private consumption and investment, and helped by a recovering banking system and a more favorable external environment.

- *Core inflation is expected to stay below 10 percent in 2010*—on account of the still-large output gap—and continue to decelerate in 2011–12, supported by prudent macroeconomic policies and vigilance against second-round effects from administrative price adjustments. Headline inflation will decline more gradually, largely reflecting adjustments in domestic gas and utility prices.

Selected Indicators, 2009–15

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| | | Proj. | | | | | |
| Real GDP Growth | -15.1 | 3.7 | 4.3 | 4.8 | 4.5 | 4.3 | 4.0 |
| Unemployment rate (ILO definition; percent) | 8.8 | 8.8 | 7.9 | 7.4 | 7.1 | 6.9 | 6.6 |
| CPI inflation (period average) | 15.9 | 9.9 | 11.9 | 8.3 | 7.5 | 5.0 | 5.0 |
| CPI inflation (end of period) | 12.3 | 12.0 | 9.2 | 9.0 | 5.9 | 5.0 | 5.0 |
| General government balance 1/ | -6.2 | -5.5 | -3.5 | -2.5 | -2.3 | -2.3 | -2.3 |
| Overall balance (including Naftogaz operational deficit) | -8.7 | -6.5 | -3.5 | -2.5 | -2.3 | -2.3 | -2.3 |
| Current account balance (percent of GDP) | -1.5 | -0.7 | -1.8 | -2.6 | -2.8 | -3.0 | -3.1 |
| Public debt (end of period) | 34.6 | 39.6 | 42.7 | 44.4 | 40.5 | 38.0 | 33.9 |
| External debt (percent of GDP) | 88.0 | 79.0 | 77.8 | 77.6 | 71.4 | 67.4 | 64.5 |

Sources: Ukrainian authorities; World Development Indicators; and IMF staff estimates and projections.

1/ The general government includes the central and local governments and the social funds.

14. **The current account deficit is expected to remain at sustainable levels over the medium term**. This year, exports will benefit from rising commodity prices, while imports will rebound more modestly, keeping the overall current account deficit to just below 1 percent of GDP. Against a background of rising confidence, the financial account deficit is projected to turn significantly positive over the medium term, supporting a reserve build up.

15. **The risks to this outlook are broadly balanced**. External risks have diminished since late 2008 but not dissipated yet given the fragile state of the recovery in Europe. Domestic demand and confidence could falter in the face of rising NPLs and possible doubts about political commitment to reform heading into local elections in late October. On the upside, a larger-than-expected increase in world steel prices, an accelerated rebound in Ukraine's major trading partners, and a return of political stability may boost investment and lead to a stronger recovery. Close implementation of policies under the program will over time deepen market access, facilitating exit from Fund support.

## C. Fiscal Policy

16. **Discussions focused on bringing public finances back to a sustainable path, without choking off the nascent economic recovery.** The authorities agreed that fiscal adjustment is essential to avoid excessive debt buildup and crowding out of private investment and that structural reforms are needed to tackle long-standing problems and underpin medium-term fiscal sustainability and growth.

Public Finance Indicators (Percent of GDP)

| | 2008 Act. | 2009 Act. | 2010 Proj. | 2011 Proj. | 2012 Proj. |
|---|---|---|---|---|---|
| | General government | | | | |
| Revenue | 44.2 | 42.2 | 42.8 | 42.3 | 42.3 |
| Expenditure and net lending | 47.3 | 48.5 | 48.3 | 45.8 | 44.8 |
| Overall balance | -3.2 | -6.2 | -5.5 | -3.5 | -2.5 |
| | General government plus Naftogaz | | | | |
| Naftogaz balance | … | -2.5 | -1.0 | 0.0 | 0.0 |
| Combined balance | -3.2 | -8.7 | -6.5 | -3.5 | -2.5 |
| | Overall balance including one-off factors | | | | |
| Bank recapitalization bonds | 0.0 | 2.6 | 1.8 | 0.0 | 0.0 |
| VAT bonds 1/ | 0.0 | 0.0 | 1.5 | 0.0 | 0.0 |
| Combined balance plus bank recap. bonds and VAT bonds | -3.2 | -11.3 | -9.9 | -3.5 | -2.5 |
| Memorandum item: | | | | | |
| Cyclically-adjusted primary balance | -4.2 | -1.0 | -0.5 | 1.0 | 1.2 |
| Public sector debt | 19.9 | 34.6 | 39.6 | 42.7 | 44.4 |

Source: IMF staff estimates.

1/ Total amount of bonds used in 2010 as payment for VAT refunds. This includes unrefunded VAT claims accumulated in 2009.

17. **For 2010, the combined general government deficit, including Naftogaz, will be limited to 6.5 percent of GDP** (MEFP ¶10–13). Without policy change, the combined general government deficit could approach 9.0 percent of GDP—reflecting revenue shortfalls, higher wages and pensions, and Euro 2012 investment needs—which would be very difficult to finance.[4] Given the half-year effect of measures and the fragility of the economy, the adjustment under the program will reduce the general government deficit to 5.5 percent of GDP and Naftogaz's deficit to 1 percent.

18. **To achieve these targets, measures are being taken to**:

- **Increase tax and pension revenue (impact 0.5 percent of GDP in 2010).** The government increased several excise rates, limited loss deductions from 2009, and raised contribution rates in the special simplified taxation system to improve the financial position of the Pension Fund.
- **Reduce government spending (impact 1.5 percent of GDP in 2010).** A supplementary budget was approved with measures equivalent to UAH 16 billion

[4] The authorities view the SSL as a key policy priority under their program to help low income households recover purchasing power lost in 2009. To keep the fiscal deficit within the targets, they are prepared to take measures to offset its impact in the short-run and undertake broader pension and public administration reforms to mitigate overall spending on wages and pensions over the medium term.

(1.5 percent of GDP) (prior action). These include reductions in current spending, subsidies, and administrative appropriations for several government bodies.

- **Raise Naftogaz's revenue and tighten control over its spending (impact 0.5 percent of GDP in 2010).** The government (i) increased final gas prices for utility companies and households on July 13 by 50 percent (prior action)[5]; (ii) eliminated gas price privileges for sugar, fertilizer, and metallurgy industries and committed to maintain gas tariffs to industrial users at import parity; (iii) established an automated drafting system for utility companies' payments to Naftogaz to improve compliance; and (iv) initiated measures to save costs and rationalize spending. These measures should raise about 0.5 percent of GDP in 2010 and bring Naftogaz's cash deficit to the targeted 1.0 percent of GDP. Steps have also been taken to enhance efficiency of the sector include establishment of an independent utility tariff regulator (prior action) which will have the authority to set heating prices for end-consumers (Box 4).
- **Mitigate the impact on the most vulnerable (impact about -0.1 to -0.2 percent of GDP).** In the near term, existing social assistance programs will be used to protect the poorest households, covering any utility costs in excess of 20 percent of their income for working families (15 percent for pensioners). This is expected to protect some 800,000 households (about 5 percent of total). Allowance has been made in the supplementary budget for this program to be fully funded. Additional measures will be taken to strengthen existing social assistance programs to ensure effective protection of the poorest and most socially vulnerable groups of the population.
- **Improve tax administration and spending monitoring.** The authorities believe that their efforts to raise tax collections will yield significant results, starting in 2010. Staff considers that any impact from such efforts would take more time. To the extent that they yield resources quickly, they will provide a cushion for any revenue shortfall. In addition, the authorities stand ready to enforce fiscal discipline to meet the end-year target. The budget code gives the Finance Minister the power to control monthly allocations to spending units as necessary to meet the program deficit target.

19. **The general government deficit will be reduced further to 3.5 percent of GDP in 2011 and 2.5 percent of GDP in 2012 while Naftogaz's deficit will be eliminated in 2011**. To ensure sustained medium-term adjustment, the following permanent structural measures will be adopted:

- **Structural pension system reforms will be initiated in 2011 (impact of 0.8 percent of GDP in 2011, and increasing over time).** Ukraine's pension spending (at 18 percent of GDP) is among the highest in Europe and the pension fund's deficit has increased to 7 percent of GDP, straining public finances. Pension

[5] The increases take effect on August 1, with the next billing cycle.

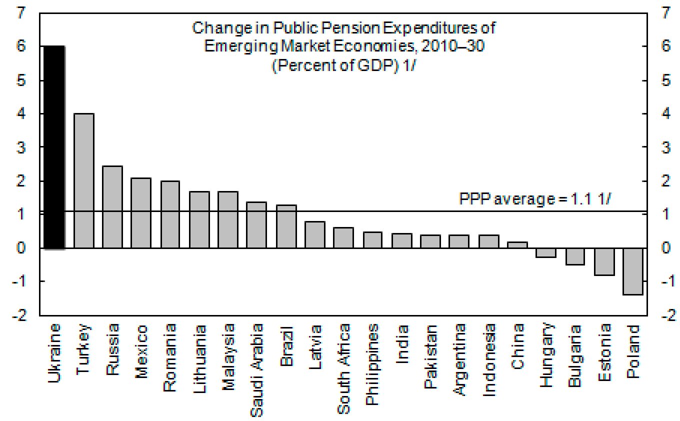
reforms will be enacted by end-2010 (structural benchmark) based on reducing early retirement benefits, increasing the qualification period for full pension benefits by 10 years, and unifying pension age limits for men and women at 60 (Box 5).

- **Fiscal reforms will be in place by end-2010**. The authorities are giving priority to improving the fiscal framework and have submitted to parliament amendments to the budget and tax codes. The tax code introduces several changes to tax policy and tax administration, aiming to gradually reduce the tax burden in the economy and enhance efficiency in tax collection—any tax rate reductions are to fit within the deficit targets defined in this program. The budget code, which was enacted recently into law, introduces a medium-term perspective for budget preparation, stronger requirements for assessing the impact of new initiatives, and elements of performance budgeting. However, several central issues such as intergovernmental fiscal relations and capital budgeting are not fully resolved. These reforms will be supported by Fund technical assistance.
- **Public administration reforms will be enacted by end-March 2011** (structural benchmark). A reorganization of public entities will be implemented with the aim of bringing on budget a larger part of user fees currently collected by public enterprises, strengthening the oversight and control over the delivery of administrative services to the public, and improving cost efficiency.
- **Additional energy sector reforms will be undertaken.** The authorities understand the importance of eliminating the need for budgetary support for Naftogaz so that resources can be redirected for more effective uses. In this context, they are committed to additional gas price increase until domestic price levels reach import parity. Gas prices for households and utility companies will be increased by an additional 50 percent in April 2011, with semiannual price increases thereafter. Once import parity is reached, an automatic price adjustment mechanism will be in place to reflect changes in import prices. Broader reforms, in accordance with the principles of the Brussels Declaration, will create conditions for private investment and development in the gas sector to be undertaken with IFI support.

20. **Given the still limited access to domestic financing and delays in official disbursements, moderate Fund financing for the budget will be needed in 2010.** Given the shallowness of domestic capital markets, and the large issuance of VAT bonds, the authorities are concerned that public borrowing would crowd out needed private financing to support the incipient recovery. In this context, they recognize the need to accelerate reforms that will be supported by IFIs and to developing the domestic Treasury bill market so that beginning 2011, market and other official sector budget financing are sufficient to cover budgetary financing needs. For 2010, while they expect to tap the Eurobond market later this year, financing needs remain considerable. To help smoothen the adjustment, they have requested temporary Fund financing for the budget of SDR 1.35 billion (equivalent to US$2.0 billion), equally split between the first two purchases.

## Box 5. Pension Reforms

**Ukraine's pay-as-you-go pension system has structural weaknesses.** Pension expenditures expressed as a share of GDP increased from around 9 percent in 2003 to well above 18 percent in 2009; one of the highest levels in the world. At the same time, Pension Fund revenues have not increased at the same pace, and increasing transfers (having reached over 7 percent of GDP in 2009) from the central government are needed to balance the accounts. These developments are the result of underlying structural weaknesses—an aging population and a trend increase in dependency ratio, low retirement age and minimum contribution periods, generous benefits, favorable treatment of working pensioners, early retirement provisions, extensive special pension regimes and compliance problems on the revenue side. Without policy change, pension spending is projected to increase sharply in the coming years




Sources: Country authorities; EC; OECD; ILO; and IMF staff estimates.
1/ Average weighted by PPP-adjusted GDP.

**The government has decided to prioritize pension reform.** Measures to increase pension fund revenue and curtail expenditures are planned for 2011. These include:

- Gradually increase the retirement age for women to 60, by 6 months every year (while the proposed pension age limit may seem low compared to other countries, life expectancy in Ukraine is very low—61 for men and 73 for women).
- Increase the qualification period to receive full pension benefits by 10 years.
- Increase the minimum insurance period from 5 to 15 years.
- Changing the base for the 1 percent increase for every additional year worked over 20/25 years for women/men (from total pension to the base pension).

Cross-Country Comparison: Public Wages and Pensions

| | Wages | | Pensions | |
|---|---|---|---|---|
| | 2009 | 2010 | 2009 | 2010 |
| Ukraine (percent of GDP) | 11.6 | 12.1 | 18.1 | 18.0 |
| Percent change (real terms) | -6.5 | 10.1 | -0.9 | 5.1 |
| Romania (percent of GDP) 1/ | 9.5 | 9.0 | 9.7 | 9.7 |
| Percent change (real terms) | -3.2 | -4.0 | 12.6 | 0.5 |
| Latvia (percent of GDP) 2/ | 10.5 | 9.8 | 8.1 | 10.3 |
| Percent change (real terms) | -20.5 | -11.8 | 7.1 | 21.1 |
| Hungary (percent of GDP) | 11.5 | 11.6 | 14.3 | 14.2 |
| Percent change (real terms) | -5.9 | -1.1 | -3.2 | -2.6 |
| Serbia | 10.4 | 10.0 | 13.3 | 12.8 |
| Percent change (real terms) | -4.7 | -2.5 | 8.1 | -2.4 |

Source: IMF staff estimates.

1/ Adjustment in 2010 to come from wages and pension freezes.

2/ Includes payment related to the recent Constitutional Court ruling invalidating previous pension savings.

### D. Monetary and Exchange Rate Policy

21. **Discussions focused on the monetary stance and near-term risks to inflation, and reforms to enhance policy formulation and implementation.**

- **Monetary policy will aim to maintain near-term core inflation in single digits** (and to bring overall inflation down to no more than 5 percent over the medium-term). Inflation risks are currently moderated by the large output gap and falling food prices. However, liquidity in the banking system is building up as savings return into the banking system—due to improving public confidence in the hryvnia—while overall lending is sluggish. In this context, the NBU is stepping up placements of CDs, repos, and outright sales of government securities and is committed to maintain refinancing rates—currently at 8.5 percent—positive in real terms going forward. (MEFP ¶14).

- **The program will be monitored through targets on monetary aggregates,** which will provide a key anchor in the early stages of the program (MEFP ¶15). The program assumes a monetary path consistent with inflation objectives, assuming a modest strengthening of money demand in the remainder of the year.

22. **The program will support a shift to a more flexible exchange rate regime** (MEFP ¶18). Greater flexibility is desirable to discourage dollarization and excessive risk-taking by unhedged borrowers, to provide a buffer against frequent external shocks, and to help focus monetary policy more squarely on meeting its price stability objective. The staff noted that now is an opportune time to initiate such a shift given a likely bounce in confidence from the authorities' policy package, and because the current real effective exchange rate appears to be broadly in line with fundamentals.

- **This shift will be supported by a more open and transparent foreign exchange framework to restore investor confidence and support inflow of capital.** A number of exchange restrictions and regulatory constraints on the foreign exchange market still remain.[6] While these may have played an important role in slowing down outflows and protecting the balance of payments during the crisis, they lack transparency, allow for excessive discretion, and inhibit the development of a derivatives market, and will be phased out. As a first step, the foreign exchange transactions tax has been removed, effective July 1, and rules on inward investment have been eased (MEFP ¶10 and 18). A full assessment of all regulatory restrictions will be completed by the fall and a timetable for the elimination of unnecessary constraints will be agreed by end-October 2010 (structural benchmark). The foreign

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[6] See IMF Country Report No. 09/173, Appendix Table I.4.

- exchange transactions tax will be permanently eliminated by end-December 2010 (structural benchmark).

- **Against this backdrop, foreign currency interventions will be limited to smoothing operations and interventions to help meet net international reserve (NIR) targets** and to secure a more adequate reserve level over time. GIR is expected to increase by US$14 billion (and NIR by US$2 billion) during the program period. The NBU will continue aligning its official exchange rate with the interbank market rate.

23. **To enhance the credibility and effectiveness of monetary policy, the NBU's independence and accountability has been strengthened** (MEFP ¶16–17). The recent enactment of amendments to the NBU law (prior action) is an important achievement that establishes price stability as the primary objective of the NBU, improves the NBU's governance structure with a more professional and less politicized NBU Council (under strict fit and proper criteria), and strengthens the NBU's financial soundness. The NBU has also amended Resolution 47—eliminating the possibility of direct NBU lending to the private sector and tightening the conditions for providing emergency liquidity assistance to banks that are solvent and financially viable but facing short-term liquidity pressures (prior action).

24. **As conditions fall into place, the NBU will gradually reorient monetary policy toward inflation targeting**. This transition will be facilitated by the planned fiscal consolidation (to reduce fiscal dominance) and steps to strengthen the institutional framework at the NBU. To help revive the still-weak transmission mechanism, the NBU will continue to enhance communication of policy intentions.

### E. Financial Sector Policy

25. **The program aims to further strengthen the banking sector through actions in three priority areas**: (i) completing recapitalization or resolution of banks; (ii) strengthening state-owned banks; and (iii) enacting key financial sector legislation.

- **Bank recapitalization will be completed by end-2010** (structural benchmark) (MEFP ¶20)**.** Full recapitalization through private equity injections was planned to be completed by end 2009, but capital adequacy levels have weakened recently due to rising NPLs. The NBU has agreed to approve bank recapitalization plans by end-July and private bank recapitalization—based on the findings of the extended audits—must be completed by end-2010 (structural benchmark). Banks that do not meet their capital needs by end-2010 will be promptly resolved. For Nadra Bank, which continues to be under temporary administration, an audit will be completed before any decision is taken about its final resolution (structural benchmark).

- **Banks under state control will be strengthened or privatized** (MEFP ¶21). Additional steps are needed to strengthen management of three recently nationalized

- banks. The government will retain an internationally-reputable financial adviser to assess their potential and recommend whether these should be privatized or resolved, with a goal of maximizing recovery value for the state. For the remaining two state-owned banks, due diligence studies will be completed by end-December 2010, reviewing operations under the existing governance structures and formulating plans to strengthen their financial condition and outlook (structural benchmark).

- **Oversight and transparency of the banking system will be strengthened** (MEFP ¶23). Measures in this area include: (i) strengthening consolidated supervision (including supervision across different financial service sectors and cross-border); and (ii) requiring full and regular public disclosure of ultimate controllers of banks, to enhance transparency and trust in the system.

- **The legal framework for corporate insolvency and other related legislation will be amended to facilitate loan workouts by end-June 2011** (structural benchmark) (MEFP ¶22).

## IV. PROGRAM MODALITIES AND CAPACITY TO REPAY

### A. Access and Phasing

26. **The authorities request a 29-month SBA in an amount equivalent to SDR 10.0 billion, or 728.9 percent of quota (about US$14.9 billion)**. Ukraine faces considerable financing needs in the coming years, mainly from reduced access to international financing, still inadequate rollover rates from corporates and banks, and the need to continue to strengthen its reserves position (Table 4). Gross external financing requirements are high at about US$31 billion on average in 2010–12, driven by current account deficits, large external debt obligations of the private sector, and the need to replenish reserves. Despite recent improvement, gross international reserves (GIR) still remain below some reserve adequacy metrics (Box 2).

Access and Phasing Under a Proposed Stand-By Arrangement

| Date | Amount of purchase: Millions of SDRs | Amount of purchase: Percent of quota | Conditions |
|---|---|---|---|
| July 28, 2010 | 1,250 | 91.1 | Board approval of arrangement |
| November 30, 2010 | 1,000 | 72.9 | First review and end-September 2010 performance criteria |
| March 15, 2011 | 1,000 | 72.9 | Second review and end-December 2010 performance criteria |
| June 15, 2011 | 1,000 | 72.9 | Third review and end-March 2011 performance criteria |
| September 15, 2011 | 1,000 | 72.9 | Fourth review and end-June 2011 performance criteria |
| December 15, 2011 | 1,000 | 72.9 | Fifth review and end-September 2011 performance criteria |
| March 15, 2012 | 1,000 | 72.9 | Sixth review and end-December 2011 performance criteria |
| June 15, 2012 | 1,000 | 72.9 | Seventh review and end-March 2012 performance criteria |
| September 15, 2012 | 1,000 | 72.9 | Eighth review and end-June 2012 performance criteria |
| December 15, 2012 | 750 | 54.7 | Ninth review and end-September 2012 performance criteria |
| Total | 10,000 | 728.9 | |

Source: IMF staff estimates.

27. **The Fund will play a key role to fill the financing needs and catalyze official sector support to cover remaining financing needs.** Absent Fund and official financing, reserve adequacy will weaken further over the medium term. Support from the Fund will help bring Ukraine's GIR to more comfortable levels (96 percent of short-term debt by 2012) through direct balance of payments support and a catalytic role. The World Bank, the European Commission, and the EBRD are expected to provide up to US$1½ billion in 2010, including for budget support operations, and private inflows are expected to increase. For 2011–12, official commitments so far amount to US$1–2 billion a year.

28. **Phasing under the program is sufficient to close financing gaps.** It is aimed to encourage the authorities to carry forward the critical agenda under the program and is consistent with the reserve objectives of the program.

## B. Exceptional Access Criteria

29. **The proposed SBA entails exceptional access.** Staff's view is that Ukraine meets all substantive exceptional access criteria and proposes that such access be on upper credit tranche terms given the financing pressures and remaining uncertainty in global financial markets.

- **Criterion 1**: The *member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account resulting in a need for Fund financing that cannot be met within the normal limits.* While an improving external environment and reduced political uncertainty have led to some stabilization, Ukraine continues to face high rollover risks and restricted market access, and official reserves are relatively weak. These are generating financing needs beyond what can be financed within normal limits. Absent strong policies and exceptional financing from the Fund, reserve cover is projected to fall sharply.

- **Criterion 2:** *A rigorous and systemic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term.* Public and publicly guaranteed debt is expected to rise to about 40 percent of GDP in 2010. The envisaged fiscal adjustment would strengthen public finances and set public debt ratio firmly on a downward path, ensuring debt sustainability with a high probability. With the completion of bank recapitalization in 2010, and barring unexpected events, potential contingent liabilities of the government would be relatively limited. Three-quarters of external debt is concentrated in the private sector, and is projected to decline as a percent of GDP over the medium term as the large buildup in bank and corporate loans over the past several years stabilizes. Stress tests indicate that Ukraine's medium-term public and external debt sustainability is dependent on strong growth assumptions (Figures 4 and 5, Tables 10 and 11).

- **Criterion 3:** *The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.* Ukraine's loss of access to capital markets is linked to the global financial crisis, exacerbated by domestic vulnerabilities and recent policies. However, non-residents' interest in Ukrainian fixed-income assets has been rekindled recently and with a successful implementation of a strong program, staff anticipates that Ukraine has good prospects of regaining greater access to private capital markets in the near term.

- **Criterion 4**: *The policy program provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.* While Ukraine's past track record of adherence to Fund programs is mixed, the economic reforms that would be supported by the proposed Fund arrangement are backed at the highest political levels. The government has already frontloaded several important policy measures through prior actions and demonstrated its willingness to address the challenges ahead as evidenced by early targets for many structural benchmarks. Nonetheless, strong and consistent policy implementation will be needed throughout the program period. The government's institutional capacity to deliver the core elements of the program will be strengthened by ongoing technical support from the Fund and other IFIs.

### C. Capacity to Repay the Fund and Risks to the Program

30. **With strong program implementation, Ukraine's capacity to repay the Fund is expected to be adequate** (Table 9)**.** By the end of the arrangement in 2012, outstanding credit to the Fund is expected to peak at about 14 percent of GDP, or 51 percent of gross reserves. Combined with outstanding use of Fund resources from the previous SBA, debt service to the Fund as a ratio of exports of goods and services would peak at 7 percent in 2013, including both the liabilities of the NBU and the central government to the Fund. Ukraine's capacity to repay will therefore depend on its ability to deepen market access and strengthen public finances. The authorities' record in repaying past loans and strong

31. commitment to the program provide assurances that it will be in a position to discharge its obligations to the Fund in a timely manner.

32. **Nevertheless, there are considerable risks to the program** These could reduce prospects for normalizing access to international capital markets within the timeframe when Fund resources are outstanding**.**

- **External developments remain highly uncertain.** External risks remain elevated given the uneven recovery in Europe and still volatile financial markets. The fallout from the Stockholm arbitration ruling could further strain public finances. The authorities are currently reviewing their options and any risks would be addressed in the context of future reviews.

- **Domestic risks, including from a fragile economy and rising NPLs, weak business environment and institutions could undermine confidence and the recovery**.

- **The political commitment to deep reforms could diminish.** With local elections on the horizon and parliamentary elections in the Fall 2012, political pressures to weaken program implementation could result in incomplete adjustment.

33. **On the positive side, stronger global growth, higher commodity prices, and stronger investor sentiment provide for upside potential**. Stronger global growth and rising steel prices could further improve the current account position in 2010 and boost growth. FDI could pick up more rapidly than anticipated and financing from external markets could resume at a faster rate, raising reserves to an even more secure level.

## D. Program Monitoring and Conditionality

34. **Program performance will be monitored through quarterly reviews.** The initial disbursement will be SDR 1.25 billion. The first review under the program will be set for November 30, 2010, based on end-September 2010 targets, while the second review is proposed for March 15, 2011, based on end-December 2010 targets. Performance will be monitored by quarterly quantitative performance criteria and structural benchmarks. The authorities are also undertaking several prior actions to support their request for the arrangement (MEFP, Appendix Table 1.2 and text box).

35. **An update to the safeguards assessment will be completed by the first review of the proposed arrangement**. There are several outstanding issues from the 2008 safeguards assessment of the NBU, including legal amendments to strengthen the NBU's independence, governance, and financial reporting practices; introduction of audit oversight by the Council, pending changes to the law; adoption of an action plan to address the recurring accounting and control weaknesses observed by the NBU's external auditor; and completion of an external review of the internal audit function.

## Box 6: Proposed Stand-By Arrangement

**Access:** SDR 10 billion (approximately 730 percent of quota or $15 billion).

**Length:** 29 months.

**Phasing:** SDR 1.25 billion will be made available upon the Board's approval of the arrangement. The nine subsequent tranches will equal SDR 8.75 billion and are contingent upon completion of quarterly reviews, starting from November 2010.

**Conditionality**

***Prior Actions***

- Enact a supplementary budget with fiscal measures of UAH 16 billion and consistent with a 5.5 percent of GDP deficit for the general government in 2010 and the commitments in the MEFP.
- Increase gas tariffs for all households and utility companies by 50 percent (effective August 1, with the coming billing cycle).
- Enact amendments to the NBU law in line with IMF recommendations.
- Amend NBU Resolution 47 (to strengthen the emergency liquidity assistance framework and eliminate the possibility of NBU lending to the private sector) in line with IMF recommendations.
- Adopt legislation transferring the authority for setting heating tariffs for communal utilities to a new independent regulator.

***Quantitative and Continuous Performance Criteria***

- Floor on net international reserves
- Ceiling on net domestic assets
- Ceiling on the cash deficit of the general government
- Ceiling on cash deficit of the general government and Naftogaz
- Ceiling on publicly guaranteed debt
- Non-accumulation of external debt payments arrears by the general government

***Quantitative Indicative Targets***

- Ceiling on monetary base
- Ceiling on VAT refund arrears

***Structural Benchmarks***

- Enact legislation to revoke the law "On temporary ban to levy penalties for overdue payments of utility bills" so that any arrears on utility payments accumulated after October 1, 2010 are subject to penalties. *By September 30, 2010*.
- Agree with Fund staff on a schedule for phasing out existing restrictions on the foreign exchange market. *By October 31, 2010.*
- Complete audit for Nadra Bank before any decision on its resolution. *By October 31, 2010.*
- Enact legislation on pension reforms consistent with commitments in the MEFP. *By December31, 2010.*
- All banks should meet capital requirements and capital deficient banks should increase their capital in line with the approved plans. *By December 31, 2010.*
- Complete due diligence of state-owned banks in line with ¶21 of the MEFP. *By December 31, 2010.*
- Initiate the implementation of the reform and restructuring strategy for Naftogaz in accordance with the principles of the Brussels declaration. *By December 31, 2010.*
- Amend the law "On surcharges for the purposes of mandatory state pension insurance" 400/97-BP to permanently eliminate the surcharge on non-cash purchase and sales of foreign currency. *By December 31, 2010.*
- Formulate a comprehensive public administration reform plan aiming to improve the cost efficiency of public service delivery. *By March 31, 2011.*
- Adopt amendments to the Law of Ukraine "On restoring the solvency of the debtor or announcing him/her bankrupt" and related regulations to expedite insolvency proceedings and to facilitate out-of-court restructuring. *By June 30, 2011.*

## V. Staff Appraisal

36. **Staff believes the authorities' economic program to be supported by the proposed SBA is sufficiently ambitious to achieve its objectives; its success, however, hinges on consistent implementation**. While Ukraine is slowly recovering from one of the sharpest crises in its recent history, the recovery is narrowly based and vulnerable. Strong policies are needed to ensure macroeconomic stability against an unsettled regional outlook and to create the basis for higher growth. The authorities have decided to press ahead with a multiyear program that is sufficiently ambitious to tackle long-standing structural weaknesses. The implementation of decisive prior actions demonstrates their commitment. However, sustained strong political backing from the highest levels within the government will be needed for the program's success, and to break from the uneven implementation that marred previous Fund-supported programs.

37. **The fiscal adjustment under the program is ambitious, but achievable.** The program envisages a sizeable improvement in the fiscal balance between 2009 and 2012 which is necessary to safeguard medium-term fiscal sustainability. However, spending pressures emerging from the Euro 2012 and the October local elections will need to be contained, possible fallout from the Stockholm arbitration ruling will need to be addressed, and fiscal control over local governments and state-owned institutions (road fund, agrarian fund) have to be strengthened.

38. **Pension system and the energy sector reforms are critically important to address long-standing structural problems**. Pension reforms are needed to help permanently address the financial problems beleaguering the pension system, and free up scarce budgetary resources. The proposed measures will help stabilize contribution rates, increase system enrollment, and encourage workers to stay longer in the labor force. Energy sector reforms are a critical step forward and together with the adoption of a comprehensive energy strategy, supported by other IFIs, would help strengthen Naftogaz's finances. The authorities deserve credit for taking politically difficult measures in 2010, while undertaking steps to protect the poorest segment of the population from adverse effects.

39. **Strengthening the NBU's autonomy is essential for a more effective monetary policy and the rehabilitation of the banking system.** The amendments to the NBU law are an important institutional step that will help monetary policy focus more squarely on inflation objectives and fend off pressures for monetization of deficits and quasi fiscal activities. For now the monetary policy stance is appropriate but the authorities will need to be vigilant against undue build up of excess reserves. A more flexible exchange rate would serve better Ukraine in facing future external shocks and to discourage excessive risk-taking by domestic borrowers and foreign lenders.

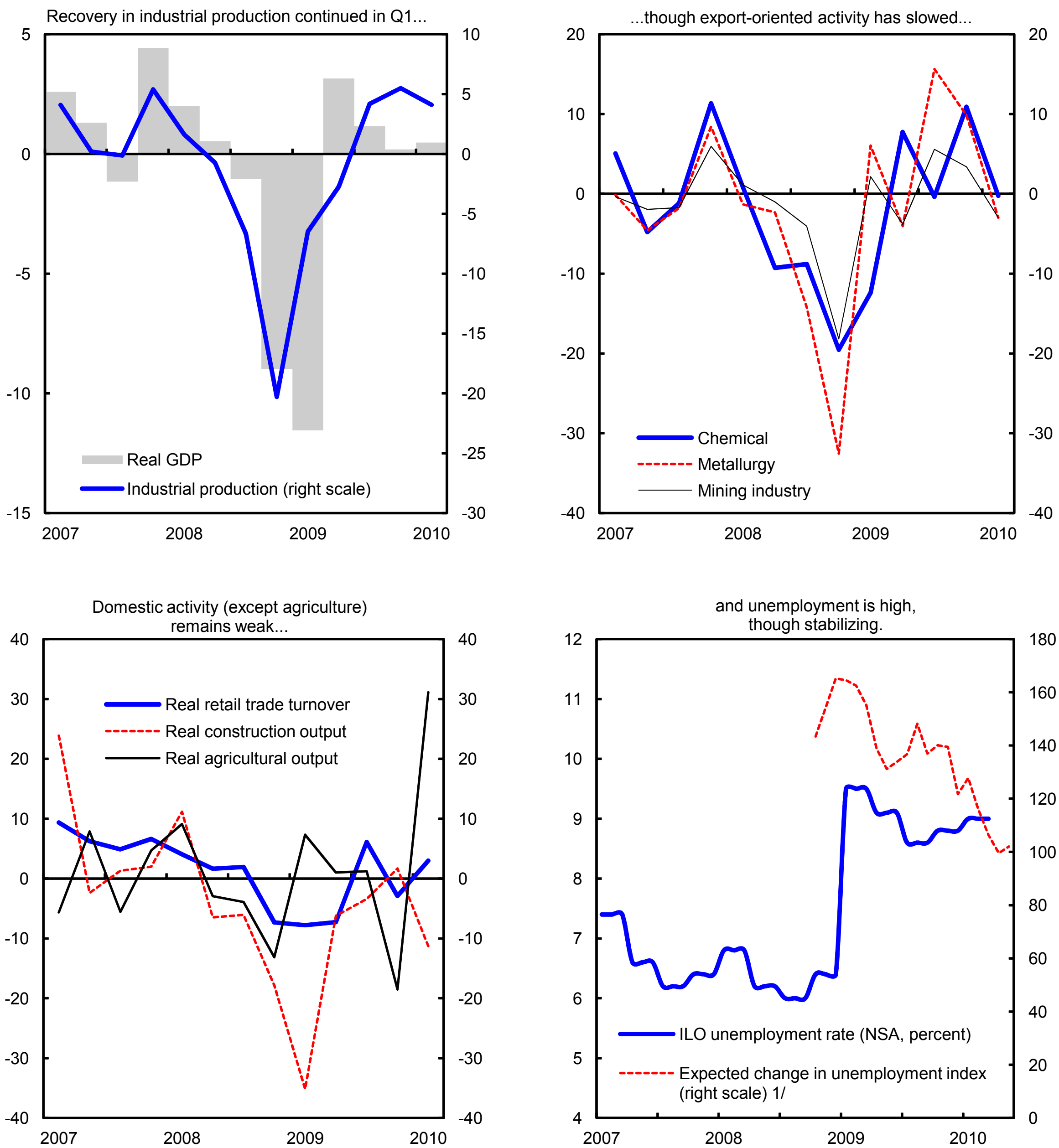
40. **Staff believes the proposed banking sector reforms will meaningfully help restore confidence in the banking system.** Steady implementation of bank recapitalization

41. (made credible by prompt remedial measures) and strengthened governance and transparency in financial sector policies are critical to restore full public confidence in banks, bring the banking system back to health, and eliminate the drain of the banking system on the budget, which are crucial for economic recovery.

42. **The program is fully financed despite the relatively high fiscal deficit target this year, but there are risks.** On the external side, these include the potential for adverse regional and/or global developments and shortfalls in assumed official financing. On the domestic side, the difficult political environment continues to pose significant implementation risks.

43. **Implementation of policies consistent with the program provides the best chance for Ukraine to succeed with reforms, reinvigorate growth, and reduce vulnerabilities.** Staff believes that strict observance of the adjustment program will allow Ukraine to exit from Fund support by the end of the arrangement. On the basis of the authorities' recent actions and forward-looking commitments, staff supports the authorities' request for a new Stand-By Arrangement.

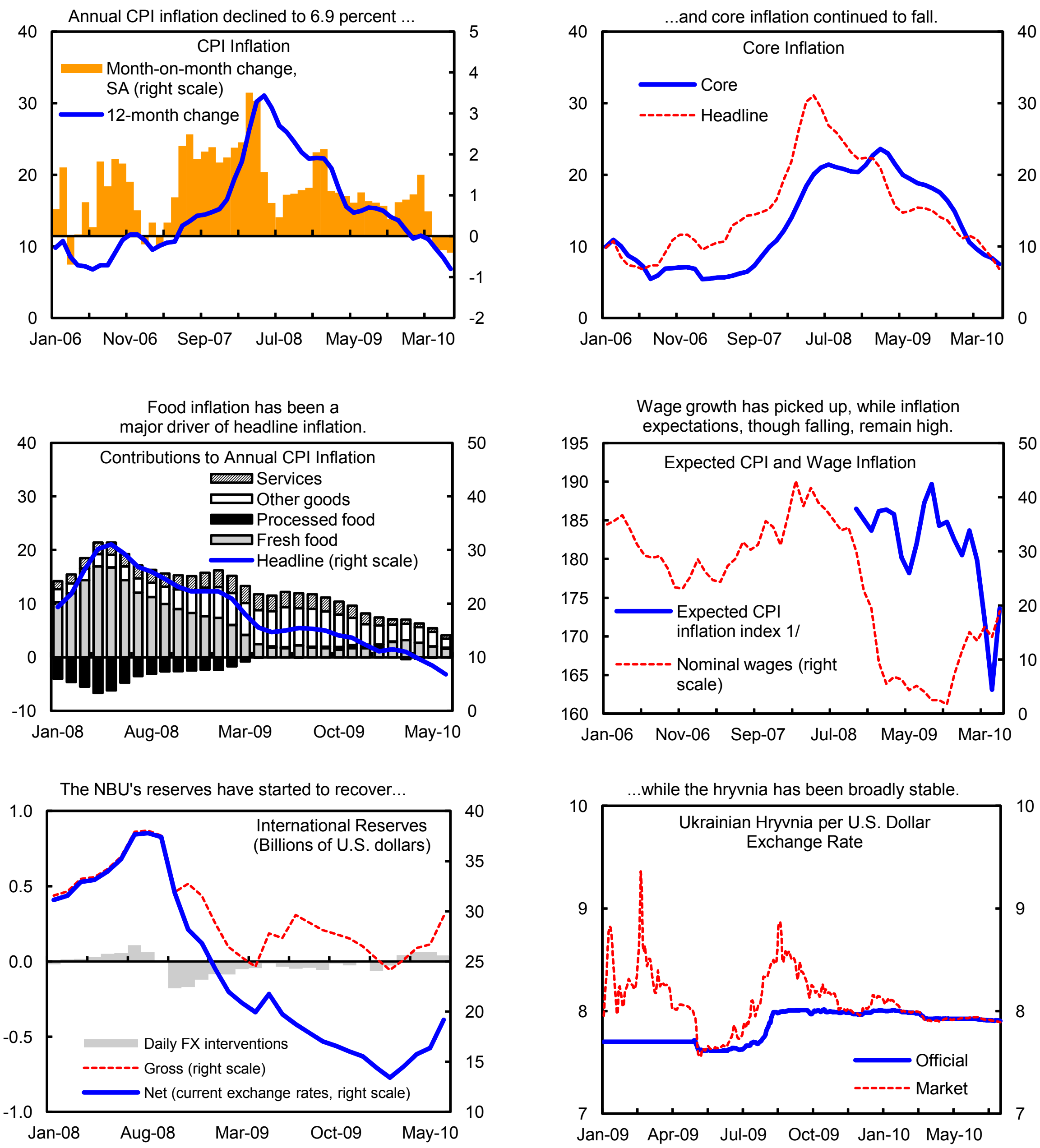
Figure 1. Ukraine: Real Sector Indicators, 2007–10
(Seasonally adjusted, quarter-on-quarter percent change, unless otherwise indicated)




Sources: State Statistics Committee of Ukraine; International Centre for Policy Studies; and IMF staff calculations.
1/ Values above 100 indicate that more respondents expect unemployment to rise than fall over the next one to two months. Values can vary from 0 to 200.

Figure 2. Ukraine: Inflation, Monetary, and Exchange Rate Developments, 2006-2010

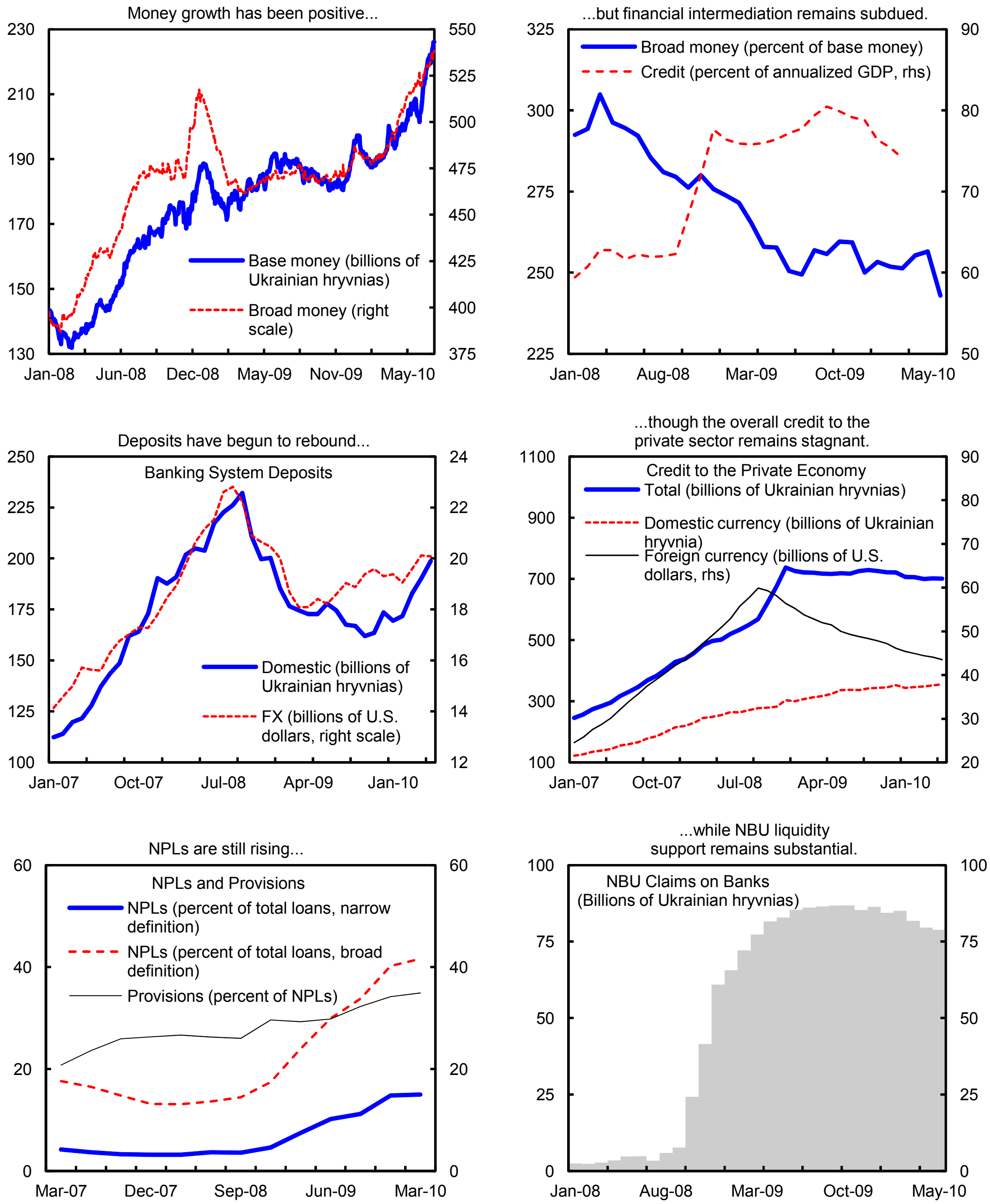
(Year-on-year percent change, unless otherwise indicated)




Sources: State Statistics Committee of Ukraine; International Centre for Policy Studies; National Bank of Ukraine; Bloomberg; and IMF staff calculations.

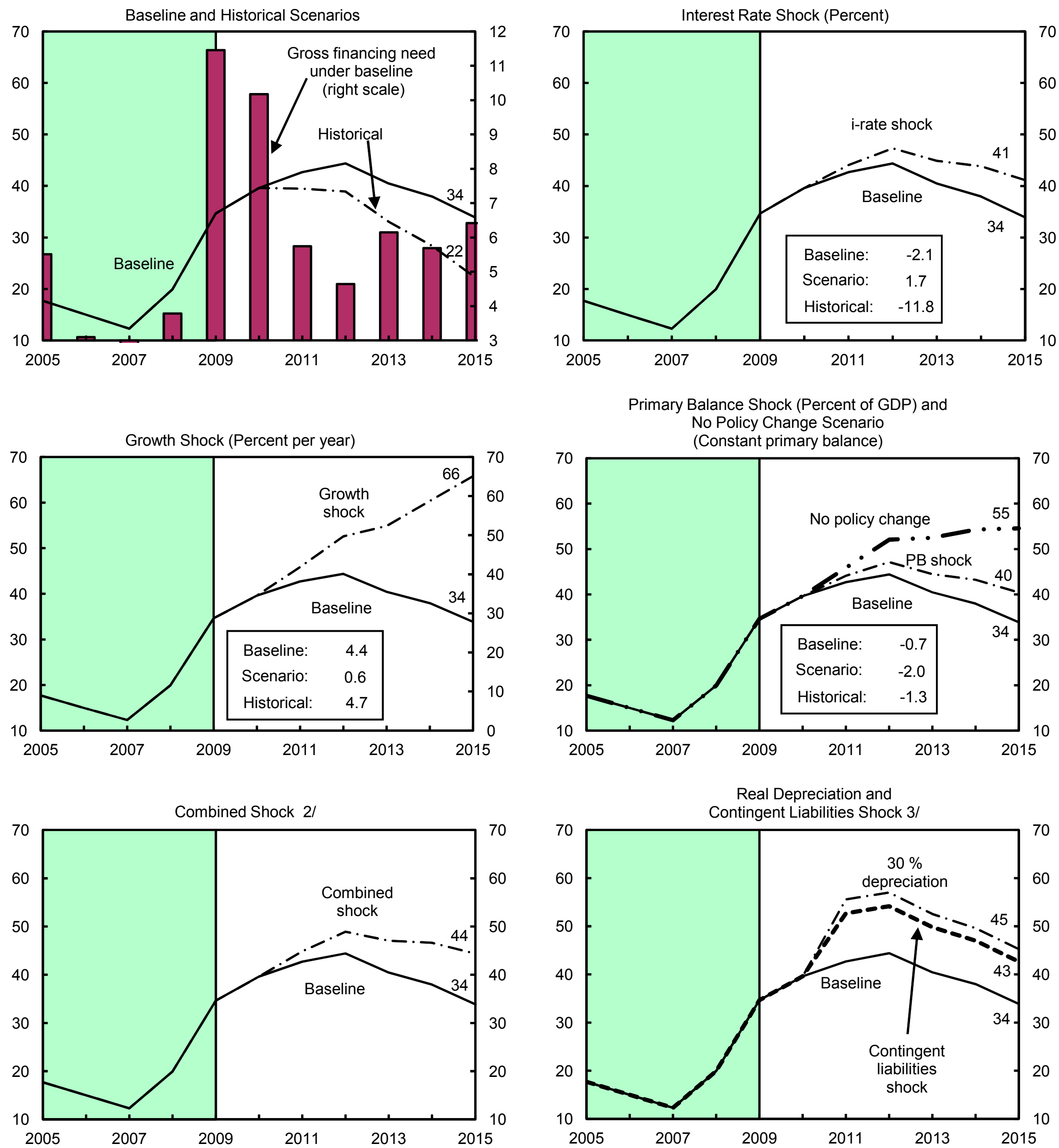
1/ Values above 100 indicate that more respondents expect inflation to rise than to fall over the next one to two months. Values can vary from 0 to 200.

Figure 3. Ukraine: Financial Sector Indicators, 2007–10




Sources: National Bank of Ukraine; and IMF staff calculations.

Figure 4. Ukraine: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



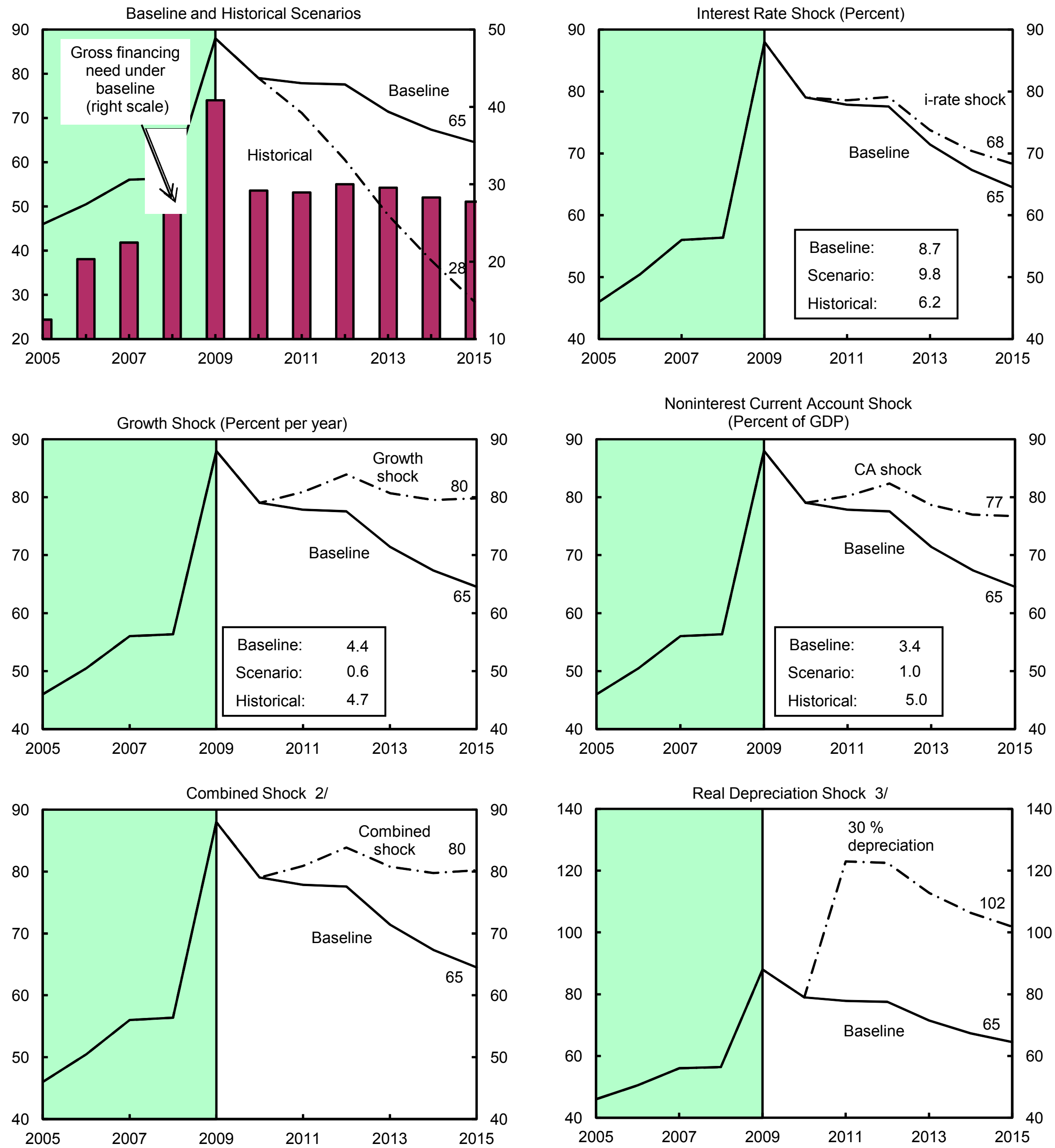

Sources: IMF staff estimates.

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 10 percent of GDP shock to contingent liabilities occur in 2010, 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 5. Ukraine: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)




Sources: IMF 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/ In line with standard IMF stress tests, the shock simulates the impact of a one-time real depreciation of 30 percent in 2010.

Table 1. Ukraine: Selected Economic and Social Indicators, 2007–12

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| | | | | | Proj. | |
| Real economy (percent change, unless otherwise indicated) | | | | | | |
| Nominal GDP (billions of Ukrainian hryvnias) | 721 | 950 | 915 | 1,083 | 1,235 | 1,405 |
| Real GDP | 7.9 | 2.1 | -15.1 | 3.7 | 4.3 | 4.8 |
| Contributions: | | | | | | |
| Domestic demand | 16.0 | 7.9 | -25.6 | 4.9 | 5.9 | 6.5 |
| Consumption | 9.4 | 6.1 | -10.0 | 1.4 | 2.9 | 4.4 |
| Investment | 6.6 | 1.8 | -15.6 | 3.4 | 3.0 | 2.1 |
| Net exports | -8.1 | -5.8 | 10.5 | -1.1 | -1.6 | -1.7 |
| Unemployment rate (ILO definition; percent) | 6.4 | 6.4 | 8.8 | 8.8 | 7.9 | 7.4 |
| Consumer prices (period average) | 12.8 | 25.2 | 15.9 | 9.9 | 10.7 | 8.3 |
| Consumer prices (end of period) | 16.6 | 22.3 | 12.3 | 12.0 | 9.7 | 9.2 |
| Nominal monthly wages (average) | 29.7 | 33.7 | 5.5 | 16.0 | 14.1 | 10.8 |
| Real monthly wages (average) | 14.9 | 6.8 | -8.9 | 5.5 | 2.0 | 2.3 |
| Public finance (percent of GDP) | | | | | | |
| General government balance 1/ | -2.0 | -3.2 | -6.2 | -5.5 | -3.5 | -2.5 |
| Overall balance (including Naftogaz operational deficit) | -2.0 | -3.2 | -8.7 | -6.5 | -3.5 | -2.5 |
| Privatization proceeds | 0.6 | 0.3 | 0.2 | 0.9 | 0.4 | 0.2 |
| Net domestic financing | 0.4 | 2.5 | 3.8 | 2.9 | 1.7 | 1.8 |
| Net external financing | 1.0 | 0.4 | 4.7 | 2.7 | 1.4 | 0.5 |
| Overall balance (including Naftogaz, and other debt creating flows) 2/ | -2.0 | -3.2 | -11.3 | -9.9 | -3.5 | -2.5 |
| Public debt (end of period) 3/ | 12.3 | 19.9 | 34.6 | 39.5 | 41.5 | 42.2 |
| Money and credit (end of period, percent change) | | | | | | |
| Base money | 46.0 | 31.6 | 4.4 | 14.4 | 13.5 | 12.5 |
| Broad money | 51.7 | 30.2 | -5.5 | 14.7 | 15.1 | 14.1 |
| Credit to nongovernment | 74.0 | 71.9 | -2.2 | 4.0 | 14.2 | 11.9 |
| Velocity | 1.8 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 |
| Interbank overnight rate (annual average, percent) 4/ | 2.3 | 13.7 | 12.6 | 1.3 | … | … |
| Balance of payments (percent of GDP) | | | | | | |
| Current account balance | -3.7 | -7.1 | -1.5 | -0.7 | -1.8 | -2.6 |
| Foreign direct investment | 6.5 | 5.5 | 4.0 | 3.4 | 3.6 | 3.9 |
| Gross reserves (end of period, billions of U.S. dollars) | 32.5 | 31.5 | 26.5 | 30.3 | 38.5 | 43.4 |
| Months of next year's imports of goods and services | 3.9 | 6.7 | 4.8 | 4.8 | 5.5 | 5.6 |
| Percent of short-term debt (remaining maturity) | 84.8 | 68.3 | 68.4 | 74.8 | 89.7 | 96.2 |
| External debt (percent of GDP) | 56.0 | 56.4 | 88.0 | 79.0 | 77.8 | 77.6 |
| Goods exports (annual volume change in percent) | 3.2 | 1.1 | -25.5 | 9.0 | 8.5 | 8.6 |
| Goods imports (annual volume change in percent) | 20.3 | 13.5 | -42.1 | 10.7 | 10.8 | 10.0 |
| Goods terms of trade (percent change) | 9.0 | 10.0 | -13.8 | 1.9 | -0.4 | 0.5 |
| Exchange rate | | | | | | |
| Hryvnia per U.S. dollar, end of period 4/ | 5.1 | 7.7 | 8.0 | 7.9 | … | … |
| Hryvnia per U.S. dollar, period average 4/ | 5.1 | 5.3 | 7.8 | 7.9 | … | … |
| Real effective rate (CPI, percent change) 5/ | 2.5 | 10.3 | -17.6 | 2.5 | … | … |
| Memorandum items: | | | | | | |
| Nominal GDP (billions of U.S. dollars) | 142.7 | 180.5 | 117.4 | 136.2 | 149.3 | 156.3 |
| Per capita GDP (2009): $2,569 (WEO) | | Percent of population below poverty line (2006): 8.0 | | | | |
| Quota (2009): SDR 1,372 million (2,116 million U.S. dollars) | | | | | | |

Sources: State Statistics Committee of Ukraine; Ministry of Finance; National Bank of Ukraine; World Bank, *World Development Indicators*; and IMF staff estimates and projections.

1/ The general government includes the central and local governments and the social funds.
2/ Other debt creating flows include bonds issued to (i) recapitalize banks in 2009–10, and (ii) settle arrears on VAT refunds in 2010.
3/ Government and government-guaranteed debt (includes debt to IMF).
4/ Latest data as of end-June, 2010.
5/ Latest data as of end-May, 2010.

Table 2. Ukraine: General Government Finances, 2008–11 1/

| | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| | | | Proj. | |
| | (Billions of Ukrainian hryvnias) | | | |
| **Revenue** | **419.7** | **386.3** | **463.3** | **522.5** |
| Tax revenue | 358.1 | 337.4 | 412.3 | 474.8 |
| Personal income tax | 45.9 | 44.5 | 50.5 | 57.2 |
| Enterprise profit tax | 47.9 | 33.0 | 44.1 | 51.3 |
| Payroll tax | 107.9 | 110.8 | 126.7 | 146.7 |
| Property tax | 6.7 | 8.4 | 9.4 | 10.5 |
| VAT | 92.1 | 84.6 | 97.8 | 112.3 |
| Other taxes on goods and services | 28.7 | 33.4 | 45.9 | 53.6 |
| Taxes on international trade | 12.3 | 6.9 | 8.8 | 10.3 |
| Other taxes | 16.7 | 15.7 | 29.1 | 32.8 |
| Nontax, capital revenue, and grants | 61.6 | 48.9 | 51.1 | 47.8 |
| **Expenditure** | **449.6** | **443.5** | **522.9** | **565.7** |
| Current expenditures | 392.5 | 420.5 | 491.1 | 535.4 |
| Wages | 97.7 | 106.0 | 131.4 | 146.0 |
| Goods and services | 59.5 | 67.6 | 67.5 | 75.6 |
| Subsidies | 34.4 | 27.2 | 24.5 | 19.1 |
| Transfers | 196.0 | 209.2 | 251.7 | 274.6 |
| Interest | 4.9 | 10.6 | 16.0 | 19.9 |
| Capital spending | 52.9 | 20.0 | 29.1 | 29.1 |
| Net lending | 2.8 | 2.8 | 1.2 | 1.3 |
| **Overall balance** | **-30.0** | **-57.1** | **-59.6** | **-43.2** |
| Naftogaz balance 2/ | … | -22.7 | -11.0 | 0.0 |
| **Overall balance (incl. Naftogaz)** | **-30.0** | **-79.8** | **-70.6** | **-43.2** |
| Other debt creating flows | … | -23.3 | -36.4 | 0.0 |
| Bank recapitalization bonds | … | -23.3 | -20.0 | 0.0 |
| Issuance of VAT bonds | … | 0.0 | -16.4 | 0.0 |
| **Overall balance (incl. Naftogaz and other debt creating flows)** | **-30.0** | **-103.1** | **-107.0** | **-43.2** |
| Financing (excluding bank recap bonds) | 30.0 | 79.8 | 70.6 | 43.2 |
| External | 3.6 | 42.7 | 29.6 | 17.8 |
| Disbursements | 6.2 | 58.4 | 52.1 | 26.5 |
| *Of which:* | | | | |
| IMF | 0.0 | 36.9 | 16.0 | 0.0 |
| Other IFIs | 6.2 | 21.5 | 9.9 | 18.2 |
| Amortization | -2.6 | -15.7 | -22.5 | -8.7 |
| Domestic | 23.9 | 35.0 | 31.0 | 20.4 |
| Banking sector | 20.0 | 29.3 | 29.4 | 20.4 |
| Borrowing | 23.4 | 38.6 | 46.5 | 39.4 |
| Amortization | -3.4 | -9.3 | -17.1 | -19.0 |
| Deposit finance | 3.9 | 5.7 | 1.6 | 0.0 |
| Privatization | 2.5 | 2.1 | 10.0 | 5.0 |

Table 2. Ukraine: General Government Finances, 2008–11 1/ (concluded)

| | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| | | | Proj. | |
| | (Percent of GDP, unless otherwise indicated) | | | |
| **Revenue** | **44.2** | **42.2** | **42.8** | **42.3** |
| Tax revenue | 37.7 | 36.9 | 38.1 | 38.5 |
| Nontax, capital revenue, and grants | 6.5 | 5.3 | 4.7 | 3.9 |
| **Expenditure** | **47.3** | **48.5** | **48.3** | **45.8** |
| Current expenditures | 41.3 | 46.0 | 45.3 | 43.4 |
| Capital spending | 5.6 | 2.2 | 2.7 | 2.4 |
| Net lending | 0.3 | 0.3 | 0.1 | 0.1 |
| Unallocated spending | 0.1 | 0.0 | 0.1 | 0.0 |
| **Overall balance** | **-3.2** | **-6.2** | **-5.5** | **-3.5** |
| Naftogaz balance 2/ | … | -2.5 | -1.0 | 0.0 |
| **Overall balance (incl. Naftogaz)** | -3.2 | -8.7 | -6.5 | -3.5 |
| Other debt creating flows | … | -2.5 | -3.4 | 0.0 |
| Bank recapitalization bonds | … | -2.5 | -1.8 | 0.0 |
| Issuance of VAT bonds | … | 0.0 | -1.5 | 0.0 |
| **Overall balance (incl. Naftogaz and other debt creating flows)** | **-3.2** | **-11.3** | **-9.9** | **-3.5** |
| Financing (excluding bank recap and VAT bonds) | 3.2 | 8.7 | 6.5 | 3.5 |
| External | 0.4 | 4.7 | 2.7 | 1.4 |
| Disbursements | 0.7 | 6.4 | 4.8 | 2.1 |
| Amortization | -0.3 | -1.7 | -2.1 | -0.7 |
| Domestic | 2.5 | 3.8 | 2.9 | 1.7 |
| Banking sector | 2.1 | 3.2 | 2.7 | 1.7 |
| Deposit finance | 0.4 | 0.6 | 0.1 | 0.0 |
| Privatization | 0.3 | 0.2 | 0.9 | 0.4 |
| Memorandum items (billions of Ukrainian hryvnias, unless otherwise indicated): | | | | |
| Net domestic financing (including bank recap and VAT bonds) | 23.9 | 58.3 | 67.4 | 20.4 |
| Output gap (percent of GDP) | 3.4 | -8.6 | -7.5 | -6.0 |
| Nominal GDP | 949.9 | 914.7 | 1,083 | 1,235 |

Sources: Ministry of Finance; National Bank of Ukraine; and IMF staff estimates and projections.

1/ The general government covers the central government, local governments, the pension fund and other social funds.

2/ The cash balance of Naftogaz reflects the balance after budget transfers.

Table 3. Ukraine: Medium-Term Balance of Payments, 2007–15

(Billions of U.S. dollars, unless otherwise indicated)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Proj. | | | |
| Current account balance | -5.3 | -12.8 | -1.8 | -1.0 | -2.7 | -4.0 | -4.8 | -5.5 | -6.2 |
| Merchandise trade balance | -10.6 | -16.1 | -4.7 | -5.5 | -7.6 | -9.0 | -9.9 | -10.5 | -11.1 |
| Exports, f.o.b. | 49.8 | 67.7 | 40.4 | 48.5 | 54.0 | 60.2 | 66.8 | 74.1 | 82.1 |
| Imports, f.o.b. | -60.4 | -83.8 | -45.0 | -54.0 | -61.6 | -69.2 | -76.7 | -84.6 | -93.2 |
| *Of which: energy* | -15.3 | -22.0 | -14.5 | -17.8 | -19.4 | -20.9 | -22.3 | -23.6 | -25.2 |
| Services (net) | 2.4 | 1.7 | 2.6 | 4.1 | 4.5 | 4.5 | 4.8 | 5.2 | 5.7 |
| Receipts | 14.2 | 17.9 | 13.9 | 16.7 | 18.1 | 19.2 | 20.3 | 21.6 | 22.9 |
| Payments | -11.7 | -16.2 | -11.2 | -12.7 | -13.7 | -14.7 | -15.6 | -16.4 | -17.2 |
| Income (net) | -0.7 | -1.5 | -2.4 | -2.4 | -2.4 | -2.5 | -3.0 | -3.8 | -4.6 |
| Current transfers (net) | 3.5 | 3.1 | 2.7 | 2.8 | 2.9 | 3.1 | 3.3 | 3.5 | 3.8 |
| Capital and financial account balance | 15.1 | 9.2 | -12.3 | -0.1 | 3.0 | 5.6 | 9.8 | 10.5 | 12.8 |
| Capital account 1/ | 0.0 | 0.0 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Financial account | 15.1 | 9.2 | -12.9 | -0.1 | 3.0 | 5.6 | 9.8 | 10.5 | 12.8 |
| Direct investment (net) | 9.2 | 9.9 | 4.7 | 4.6 | 5.4 | 6.2 | 6.8 | 7.4 | 7.9 |
| Portfolio investment (net) | 5.8 | -1.3 | -1.6 | 1.5 | 1.1 | 1.2 | 2.1 | 2.7 | 3.1 |
| Other investment (net) | 0.2 | 0.5 | -16.0 | -6.1 | -3.5 | -1.8 | 0.9 | 0.5 | 1.7 |
| Medium and long-term loans | 14.4 | 14.8 | -3.3 | -2.6 | 0.5 | 1.9 | 4.2 | 3.6 | 4.6 |
| Official | 0.5 | 0.5 | 0.2 | -0.4 | 0.0 | 0.6 | 1.7 | 0.3 | 0.3 |
| Disbursements 2/ | 1.2 | 0.9 | 0.7 | 2.0 | 0.5 | 1.0 | 2.1 | 2.6 | 2.1 |
| Repayments | -0.8 | -0.5 | -0.5 | -2.5 | -0.5 | -0.4 | -0.4 | -2.3 | -1.8 |
| Banks | 6.6 | 8.1 | -1.9 | -1.5 | 0.4 | 0.8 | 1.5 | 2.1 | 2.7 |
| Other sectors | 7.3 | 6.2 | -1.6 | -0.6 | 0.1 | 0.5 | 1.0 | 1.2 | 1.7 |
| Short-term loans | -0.6 | -3.0 | -1.5 | 1.4 | 0.2 | 0.5 | 0.8 | 1.0 | 1.2 |
| Banks | 4.1 | -1.8 | -4.7 | 0.3 | 0.1 | 0.2 | 0.3 | 0.5 | 0.6 |
| Other sectors | -4.6 | -1.2 | 3.2 | 1.1 | 0.1 | 0.3 | 0.5 | 0.6 | 0.7 |
| Currency and deposits | -13.7 | -11.3 | -11.3 | -5.0 | -4.2 | -4.2 | -4.1 | -4.1 | -4.1 |
| Banks | -0.1 | 1.6 | -1.6 | -1.0 | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 |
| Other sectors 3/ | -13.6 | -12.9 | -9.7 | -4.0 | -4.5 | -4.5 | -4.5 | -4.5 | -4.5 |
| Errors and omissions | -0.4 | 0.5 | 0.4 | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Overall balance | 9.4 | -3.1 | -13.7 | -1.3 | 0.3 | 1.6 | 5.0 | 5.0 | 6.6 |
| Prospective official financing | ... | ... | ... | 1.6 | 1.9 | 1.1 | ... | ... | ... |
| European Commission | ... | ... | ... | 0.5 | 0.7 | 0.2 | ... | ... | ... |
| World Bank | ... | ... | ... | 0.5 | 0.9 | 0.5 | ... | ... | ... |
| EBRD/Others | ... | ... | ... | 0.6 | 0.4 | 0.4 | ... | ... | ... |
| Financing | -9.4 | 3.1 | 13.7 | -0.2 | -2.2 | -2.7 | -5.0 | -5.0 | -6.6 |
| Gross official reserves (increase: -) | -9.0 | -1.1 | 5.5 | -3.6 | -8.2 | -5.0 | 0.4 | -0.3 | -1.0 |
| Net use of IMF resources 4/ | -0.4 | 4.2 | 8.2 | 3.3 | 6.0 | 2.3 | -5.5 | -4.7 | -5.6 |
| Memorandum items: | | | | | | | | | |
| Total external debt | 80.0 | 101.7 | 103.3 | 107.6 | 116.2 | 121.1 | 120.7 | 123.4 | 127.2 |
| Total external debt (percent of GDP) | 56.0 | 56.4 | 88.0 | 79.0 | 77.8 | 77.6 | 71.4 | 67.4 | 64.5 |
| Current account balance (percent of GDP) | -3.7 | -7.1 | -1.5 | -0.7 | -1.8 | -2.6 | -2.8 | -3.0 | -3.1 |
| Excluding transfers | -6.2 | -8.8 | -3.8 | -2.8 | -3.7 | -4.5 | -4.8 | -5.0 | -5.1 |
| Gross international reserves (end of period) | 32.5 | 31.5 | 26.5 | 30.3 | 38.5 | 43.4 | 43.0 | 43.3 | 44.3 |
| Months of next year's imports of goods and services | 3.9 | 6.7 | 4.8 | 4.8 | 5.5 | 5.6 | 5.1 | 4.7 | 4.6 |
| Percent of short-term debt (remaining maturity) | 84.8 | 68.3 | 68.4 | 74.8 | 89.7 | 96.2 | 92.9 | 89.3 | 87.9 |
| Merchandise export value (percent change) | 28.0 | 35.9 | -40.3 | 20.1 | 11.3 | 11.4 | 11.0 | 10.9 | 10.9 |
| Merchandise import value (percent change) | 36.9 | 38.7 | -46.2 | 19.9 | 14.0 | 12.4 | 10.9 | 10.3 | 10.2 |
| Merchandise export volume (percent change) | 3.2 | 1.1 | -25.5 | 9.0 | 8.5 | 8.6 | 8.2 | 8.1 | 8.1 |
| Merchandise import volume (percent change) | 20.3 | 13.5 | -42.1 | 10.7 | 10.8 | 10.0 | 8.8 | 8.3 | 8.1 |
| Goods terms of trade (percent change) | 9.0 | 10.0 | -13.8 | 1.9 | -0.4 | 0.5 | 0.7 | 0.8 | 0.7 |

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

1/ Includes one-time sale of greenhouse gas emission quotas in 2009.

2/ For program period (2010–12), prospective financing from official sources are recorded below the line. This treatment is different from that presented in IMF Staff Report No. 09/270. Includes bilateral loans for government-guaranteed energy project.

3/ Mainly reflects the withdrawal of residents' foreign currency cash holdings from the banking system.

4/ Includes the general and special allocations of SDR 1,309.4 million (about US$2 billion) in August and September, 2009.

## Table 4. Ukraine: Gross External Financing Requirements, 2009–12

(Billions of U.S. dollars)

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| **Total financing requirements** | 44.7 | 30.6 | 31.3 | 32.0 |
| Current account deficit | 1.8 | 1.0 | 2.7 | 4.0 |
| Medium and long-term debt | 18.5 | 15.4 | 15.5 | 14.8 |
| Private | 16.4 | 12.6 | 14.5 | 14.0 |
| Public (including bonds) | 2.1 | 2.8 | 1.1 | 0.8 |
| Short-term debt (including deposits) | 13.2 | 9.6 | 8.6 | 8.6 |
| Other net capital outflows 1/ | 11.2 | 4.6 | 4.5 | 4.5 |
| **Total financing sources** | 30.6 | 29.5 | 31.6 | 33.6 |
| Capital transfers 2/ | 0.6 | 0.0 | 0.0 | 0.0 |
| Direct investment, net | 4.7 | 4.6 | 5.4 | 6.2 |
| Portfolio investment | 0.0 | 1.9 | 1.6 | 1.6 |
| Medium and long-term loans | 14.0 | 12.5 | 15.5 | 16.3 |
| Private | 13.3 | 10.5 | 15.0 | 15.3 |
| Public 3/ | 0.7 | 2.0 | 0.5 | 1.0 |
| Short-term loans (including deposits) | 9.4 | 9.4 | 8.6 | 9.0 |
| Trade credit, net | 2.0 | 1.2 | 0.5 | 0.5 |
| **Increase in gross reserves** | -5.5 | 3.6 | 8.2 | 5.0 |
| **Errors and omissions** | 0.4 | -0.3 | 0.0 | 0.0 |
| **Financing gap** | 8.2 | 4.9 | 7.9 | 3.4 |
| **Prospective official financing** | 8.2 | 4.9 | 7.9 | 3.4 |
| IMF | 8.2 | 3.3 | 6.0 | 2.3 |
| Purchases 4/ | 8.3 | 3.3 | 6.0 | 5.6 |
| Repurchases | 0.1 | 0.0 | 0.0 | 3.3 |
| Official creditors | … | 1.6 | 1.9 | 1.1 |
| European Commission | … | 0.5 | 0.7 | 0.2 |
| World Bank | … | 0.5 | 0.9 | 0.5 |
| EBRD/Others | … | 0.6 | 0.4 | 0.4 |
| Memorandum item: | | | | |
| Gross international reserves | 26.5 | 30.3 | 38.5 | 43.4 |

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

1/ Mainly reflects the withdrawal of residents' foreign currency cash holdings from the banking system.
2/ Includes one-time sale of greenhouse gas emission quotas in 2009.
3/ For program period (2010-2012), prospective financing from official sources are recorded below the line. This treatment is different from that presented in IMF Staff Report No. 09/270. Includes bilateral loans for government-guaranteed energy projects.
4/ Includes the general and special allocations of SDR 1,309.4 million (about US$2 billion) in August and September 2009.

Table 5. Ukraine: Monetary Accounts, 2007–11

| | 2007 | 2008 | 2009 | 2010 | | | | 2011 |
|---|---|---|---|---|---|---|---|---|
| | | | | Mar. | Jun. | Sep. | Dec. | |
| | | | | Act. | | Proj. | | Proj. |
| | (Millions of Ukrainian hryvnias) | | | | | | | |
| **Monetary survey** | | | | | | | | |
| Net foreign assets | 50,978 | -32,332 | -25,915 | -19,876 | 19,578 | 25,889 | 17,365 | 13,644 |
| Net domestic assets | 345,179 | 548,059 | 513,213 | 514,100 | 513,590 | 524,493 | 541,676 | 629,986 |
| Domestic credit | 436,285 | 776,162 | 807,219 | 804,690 | 818,596 | 847,239 | 892,007 | 1,014,907 |
| Net claims on government | -6,658 | 22,274 | 73,723 | 92,104 | 92,843 | 109,885 | 129,335 | 143,854 |
| Credit to the economy | 428,347 | 737,273 | 720,649 | 700,147 | 713,085 | 724,484 | 749,315 | 855,797 |
| Other claims on the economy | 14,597 | 16,615 | 12,847 | 12,438 | 12,668 | 12,871 | 13,358 | 15,256 |
| Other items, net | -91,107 | -228,103 | -294,006 | -290,590 | -305,006 | -322,747 | -350,331 | -384,920 |
| Broad money | 396,156 | 515,727 | 487,298 | 494,224 | 533,168 | 550,382 | 559,041 | 643,630 |
| Currency in circulation | 111,119 | 154,759 | 157,029 | 155,102 | 175,478 | 177,978 | 178,312 | 201,736 |
| Total deposits | 280,154 | 357,768 | 327,743 | 337,862 | 356,330 | 371,000 | 377,830 | 438,557 |
| Domestic currency deposits | 190,287 | 200,257 | 173,586 | 182,709 | 190,625 | 199,945 | 205,822 | 241,977 |
| Foreign currency deposits | 89,867 | 157,512 | 154,156 | 155,153 | 165,705 | 171,055 | 172,008 | 196,580 |
| Money market instruments | 4,884 | 3,200 | 2,526 | 1,261 | 1,360 | 1,404 | 2,898 | 3,337 |
| **Accounts of the National Bank of Ukraine** | | | | | | | | |
| Net foreign assets | 164,859 | 193,783 | 123,205 | 117,013 | 151,460 | 155,467 | 148,860 | 159,671 |
| Net domestic assets | -22,958 | -7,113 | 71,761 | 79,632 | 68,046 | 67,079 | 74,100 | 93,378 |
| Net domestic credit | -7,856 | 69,023 | 138,645 | 133,854 | 124,069 | 126,512 | 142,903 | 158,653 |
| Net claims on government | -6,274 | 10,754 | 55,619 | 61,649 | 57,484 | 60,289 | 78,247 | 78,247 |
| Claims on government | 9,058 | 23,674 | 57,011 | 68,129 | 68,129 | 74,934 | 81,739 | 81,739 |
| Liabilities government | 15,332 | 12,920 | 1,392 | 6,480 | 10,645 | 14,645 | 3,492 | 3,492 |
| Net claims on the economy | 165 | 379 | 279 | 333 | 387 | 278 | 279 | 279 |
| Net claims on banks | -1,748 | 57,890 | 82,747 | 71,872 | 66,197 | 65,944 | 64,377 | 80,127 |
| Other items, net | -15,102 | -76,136 | -66,884 | -54,222 | -56,023 | -59,432 | -68,803 | -65,275 |
| Base money | 141,901 | 186,671 | 194,965 | 196,644 | 219,506 | 222,546 | 222,960 | 253,049 |
| Currency in circulation | 111,119 | 154,759 | 157,029 | 155,102 | 175,478 | 177,978 | 178,312 | 201,736 |
| Banks' reserves | 30,782 | 31,912 | 37,936 | 41,543 | 44,028 | 44,568 | 44,648 | 51,313 |
| Cash in vault | 11,352 | 12,779 | 13,506 | 11,787 | 13,279 | 12,959 | 12,456 | 14,386 |
| Required reserves | 9,683 | 13,672 | 12,304 | 11,572 | 12,186 | 12,688 | 12,922 | 14,999 |
| Excess reserves | 9,748 | 5,461 | 12,125 | 18,184 | 18,562 | 18,921 | 19,269 | 21,928 |
| **Deposit money banks** | | | | | | | | |
| Net foreign assets | -113,882 | -226,116 | -149,120 | -136,889 | -131,882 | -129,577 | -131,495 | -146,028 |
| Net domestic assets | 393,620 | 583,320 | 475,486 | 470,861 | 488,212 | 500,577 | 509,325 | 584,585 |
| Domestic credit | 474,197 | 738,316 | 705,217 | 708,456 | 738,239 | 764,770 | 792,703 | 904,744 |
| Net claims on government | -384 | 11,520 | 18,104 | 30,455 | 35,359 | 49,595 | 51,088 | 65,607 |
| Credit to the economy 1/ | 428,146 | 736,840 | 720,241 | 699,697 | 712,611 | 724,112 | 748,906 | 855,389 |
| Other claims on the economy | 14,597 | 16,615 | 12,847 | 12,438 | 12,438 | 12,438 | 12,438 | 12,563 |
| *Of which:* | | | | | | | | |
| NBU refinancing loans | 1,549 | 60,799 | 86,242 | 81,624 | ... | ... | ... | ... |
| Banks' reserves | 30,782 | 31,912 | 37,936 | 41,543 | 44,028 | 44,568 | 44,648 | 51,313 |
| Other items, net 1/ | -80,577 | -154,996 | -229,731 | -237,595 | -250,027 | -264,193 | -283,378 | -320,159 |
| Banks' liabilities | 279,738 | 357,204 | 326,366 | 333,972 | 356,330 | 371,000 | 377,830 | 438,557 |
| Demand deposits | 90,364 | 104,807 | 116,786 | 114,933 | ... | ... | ... | ... |
| Time deposits | 189,374 | 252,397 | 209,581 | 219,038 | ... | ... | ... | ... |
| Memorandum items: | (Year-on-year percent change) | | | | | | | |
| Base money | 46.0 | 31.6 | 4.4 | 12.5 | 16.3 | 21.2 | 14.4 | 13.5 |
| Broad money | 51.7 | 30.2 | -5.5 | 6.6 | 12.8 | 17.2 | 14.7 | 15.1 |
| Credit to the economy | 74.0 | 71.9 | -2.2 | -2.8 | -0.7 | -0.6 | 4.0 | 14.2 |
| | (Ratio) | | | | | | | |
| Velocity of broad money | 1.8 | 1.8 | 1.9 | ... | ... | ... | 1.9 | 1.9 |
| Money multiplier | 2.8 | 2.8 | 2.5 | 2.5 | 2.4 | 2.5 | 2.5 | 2.5 |

Sources: National Bank of Ukraine; and IMF staff estimates and projections.
1/ Projections do not reflect possible writedowns of nonperforming loans.

Table 6. Medium-term Macroeconomic Framework, 2007–15

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Proj. | | | | | |
| Output and prices | | | | | | | | | |
| Nominal GDP (billions of Ukrainian hryvnias) | 721 | 950 | 915 | 1083 | 1235 | 1405 | 1582 | 1750 | 1919 |
| Real GDP growth (percent change) | 7.9 | 2.1 | -15.1 | 3.7 | 4.3 | 4.8 | 4.5 | 4.3 | 4.0 |
| Real domestic demand growth (percent change) | 16.5 | 7.5 | -23.0 | 4.8 | 5.8 | 6.3 | 5.3 | 4.8 | 4.4 |
| Consumer prices (percent change; average) | 12.8 | 25.2 | 15.9 | 9.9 | 10.7 | 8.3 | 7.5 | 5.0 | 5.0 |
| Consumer prices (percent change; end of period) | 16.6 | 22.3 | 12.3 | 12.0 | 9.7 | 9.2 | 5.9 | 5.0 | 5.0 |
| Public finances (percent of GDP) | | | | | | | | | |
| General government balance 1/ | -2.0 | -3.2 | -6.2 | -5.5 | -3.5 | -2.5 | -2.3 | -2.3 | -2.3 |
| Overall balance (including Naftogaz operational deficit) | -2.0 | -3.2 | -8.7 | -6.5 | -3.5 | -2.5 | -2.3 | -2.3 | -2.3 |
| Privatization receipts | 0.6 | 0.3 | 0.2 | 0.9 | 0.4 | 0.2 | 0.2 | 0.1 | 0.1 |
| Net domestic financing | 0.4 | 2.5 | 3.8 | 2.9 | 1.7 | 1.8 | 2.4 | 2.6 | 2.1 |
| Net external financing | 1.0 | 0.4 | 4.7 | 2.7 | 1.4 | 0.5 | -0.2 | -0.5 | 0.1 |
| Overall balance (including Naftogaz and other debt creating flows) 2/ | -2.0 | -3.2 | -11.3 | -9.9 | -3.5 | -2.5 | -2.3 | -2.3 | -2.3 |
| Public debt (end of period) 3/ | 12.3 | 19.9 | 34.6 | 39.5 | 41.5 | 42.2 | 40.6 | 38.7 | 34.1 |
| Money and credit | | | | | | | | | |
| Base money (percent change, end of period) | 46.0 | 31.6 | 4.4 | 14.4 | 13.5 | 12.5 | 11.6 | 11.0 | 9.8 |
| Credit to nongovernment (percent change, end of period) | 74.0 | 71.9 | -2.2 | 4.0 | 14.2 | 11.9 | 11.5 | 8.8 | 8.0 |
| Share of fx credit in total credit | 49.9 | 59.1 | 51.2 | 49.3 | 49.7 | 50.3 | 50.7 | 52.0 | 53.0 |
| External sector | | | | | | | | | |
| Current account balance (percent of GDP) | -3.7 | -7.1 | -1.5 | -0.7 | -1.8 | -2.6 | -2.8 | -3.0 | -3.1 |
| Total external debt (percent of GDP) | 56.0 | 56.4 | 88.0 | 79.0 | 77.8 | 77.6 | 71.4 | 67.4 | 64.5 |
| Goods exports, value (percent change) | 28.0 | 35.9 | -40.3 | 20.1 | 11.3 | 11.4 | 11.0 | 10.9 | 10.9 |
| Goods imports, value (percent change) | 36.9 | 38.7 | -46.2 | 19.9 | 14.0 | 12.4 | 10.9 | 10.3 | 10.2 |
| Foreign direct investment (percent of GDP) | 6.5 | 5.5 | 4.0 | 3.4 | 3.6 | 3.9 | 4.0 | 4.0 | 4.0 |
| Gross official reserves (end of period; billions of U.S. dollars) | 32.5 | 31.5 | 26.5 | 30.3 | 38.5 | 43.4 | 43.0 | 43.3 | 44.3 |
| Months of imports of goods and services | 3.9 | 6.7 | 4.8 | 4.8 | 5.5 | 5.6 | 5.1 | 4.7 | 4.6 |
| Percent of short-term debt (remaining maturity) | 84.8 | 68.3 | 68.4 | 74.8 | 89.7 | 96.2 | 92.9 | 89.3 | 87.9 |
| Hryvnia per U.S. dollar (end of period) 4/ | 5.1 | 7.7 | 8.0 | 7.9 | ... | ... | ... | ... | ... |
| Goods terms of trade (percent change) | 9.0 | 10.0 | -13.8 | 1.9 | -0.4 | 0.5 | 0.7 | 0.8 | 0.7 |
| Savings-investment balance (percent of GDP) | | | | | | | | | |
| Foreign savings | 3.7 | 7.1 | 1.5 | 0.7 | 1.8 | 2.6 | 2.8 | 3.0 | 3.1 |
| Gross national savings | 24.5 | 21.8 | 15.6 | 19.4 | 20.0 | 20.2 | 20.2 | 20.1 | 20.2 |
| Nongovernment | 23.9 | 22.5 | 20.6 | 22.9 | 21.7 | 20.9 | 20.7 | 20.6 | 20.7 |
| Government | 0.7 | -0.7 | -5.0 | -3.4 | -1.7 | -0.7 | -0.5 | -0.5 | -0.5 |
| Gross investment | 28.2 | 28.8 | 17.1 | 20.2 | 21.8 | 22.8 | 23.0 | 23.1 | 23.3 |
| Nongovernment | 25.6 | 26.4 | 15.9 | 18.1 | 20.0 | 21.0 | 21.2 | 21.3 | 21.5 |
| Government | 2.6 | 2.5 | 1.3 | 2.1 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |

Sources: State Statistics Committee of Ukraine; Ministry of Finance; National Bank of Ukraine; World Bank, *World Development Indicators*; and IMF staff estimates and projections.

1/ The general government includes the central and local governments and the social funds.
2/ Other debt creating flows include bonds issued to recapitalized banks in 2009 and 2010, and bonds issued to settle arrears on VAT refunds in 2010.
3/ Government and government-guaranteed debt (includes debt to IMF).
4/ Latest data as of end-June, 2010.

Table 7. Ukraine: Financial Soundness Indicators for the Banking Sector, 2006–10

(Percent, unless otherwise indicated)

| | 2006 | 2007 | 2008 | 2009 | | | | 2010 |
|---|---|---|---|---|---|---|---|---|
| | | | | Mar. | Jun. | Sep. | Dec. | Mar. |
| Ownership | | | | | | | | |
| Number of banks 1/ | 170 | 175 | 184 | 185 | 187 | 185 | 182 | 175 |
| Private | 168 | 173 | 182 | 183 | 185 | 183 | 180 | 173 |
| Domestic | 133 | 126 | 132 | 131 | 134 | 134 | 129 | 122 |
| Foreign | 35 | 47 | 50 | 52 | 51 | 49 | 51 | 51 |
| *Of which:* 100% foreign-owned | 13 | 17 | 18 | 17 | 17 | 17 | 18 | 18 |
| State-owned | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Foreign-owned banks' share in statutory capital | 27.6 | 35.0 | 36.7 | 37.6 | 39.1 | 36.1 | 35.8 | 34.2 |
| Concentration | | | | | | | | |
| Share of assets of largest 10 banks | 52.4 | 49.7 | 52.0 | 53.0 | 53.2 | 53.2 | 52.8 | 53.5 |
| Share of assets of largest 25 banks | 74.3 | 75.2 | 76.4 | 76.5 | 76.1 | 76.1 | 76.5 | 77.1 |
| Number of bank with assets less than $150 million | 109 | 85.0 | 81.0 | 106.0 | 109.0 | 110.0 | 107.0 | 100.0 |
| Capital Adequacy | | | | | | | | |
| Regulatory capital to risk-weighted assets | 14.2 | 13.9 | 14.0 | 15.4 | 14.5 | 15.6 | 18.1 | 20.8 |
| Capital to total assets | 12.5 | 11.6 | 12.9 | 13.4 | 13.0 | 13.2 | 13.1 | 14.5 |
| Asset Quality | | | | | | | | |
| Credit growth (year-over-year percent change) 2/ | 70.7 | 74.1 | 72.1 | 48.3 | 37.3 | 28.2 | -2.3 | -2.3 |
| Credit to GDP ratio 2/ 3/ | 45.2 | 59.4 | 77.7 | 75.8 | 77.4 | 81.2 | 78.7 | 74.1 |
| Change of loan to GDP ratio (year-over-year, percentage points) 2/ 3/ | 12.6 | 14.2 | 18.3 | 13.3 | 15.6 | 19.4 | 1.0 | -1.7 |
| NPLs to total loans (broad definition) 4/ | 17.8 | 13.2 | 17.4 | 24.0 | 29.9 | 33.8 | 40.2 | 41.6 |
| NPLs to total loans (narrow definition) 5/ | 4.2 | 3.2 | 4.6 | 7.5 | 10.2 | 11.2 | 14.8 | 15.0 |
| NPLs net of provisions to capital 6/ | ... | ... | 9.2 | 14.3 | 24.2 | 23.0 | 32.0 | 29.6 |
| Specific provisions (percent of NPLs) 6/ | ... | ... | 132.4 | 64.7 | 60.4 | 64.4 | 65.1 | 64.2 |
| Specific provisions (percent of total loans) | 4.2 | 3.3 | 5.1 | 4.0 | 5.4 | 6.2 | 8.9 | 8.8 |
| Foreign Exchange Rate Risk | | | | | | | | |
| Loans in foreign currency to total loans 2/ | 49.4 | 49.8 | 58.9 | 56.8 | 53.4 | 53.1 | 51.2 | 50.3 |
| Deposits in foreign currency to total deposits | 38.1 | 32.1 | 44.0 | 44.5 | 44.0 | 47.8 | 47.2 | 46.4 |
| Foreign currency loans to foreign currency deposits 2/ | 173.3 | 237.3 | 275.5 | 292.3 | 274.6 | 256.1 | 239.2 | 227.0 |
| Total net open positions in foreign currency to regulatory capital | 8.4 | 7.0 | 10.4 | 12.2 | … | … | … | … |
| Liquidity Risk | | | | | | | | |
| Liquid assets to total assets | 12.6 | 10.3 | 8.2 | 7.9 | 9.0 | 8.5 | 9.6 | 10.0 |
| Customer deposits to total loans to the economy 2/ | 74.9 | 65.3 | 48.5 | 43.7 | 44.2 | 43.4 | 45.3 | 47.7 |
| Earnings and Profitability | | | | | | | | |
| Return on assets (after tax; end-of-period) | 1.6 | 1.5 | 1.0 | -3.2 | -3.3 | -3.2 | -4.4 | -2.1 |
| Return on equity (after tax; end-of-period) | 13.5 | 12.7 | 8.5 | -23.4 | -24.5 | -23.8 | -32.5 | -14.8 |
| Net interest margin to total assets | 5.3 | 5.0 | 5.3 | 6.6 | 6.3 | 6.3 | 6.2 | 5.6 |
| Interest rate spreads (percentage points; end-of-period) | | | | | | | | |
| Between loans and deposits in domestic currency | 7.2 | 5.8 | 8.6 | 11.3 | 4.8 | 5.4 | 5.6 | 3.6 |
| Between loans and deposits in foreign currency | 5.4 | 4.9 | 4.4 | 3.0 | 1.1 | 0.8 | 0.7 | 2.5 |
| Between loans in domestic and foreign currency | 3.6 | 3.2 | 9.0 | 15.6 | 9.1 | 7.6 | 9.4 | 5.5 |
| Between deposits in domestic and foreign currency | 1.8 | 2.3 | 4.9 | 7.3 | 5.4 | 3.0 | 4.5 | 4.4 |
| Number of banks not complying with banking regulations | | | | | | | | |
| Not meeting capital adequacy requirements for Tier I capital | 0 | 0 | 4 | 8 | 13 | 11 | 12 | 3 |
| Not meeting prudential regulations | 1 | 1 | 13 | 23 | 34 | 25 | 22 | 12 |
| Not meeting reserve requirements | 1 | 1 | 5 | 25 | 20 | 14 | 15 | 11 |

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

1/ The increase in the number of banks in 2008–09 reflects the granting of bank licenses that had been in the pipeline.
2/ Monetary statistics data.
3/ Calculated using a moving average of GDP for the previous four quarters.
4/ Includes NPLs that are classified as substandard, doubtful, and loss. The NBU’s approach to the loan portfolio classification is stricter than in other countries as, in addition to servicing status, loan classification also depends on borrower’s financial conditions and collateralization level.
5/ Excludes substandard loans serviced in a timely manner.
6/ Nonperforming loans include doubtful and loss loans in compliance with IMF’s Methodology for the Compilation of FSIs. NBU data since 2008.

Table 8. Ukraine: Selected Vulnerability Indicators, 2006–10

| | 2006 | 2007 | 2008 | 2009 | 2010 | Latest observation |
|---|---|---|---|---|---|---|
| Financial market indicators | | | | | | |
| Short-term interest rate (percent) 1/ | 3.6 | 2.3 | 13.7 | 12.6 | 1.0 | 08-Jul-10 |
| EMBI secondary market spread (basis points, end of period) | 172 | 303 | 2,771 | 989 | 630 | 08-Jul-10 |
| Foreign currency debt rating 2/ | B1 | B1 | B1 | B2 | B2 | 12-May-09 |
| Exchange rate (hryvnia per U.S. dollar, end of period) | 5.1 | 5.1 | 7.7 | 8.0 | 7.9 | 08-Jul-10 |
| Stock market index (PFTS) | 498.9 | 1,174.0 | 301.4 | 572.9 | 808.3 | 08-Jul-10 |
| Broad money to gross reserves (percent) | 232.3 | 241.6 | 212.3 | 230.2 | 228.7 | 08-Jul-10 |
| External sector | | | | | | |
| Current account balance (percent of GDP) | -1.5 | -3.7 | -7.1 | -1.5 | -0.7 | Proj. |
| Capital and financial account balance (percent of GDP) | 3.7 | 10.6 | 5.1 | -10.5 | 1.1 | Proj. |
| Net FDI inflows (percent of GDP) | 5.3 | 6.5 | 5.5 | 4.0 | 3.4 | Proj. |
| Exports of goods and nonfactor services (percent change of U.S. dollar value) | 13.2 | 27.4 | 33.8 | -36.6 | 20.3 | Proj. |
| Real effective exchange rate (percent change) 3/ | 4.7 | 2.5 | 10.3 | -17.6 | -3.2 | Apr-10 |
| Gross international reserves (billions of U.S. dollars) | 22.3 | 32.5 | 31.5 | 26.5 | 30.3 | Proj. |
| Months of next year's imports of goods and services | 3.7 | 3.9 | 6.7 | 4.8 | 4.8 | Proj. |
| Percent of short-term debt at remaining maturity | 83.0 | 84.8 | 68.3 | 68.4 | 74.8 | Proj. |
| Net international reserves (billions of U.S. dollars) | 21.4 | 32.0 | 26.9 | 15.5 | 16.6 | Proj. |
| Total external debt (percent of GDP) | 50.5 | 56.0 | 56.4 | 88.0 | 79.0 | Proj. |
| *Of which:* short-term external debt (original maturity, percent of total external debt) | 27.9 | 25.9 | 20.0 | 18.4 | 18.6 | Proj. |
| External debt of domestic private sector (percent of total external debt) | 78.3 | 84.6 | 83.6 | 76.8 | 71.8 | Proj. |
| Public sector 4/ | | | | | | |
| Overall balance excluding bank recapitalization costs (percent of GDP) | -1.4 | -2.0 | -3.2 | -6.2 | -5.5 | Proj. |
| Primary balance (percent of GDP) | -0.7 | -1.5 | -2.6 | -5.1 | -4.0 | Proj. |
| Gross public sector financing requirement (percent of GDP) 5/ | -0.3 | 1.1 | 2.5 | 3.5 | 1.8 | Proj. |
| Public sector gross debt (percent of GDP) | 15.7 | 12.3 | 19.9 | 34.6 | 39.6 | Proj. |

Sources: Bloomberg; National Bank of Ukraine; Ministry of Finance; and IMF staff estimates and projections.

1/ Overnight interbank rate. Monthly average for December or month of latest observation.
2/ Moody's Investors Service (latest report).
3/ Period averages; (+) represents real appreciation; based on CPI and INS trade weights (1999-2001).
4/ Public sector covers the consolidated government (excluding public enterprises). Public debt also includes arrears and debt by the central bank.
5/ Overall balance plus debt amortization. Excludes bank recapitalization costs.

Table 9. Ukraine: Indicators of Fund Credit, 2008–15

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | Proj. | | | | | |
| Stock of existing and prospective Fund credit 1/ 2/ | | | | | | | | |
| Millions of SDRs | 3,057 | 7,000 | 9,250 | 13,250 | 14,766 | 11,109 | 7,969 | 4,250 |
| Percent of quota | 223 | 510 | 674 | 966 | 1,076 | 810 | 581 | 310 |
| Percent of GDP | 3 | 9 | 10 | 13 | 14 | 10 | 7 | 3 |
| Percent of exports of goods and services | 5 | 20 | 21 | 27 | 28 | 19 | 12 | 6 |
| Percent of gross reserves | 15 | 42 | 45 | 51 | 51 | 39 | 28 | 14 |
| Existing Fund credit 1/ 2/ | | | | | | | | |
| Millions of SDRs | 3,057 | 7,000 | 7,000 | 7,000 | 4,766 | 1,266 | 0 | 0 |
| Percent of quota | 223 | 510 | 510 | 510 | 347 | 92 | 0 | 0 |
| Percent of GDP | 3 | 9 | 8 | 7 | 5 | 1 | 0 | 0 |
| Percent of exports of goods and services | 5 | 20 | 16 | 14 | 9 | 2 | 0 | 0 |
| Percent of gross reserves | 15 | 42 | 34 | 27 | 16 | 4 | 0 | 0 |
| Prospective Fund credit 1/ 2/ | | | | | | | | |
| Millions of SDRs | 0 | 0 | 2,250 | 6,250 | 10,000 | 9,844 | 7,969 | 4,250 |
| Percent of quota | 0 | 0 | 164 | 456 | 729 | 717 | 581 | 310 |
| Percent of GDP | 0 | 0 | 2 | 6 | 10 | 9 | 7 | 3 |
| Percent of exports of goods and services | 0 | 0 | 5 | 13 | 19 | 17 | 12 | 6 |
| Percent of gross reserves | 0 | 0 | 11 | 24 | 34 | 34 | 28 | 14 |
| Obligations to the Fund from existing and prospective drawings 2/ | | | | | | | | |
| Millions of SDRs | 224 | 145 | 171 | 279 | 2,650 | 4,111 | 3,449 | 3,899 |
| Percent of quota | 16 | 11 | 12 | 20 | 193 | 300 | 251 | 284 |
| Percent of GDP | 0 | 0 | 0 | 0 | 3 | 4 | 3 | 3 |
| Percent of exports of goods and services | 0 | 0 | 0 | 1 | 5 | 7 | 5 | 6 |
| Percent of gross reserves | 1 | 1 | 1 | 1 | 9 | 14 | 12 | 13 |
| Obligations to the Fund from existing drawings 2/ | | | | | | | | |
| Millions of SDRs | 224 | 145 | 149 | 152 | 2,370 | 3,554 | 1,277 | 4 |
| Percent of quota | 16 | 11 | 11 | 11 | 173 | 259 | 93 | 0 |
| Percent of GDP | 0 | 0 | 0 | 0 | 2 | 3 | 1 | 0 |
| Percent of exports of goods and services | 0 | 0 | 0 | 0 | 5 | 6 | 2 | 0 |
| Percent of gross reserves | 1 | 1 | 1 | 1 | 8 | 12 | 4 | 0 |
| Obligations to the Fund from prospective drawings 2/ | | | | | | | | |
| Millions of SDRs | 0 | 0 | 22 | 128 | 280 | 557 | 2,172 | 3,895 |
| Percent of quota | 0 | 0 | 2 | 9 | 20 | 41 | 158 | 284 |
| Percent of GDP | 0 | 0 | 0 | 0 | 0 | 0 | 2 | 3 |
| Percent of exports of goods and services | 0 | 0 | 0 | 0 | 1 | 1 | 3 | 6 |
| Percent of gross reserves | 0 | 0 | 0 | 0 | 1 | 2 | 8 | 13 |

Sources: IMF staff estimates.

1/ End of period.
2/ Repayment schedule based on repurchase obligations.

Table 10. Ukraine: Public Sector Debt Sustainability Framework, 2005–15

(Percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | Debt-stabilizing primary balance 9/ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | |
| Baseline: public sector debt 1/ | 17.7 | 15.0 | 12.3 | 19.9 | 34.6 | 39.6 | 42.7 | 44.4 | 40.5 | 38.0 | 33.9 | -0.6 |
| *Of which:* foreign-currency denominated | 14.1 | 12.5 | 9.7 | 15.0 | 23.1 | 23.7 | 27.4 | 29.2 | 24.9 | 21.4 | 16.8 | |
| Change in public sector debt | -7.0 | -2.7 | -2.7 | 7.6 | 14.7 | 5.0 | 3.1 | 1.7 | -3.9 | -2.5 | -4.1 | |
| Identified debt-creating flows (4+7+12) | -8.8 | -2.2 | -2.4 | 3.9 | 12.5 | 3.6 | -1.8 | -2.8 | -2.9 | -1.7 | -1.2 | |
| Primary deficit | 1.5 | 0.7 | 1.5 | 2.6 | 7.6 | 5.0 | 1.9 | 0.5 | 0.3 | 0.3 | 0.3 | |
| Revenue and grants | 41.8 | 43.7 | 41.8 | 44.2 | 42.2 | 42.8 | 41.8 | 41.7 | 41.7 | 41.7 | 41.7 | |
| Primary (noninterest) expenditure | 43.3 | 44.5 | 43.3 | 46.8 | 49.8 | 47.8 | 43.7 | 42.2 | 42.1 | 42.1 | 42.0 | |
| Automatic debt dynamics 2/ | -5.4 | -2.5 | -3.3 | 1.5 | 2.6 | -3.9 | -3.3 | -3.1 | -3.1 | -1.9 | -1.3 | |
| Contribution from interest rate/growth differential 3/ | -4.7 | -2.5 | -3.3 | -2.5 | 1.9 | -3.9 | -3.3 | -3.1 | -3.1 | -1.9 | -1.3 | |
| Of which contribution from real interest rate | -4.1 | -1.5 | -2.4 | -2.3 | -1.2 | -2.8 | -1.7 | -1.3 | -1.3 | -0.3 | 0.1 | |
| Of which contribution from real GDP growth | -0.5 | -1.0 | -0.9 | -0.2 | 3.1 | -1.1 | -1.5 | -1.8 | -1.8 | -1.6 | -1.4 | |
| Contribution from exchange rate depreciation 4/ | -0.7 | 0.0 | 0.0 | 4.0 | 0.7 | ... | ... | ... | ... | ... | ... | |
| Other identified debt-creating flows | -5.0 | -0.4 | -0.6 | -0.3 | 2.3 | 2.4 | -0.4 | -0.2 | -0.2 | -0.1 | -0.1 | |
| Privatization receipts (negative) | -5.0 | -0.4 | -0.6 | -0.3 | -0.2 | -0.9 | -0.4 | -0.2 | -0.2 | -0.1 | -0.1 | |
| Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Other (bank recapitalization and VAT bonds) | 0.0 | 0.0 | 0.0 | 0.0 | 2.5 | 3.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes (2-3) 5/ | 1.8 | -0.5 | -0.3 | 3.7 | 2.2 | 1.4 | 4.8 | 4.5 | -1.1 | -0.7 | -2.9 | |
| Public sector debt-to-revenue ratio 1/ | 42.3 | 34.2 | 29.4 | 45.1 | 82.0 | 92.6 | 102.2 | 106.3 | 96.9 | 91.0 | 81.1 | |
| Gross financing need 6/ | 5.5 | 3.1 | 2.8 | 3.8 | 11.5 | 10.2 | 5.7 | 4.6 | 6.2 | 5.7 | 6.4 | |
| Billions of U.S. dollars | 4.7 | 3.3 | 4.0 | 6.8 | 13.5 | 13.8 | 8.6 | 7.3 | 10.4 | 10.4 | 12.6 | |
| Scenario with key variables at their historical averages 7/ | | | | | | 39.6 | 39.5 | 38.9 | 33.0 | 28.4 | 22.3 | -3.3 |
| Scenario with no policy change (constant primary balance) in 2009–14 | | | | | | 39.6 | 45.9 | 52.1 | 52.5 | 54.3 | 54.6 | -1.5 |
| Key macroeconomic and fiscal assumptions underlying baseline | | | | | | | | | | | | |
| Real GDP growth (percent) | 2.7 | 7.1 | 7.9 | 2.1 | -15.1 | 3.7 | 4.3 | 4.8 | 4.5 | 4.3 | 4.0 | |
| Average nominal interest rate on public debt (percent) 8/ | 3.9 | 4.4 | 4.6 | 5.5 | 5.6 | 5.0 | 4.6 | 5.4 | 5.0 | 5.4 | 5.9 | |
| Average real interest rate (nominal rate minus change in GDP deflator, percent) | -20.7 | -9.3 | -19.7 | -23.6 | -7.8 | -9.1 | -4.6 | -3.0 | -2.9 | -0.7 | 0.5 | |
| Nominal appreciation (increase in US dollar value of local currency, percent) | 5.1 | 0.0 | 0.0 | -34.1 | -3.9 | ... | ... | ... | ... | ... | ... | |
| Inflation rate (GDP deflator, percent) | 24.6 | 13.7 | 24.2 | 29.1 | 13.4 | 14.2 | 9.2 | 8.4 | 7.9 | 6.1 | 5.4 | |
| Growth of real primary spending (deflated by GDP deflator, percent) | 9.6 | 9.9 | 5.0 | 10.4 | -9.7 | -0.4 | -4.7 | 1.4 | 4.2 | 4.3 | 3.9 | |
| Primary deficit | 1.5 | 0.7 | 1.5 | 2.6 | 7.6 | 5.0 | 1.9 | 0.5 | 0.3 | 0.3 | 0.3 | |

Memo item: Guaranteed debt stock

1/ The coverage of the public sector is the general government, and also includes Naftogaz starting from 2009.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 ae(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 (understates interest rate given inclusion of guaranteed debt).

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 11. Ukraine: External Debt Sustainability Framework, 2005–15

(Percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | Debt-stabilizing non-interest current account 6/ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | |
| Baseline: external debt | 46.0 | 50.5 | 56.0 | 56.4 | 88.0 | 79.0 | 77.8 | 77.6 | 71.4 | 67.4 | 64.5 | -4.2 |
| Change in external debt | -1.2 | 4.5 | 5.5 | 0.3 | 31.6 | -9.0 | -1.2 | -0.3 | -6.1 | -4.1 | -2.8 | |
| Identified external debt-creating flows (4+8+9) | -26.5 | -16.4 | -19.1 | -9.4 | 29.1 | -6.6 | -5.7 | -5.8 | -5.7 | -5.3 | -5.0 | |
| Current account deficit, excluding interest payments | -5.0 | -1.3 | 0.7 | 3.2 | -4.5 | -4.5 | -3.5 | -3.5 | -3.5 | -3.2 | -3.1 | |
| Deficit in balance of goods and services | -0.8 | 2.8 | 5.7 | 8.0 | 1.7 | 1.0 | 2.1 | 2.9 | 3.0 | 2.9 | 2.8 | |
| Exports | 51.5 | 46.5 | 44.8 | 47.5 | 46.2 | 47.9 | 48.3 | 50.8 | 51.6 | 52.2 | 53.3 | |
| Imports | 50.7 | 49.4 | 50.6 | 55.4 | 47.9 | 49.0 | 50.4 | 53.7 | 54.6 | 55.1 | 56.1 | |
| Net non-debt creating capital inflows (negative) | -11.9 | -8.6 | -10.5 | -4.8 | -2.6 | -4.5 | -4.3 | -4.7 | -5.3 | -5.5 | -5.6 | |
| Automatic debt dynamics 1/ | -9.6 | -6.5 | -9.3 | -7.8 | 36.2 | 2.4 | 2.1 | 2.4 | 3.1 | 3.4 | 3.7 | |
| Contribution from nominal interest rate | 2.0 | 2.8 | 3.0 | 3.9 | 6.0 | 5.2 | 5.3 | 6.0 | 6.4 | 6.3 | 6.2 | |
| Contribution from real GDP growth | -0.9 | -2.7 | -3.0 | -0.9 | 13.1 | -2.8 | -3.1 | -3.6 | -3.2 | -2.9 | -2.5 | |
| Contribution from price and exchange rate changes 2/ | -10.7 | -6.6 | -9.3 | -10.8 | 17.1 | ... | ... | ... | ... | ... | ... | |
| Residual, including change in gross foreign assets (2-3) 3/ | 25.3 | 20.9 | 24.6 | 9.7 | 2.5 | -2.4 | 4.5 | 5.5 | -0.4 | 1.2 | 2.2 | |
| External debt-to-exports ratio (percent) | 89.3 | 108.5 | 124.9 | 118.7 | 190.4 | 164.9 | 161.1 | 152.6 | 138.5 | 129.0 | 121.1 | |
| Gross external financing need (billions of U.S. dollars) 4/ | 10.8 | 22.0 | 32.1 | 51.1 | 48.0 | 39.8 | 43.2 | 46.9 | 50.0 | 51.8 | 54.7 | |
| Percent of GDP | 12.5 | 20.3 | 22.5 | 28.3 | 40.8 | 29.2 | 29.0 | 30.0 | 29.6 | 28.3 | 27.8 | |
| Scenario with key variables at their historical averages 5/ | | | | | | 79.0 | 71.1 | 60.5 | 48.1 | 37.8 | 28.5 | -6.7 |
| Key macroeconomic assumptions underlying baseline | | | | | | | | | | | | |
| Real GDP growth (percent) | 2.6 | 7.3 | 7.9 | 2.1 | -15.1 | 3.7 | 4.3 | 4.8 | 4.5 | 4.3 | 4.0 | |
| GDP deflator in U.S. dollars (change in percent) | 29.4 | 16.9 | 22.5 | 23.8 | -23.3 | 11.8 | 5.1 | -0.2 | 3.6 | 3.9 | 3.4 | |
| Nominal external interest rate (percent) | 5.7 | 7.7 | 7.9 | 8.7 | 6.9 | 6.9 | 7.3 | 8.1 | 8.9 | 9.5 | 10.0 | |
| Growth of exports (U.S. dollar terms, percent) | 7.5 | 13.2 | 27.4 | 33.8 | -36.6 | 20.3 | 10.6 | 10.0 | 9.8 | 9.8 | 9.8 | |
| Growth of imports (U.S. dollar terms, percent) | 20.4 | 22.0 | 35.4 | 38.5 | -43.7 | 18.5 | 12.9 | 11.4 | 10.0 | 9.4 | 9.4 | |
| Current account balance, excluding interest payments | 5.0 | 1.3 | -0.7 | -3.2 | 4.5 | 4.5 | 3.5 | 3.5 | 3.5 | 3.2 | 3.1 | |
| Net non-debt creating capital inflows | 11.9 | 8.6 | 10.5 | 4.8 | 2.6 | 4.5 | 4.3 | 4.7 | 5.3 | 5.5 | 5.6 | |

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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.

## APPENDIX I: UKRAINE: LETTER OF INTENT

Kyiv, July 16, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington DC, 20431, U.S.A.

Dear Mr. Strauss-Kahn:

1. The Ukrainian economy is gradually recovering from the deep crisis of 2008–09. A turnaround of the economy has started, the exchange rate has stabilized, savings have begun to return to the banking system, sovereign spreads have narrowed, and progress has been made in strengthening and rehabilitating the banking system.

2. Despite these encouraging signs, the crisis has left deep scars on the economy and the foundation for a sustainable recovery has not been firmly established. Public finances have weakened, inflation, albeit on a downward trend, remains one of the highest in the region, bank credit has stagnated under pressure from nonperforming loans and heightened risk aversion, and external financing remains tight with significant external debt payments over the medium term. Key policy reforms have been on hold until recently.

3. To support our efforts to firmly establish macroeconomic stability and a sustainable economic recovery, we request a new 29-month Stand-By Arrangement (SBA) with the IMF. Based on our balance of payments needs—including those arising from the repayment of external obligations of the government—and our policies described in the attached Memorandum of Economic and Financial Policies (MEFP), we request the approval of a SBA in an amount equivalent to SDR 10.0 billion (728.9 percent of our quota) for the period July 2010 through December 2012, of which we request the equivalent of US$2.0 billion be channeled to the budget in 2010. We believe the policies described in the MEFP will promote robust long-term growth, lower inflation, sustainable public finances, and continued external viability. The government stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives.

4. We will consult with the Fund on adoption of new measures and provide the Fund with the information it requests for monitoring progress during program implementation. The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural benchmarks. The first review will be held by December 2010, and subsequent quarterly reviews will be held thereafter for the duration of the arrangement.

5. Finally, we request cancellation of the November 2008 SBA, including all remaining disbursements under that arrangement.

Yours sincerely,

| /s/ | /s/ | /s/ |
|---|---|---|
| Mykola Azarov | Fedir Yaroshenko | Volodymyr Stelmakh |
| Prime Minister | Finance Minister | Governor of National Bank of Ukraine |

## UKRAINE: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

### I. BACKGROUND AND MACROECONOMIC FRAMEWORK

1. **Ukraine was hit hard by the global crisis, experiencing one of the sharpest recessions in Europe.** The contraction reflected the acute deterioration in the external environment that triggered a large decline in exports, capital outflows, a sharp depreciation of the hryvnia, and a run on bank deposits. The impact of these external shocks was exacerbated by pre-existing economic and financial vulnerabilities—in particular dependence on energy imports, the low degree of export diversification, and widespread dollarization of private sector liabilities. In 2009, real GDP fell by 15.1 percent, led by contractions in domestic demand and exports, and inflation decelerated rapidly to 12.3 percent by year-end. Though the current account deficit narrowed sharply to 1½ percent of GDP due to a significant compression in domestic demand, weaker FDI and large capital outflows due to low confidence led to a large balance of payments deficit and drop in net international reserves.

2. **Reflecting mainly the impact of the global financial crisis, public finances worsened significantly in 2009.** The fiscal deficit increased to about 8.8 percent of GDP—6.3 percent of GDP for the general government and 2.5 percent of GDP for Naftogaz. Including bonds issued for bank recapitalization (2.6 percent of GDP), public debt increased to 25 percent of GDP while public and publicly guaranteed debt surged to 35 percent of GDP. At the same time, fiscal performance was eroded further by a buildup of VAT refund claims and the carry-forward of corporate losses that will have an impact on the 2010 budget.

3. **Going forward, we expect the economy to grow by around 3.7 percent in 2010 followed by a stronger recovery over the medium term.** In fact, real GDP growth amounted to 6.1 percent in the first five months, starting from a low base, bringing the annual growth within reach. Sources of growth include robust exports benefiting from the recovery of steel and other commodity prices and higher investment, including that related to the EURO 2012. The implementation of policies under our economic program will strengthen fiscal sustainability and confidence in the banking sector and the economy as a whole. Core inflation is anticipated to remain in single digits for the remainder of 2010 on account of the still-large output gap, while headline inflation will be around 12 percent at end-year, partly due to adjustment of energy prices. Then, it will gradually fall towards 5 percent by 2014.

4. **Gross financing needs will remain substantial in the coming years.** The current account deficit is expected to narrow slightly to about 1 percent of GDP in 2010 and rise somewhat over the medium term, while the financial account will improve steadily as short-term capital outflows decline considerably and FDI recovers. Nevertheless, gross external financing needs are expected to remain large, including to build up our reserves to more comfortable levels, and we expect a financing gap of $16 billion in 2010–12.

## II. Program Objectives

5. **Our program aims to entrench fiscal and financial stability and put Ukraine on a path to sustained and balanced growth.** The policy strategy will center on durable reforms and policies to consolidate public finances, restore banking system soundness, and develop a more robust monetary policy framework focused on domestic price stability with greater exchange rate flexibility. To this end, we will implement reforms and institutional changes, including tax and expenditure policies, pension reforms, energy sector reforms, and measures to strengthen central bank independence and rehabilitate the banking system.

6. **These policies will help reduce financing needs, strengthen confidence and entrench external sustainability.** Though market financing prospects for Ukraine depend heavily on the speed of financial market recovery, we expect risk aversion towards Ukraine to abate as the government's pro-reform credentials are demonstrated, allowing a gradual shift to market financing to help reach and maintain adequate reserve levels. Until market financing can be fully mobilized, official financing will play an important role in supporting our adjustment and reforms efforts, temporarily covering financing needs**.** In addition to financial support from the Fund, we will secure additional financing from the World Bank, the EBRD, the EIB, and the EC through close collaboration in key reform areas.

7. **We are prepared to respond flexibly to economic developments**. We stand ready to take additional measures to ensure that our program objectives are met.

## III. Policies

### A. Fiscal Policy

8. **The government's objective is to bring public finances back to a sustainable position.** A robust medium-term fiscal framework based on prudent budget deficits and frontloaded reforms that tackle budgetary rigidities will allow us to reduce gradually the weight of the public sector on the economy, support the reallocation of public resources toward capital spending, strengthen confidence, and support growth. To this end, we envisage a fiscal consolidation path that would: (i) lead to a deficit that can be fully financed by markets by 2011; (ii) set the public and publicly guaranteed debt-to-GDP ratio firmly on a downward path with the objective of stabilizing it below 35 percent by 2015; and (iii) rely proportionally more on expenditure-saving measures to gradually reduce the tax burden on the economy.

9. **In 2010, given that the economic recovery is still fragile and measures will only have a half-year impact, the combined deficit of the general government and Naftogaz will remain high at 6.5 percent of GDP.** This does not include bonds issued for bank recapitalization (which will total no more than UAH 20 billion) and bonds issued to settle past VAT refund arrears. Initiating adjustment measures in 2010 together with the enactment of structural reforms will pave the way to bringing the overall deficit to 3.5 percent of GDP

in 2011 and 2.5 percent of GDP by 2012. Naftogaz's deficit will be eliminated starting in 2011.

10. **Consistent with this, we have amended tax legislation, enacted a supplementary budget and taken supporting measures, which, together, will help reduce the general government deficit in 2010 to 5.5 percent of GDP** (prior action)**.** These include:

**Revenue measures**

- To raise revenue, we have increased excise duties for gasoline, filtered cigarettes, and various types of alcoholic beverages; increased the surcharge on the use of radio frequency used by cell phones; and put a limit on the carry-over of 2009 losses that would otherwise have eroded company profit tax this year. All these measures combined are expected to generate UAH 6.1 billion in 2010 and an additional UAH 4.2 billion in 2011.

- We will broaden the tax base and made the tax system more uniform by reducing the threshold turnover for qualifying for the Simplified Taxation System to UAH 300,000 for physical persons (effective January 1, 2011).

- We have suspended the surcharge on non-cash purchases and sales of foreign currency which had been introduced for the purposes of mandatory pension insurance, under Law No.400/97, June 26, 1997, and intend to permanently eliminate it by end-December 2010 (structural benchmark).

- We have stepped up efforts to improve tax administration with the objective of strengthening compliance, reducing fraud, and closing taxation loopholes by widening the authority of the tax inspection and improving monitoring of tax returns on the basis of enhanced documentation.

- We are committed to ensuring the payment of all VAT refunds accruing in the remainder of the year in full and on time and we will not accumulate any arrears during the year (indicative target).

**Expenditure measures**

- We are determined to keep other spending under tight control in the period ahead. We have adopted a supplementary budget that reduces expenditure compared to the approved budget by UAH 16 billion. These budget cuts include: reduced subsidies to the various economic sectors, and lower administrative appropriations for several government bodies.

- To avoid an increase in the general government deficit, we will ensure that (i) all lending to the Agrarian Fund under Article 77 of the 2010 budget be repaid to the budget by end-December 2010; (ii) all EURO 2012-related spending is included in the budget; and (iii) local governments, the Unemployment Insurance Fund, the Disability Insurance Fund or the Accident Fund will be balanced in 2010.

**Pension reforms**

- We intend to reform the pension system with the objective of putting it on sound financial footing, including by significantly reducing the deficit transfer to the Pension Fund in 2011 and pension spending over the medium term, while not jeopardizing the welfare of vulnerable groups. As a first step, we have enacted legislation that requires both legal persons and physical entities participating in the Simplified Taxation System to pay contributions to the pension fund corresponding to the minimum wage surcharges. This measure will generate pension fund revenue of UAH 3.0 billion in 2011.

- We will enact by end-December 2010 changes to the base for calculating the additional 1 percent pension benefits accrued for each year of service above 20/25 for women/men. This base for the long service pension benefit will be the basic working pension. This measure is expected to reduce pension fund expenditure by UAH 6.2 billion in 2011.

- To address structural problems of the pension system, we will submit a law by end-September 2010, for enactment by end-December 2010 (structural benchmark), that will:

    - increase the minimum required insurance period from 5 to 15 years;

    - gradually increase the pension age for women from 55 to 60 years, by adding 6 months every year starting in 2010, aiming to equalize the pension age for all workers;

    - increase by 10 years the qualification period for receiving full pension benefits. This measure will motivate workers to stay in the work force, improving the balance of the Pension Fund by UAH 2.0 billion in 2011.

**Contingent liabilities**

- **In addition, to keep the overall public indebtedness under control at a time of fiscal uncertainty,** state guarantees in 2010 will amount to no more than UAH 15 billion (quantitative performance criterion).

11. **We are determined to contain the rapid growth of the public sector wage bill in 2011 and the medium term**. In this context, we will refrain from increases in 2011 above what is mandated by the inflation indexation mechanism for civil servant wages. We will

also initiate a comprehensive public administration reform by the beginning of 2011 aiming for a smaller and more efficient public administration. In this context, we will clarify the roles and responsibilities of the state, and ensure a consistent model for public service delivery. A comprehensive plan, including objectives, measures, and a timetable of the reforms will be specified by end-March 2011 (structural benchmark).

12. **The government recognizes the needs to reduce the deficit of Naftogaz to 1.0 percent of GDP in 2010 and eliminate it thereafter, while protecting the most vulnerable segments of the society.** To meet these objectives, we have adopted a 2010 financial plan for the company that reflects the following actions:

- We have reduced operating costs.

- We increased final gas prices for utility companies and all households by 50 percent (prior action), which will take effect the coming billing cycle (August 1). At the same time, households receiving subsidies and compensation in accordance with the corresponding law will receive additional subsidies to offset the impact of the higher prices. This social assistance program is fully funded in 2010 with support from resources received from international financial institutions.

- We have also eliminated price privileges for sugar, chemical, fertilizer, and metallurgy industries and will maintain gas prices for industrial users consistent with import parity.

- Further increases will be necessary to unify prices for all users of gas at import parity and provide Naftogaz the resources it needs to improve infrastructure and meet its obligations, without relying on budgetary resources. To this end, an additional price increase of 50 percent for households and utilities will be effected in April 2011. Semiannual increases of gas prices paid by households and utility companies will continue until domestic price levels reach import parity. Thereafter, all gas prices will be adjusted as needed to reflect market prices.

- To ensure that utility companies pass on gas price increases to their customers, legislation to transfer the authority for setting heating tariffs for communal utilities to a new independent regulator has been adopted (prior action). The independent regulator will be operational no later than end-2010. While the new regulator is being set up, the law gives the National Electricity Regulation Council (NERC) the power to set heating tariffs for communal utilities.

- We will support Naftogaz's efforts to collect payment arrears. In particular, by end-September, we will pass legislation to revoke the Law "On Temporary Ban to Levy Penalties on Ukraine's Citizens For Overdue Payments of Utility Bills" so that any arrears on utility payments accumulated after October 1, 2010 are subject to penalties (structural benchmark). We will also introduce the distribution accounts for heating utilities. A law to this effect has been adopted by the parliament.

13. **We are also determined to undertake additional measures to strengthen the transparency and governance of the gas sector, in accordance with the principles of the Brussels declaration** (structural benchmark). In this context, (i) a gas sector law has been adopted ensuring compliance with EC Directive 2003/55/EC; and (ii) progress has been made towards joining EITI and the European Energy Community.

### B. Monetary and Exchange Rate Policy

14. **Monetary policy will aim to maintain core CPI inflation in single digits this year, and bring overall CPI to no more than 5 percent over the medium term**. Inflation remains well above EU and our trading partner averages. To achieve our monetary program and the inflation objectives, we will—as the financial system recovers and the transmission mechanism becomes more robust—focus our monetary policy more firmly around policy interest rates and exchange rate flexibility. In particular, to prevent the buildup of risks to inflation in the context of growing bank liquidity, we have strengthened operations aimed at mopping up excess liquidity in banks via stepped up placement of CDs, repos, and outright sales of government securities and have required banks to keep the entire amount of required reserves at a separate account with the National Bank of Ukraine (NBU). In this context, we increased interest rates on three-month CDs and repos to the 7 to 9 percent range. We will continue to maintain positive real refinancing rates going forward and we will enhance the communication of our policy intentions. We will set policy rates during regular and pre-announced meetings of the NBU Board, and publish a statement on the economic reasons for our decision on the same day.

15. **We will monitor our program through targets on money aggregates (Table Appendix I.3).** We intend to meet net domestic asset (NDA) ceilings and net international reserve (NIR) floors as specified in Table Appendix I.3 (quantitative performance criteria). Base money is expected to grow by about 14 percent in 2010, consistent with our core inflation objective, given projected nominal GDP growth and money demand path. We stand ready to adapt our monetary policy stance if pressures on inflation or the exchange rate emerge. In this context, the target on NIR is designed to ensure an increasingly adequate level of international reserves. We will refrain from changes in reserve requirements and imposing administrative measures without prior consultation with the Fund staff.

16. **In support of our goals**, **we place a high priority on strengthening the independence and accountability of the NBU.** Amendments to the NBU law will be enacted (prior action) in line with IMF recommendations. The amendments, among other things, will:

- define precise priority of the NBU goals in line with provisions in the Constitution of Ukraine. In this regard, when performing its main function, the NBU shall choose ensuring and maintaining price stability in the country as the primary objective;

- improve the NBU's autonomy to enable effective performance of its monetary policy function (including prohibiting the appointment to the NBU Council of persons with conflicts of interest); and

- strengthen the NBU's financial soundness, autonomy and transparency in line with international best practice.

17. **To ensure consistency with its core mandate, the NBU will amend Resolution 47** (prior action). Specifically, it will: (i) eliminate stimulation loans; (ii) limit stabilization loans to exceptional cases for solvent and financially viable banks in times of funding pressures, for a maximum term of three months, with limited rollovers (no more than four times or maximum 1 year); and (iii) ensure that such loans are backed by adequate, high quality collateral (such as government paper) and penalty pricing, and are subject to appropriate supervisory oversight and measures. In the absence of a renewed systemic deposit drain, we will not grant new emergency liquidity assistance, and will withdraw existing exceptional support as quickly as conditions permit. Existing refinancing loans that meet the criteria in amended Resolution 47 will be rolled into the stabilization loan framework, or wound down. We will not extend or grant new liquidity support to any insolvent bank. We will recognize losses on the NBU balance sheet in line with IFRS to the full extent. Finally, in the implementation of the recapitalization program, we will avoid undue monetary expansion and safeguard the financial position of the NBU. Consistent with this, the government will let the requirement that the recapitalization bonds be subject to mandatory repurchase at their face value by the NBU lapse at end-2010.

18. **We are continuing our efforts to improve the functioning of the foreign exchange market.** Our intervention strategy will continue to allow for greater exchange rate flexibility, while gradually rebuilding an adequate international reserves position as market conditions permit. To this end:

- We will continue to set the official exchange rate equal to the average rate on the interbank market of the previous day with a deviation not exceeding 2 percent.

- We will eliminate the existing exchange rate restrictions under the Fund's jurisdiction and multiple currency practices and will streamline and, as warranted, reduce the scope of other regulatory restrictions having an impact on transactions in the foreign exchange market. To this end, we will undertake a review of current regulations and legislation. On the basis of this assessment, and after consultations with participants of financial market, we will develop by end-October a schedule for phasing out the restrictions which might be eliminated or relaxed without jeopardizing the sustainability of the balance of payment and financial system (structural benchmark). As a first step, we have abolished foreign investment registration requirement and removed the ban on early repayment of external obligations. For the exchange restrictions under the Fund's jurisdiction that we believe are temporarily necessary for balance of payments reasons, we will request approval from the Fund.

- We will also promote the development of forward exchange market by end-March 2011.

## C. Financial Sector Policies

19. **Reforms to the financial sector will center on completing the resolution and recapitalization of systemic banks, and enacting key legislation and regulations.** The banking system has stabilized through our efforts to enhance the capital level and resolve failing banks. However, continued efforts are needed, consistent with our principles of transparency and least cost to the public sector, to ensure the solvency and viability of all banks given the large and partly hidden losses.

20. **We will ensure that banks are fully capitalized no later than end-December 2010** (structural benchmark). Banks completed their extended audits in April and have submitted recapitalization plans to be approved by the NBU by end-July. Private shareholders are required to complete the injection of the committed capital no later than end-2010 or the bank(s) will be intervened and if necessary recapitalized or resolved in line with the bank restructuring strategy agreed with the IMF and the World Bank. In addition:

- We will support a solution for Nadra Bank consistent with the objective of the least cost option for the government and under the conditions that (i) an audit of the end-June financial statements under IFRS and audited under IAS is conducted by an reputable international auditing firm, with the lead auditor coming from outside Ukraine, to assess the full recapitalization need. The auditing firm shall be hired and terms of reference for the audit be finalized in consultation with the IMF no later than July 30, 2010 and the audit shall be completed by end-October 2010 (structural benchmark), and (ii) an agreement with a fit and proper investor that has submitted a viable business plan to restore the bank to profitability is reached by end-November 2010. The bank shall be fully recapitalized with upfront cash by end-2010. The recapitalization process will be completed according to established procedures, including CoM Resolution 960. If this is not possible we will promptly resolve the bank according to the provisions in the Banking Act at the least cost method to the government.

21. **We will pursue measures to strengthen state-owned banks.** We will conduct a due diligence led by reputable international auditing firm to review operations under the existing

governance structures in the two state banks by end-December 2010 (structural benchmark) and then formulate plans to strengthen these banks. The terms of reference for the due diligence study will be agreed with the IMF. The due diligence would include assessments of: (i) the main financial, legal and operational risks; (ii) adequacy of risk management and internal controls; and (iii) future viability under different scenarios. Regarding the three state-recapitalized banks, we will retain an internationally-reputable financial adviser to assess the potential of the banks, and to recommend whether to restructure and prepare them for sale, or to pursue an orderly winding down that maximizes the recovery value for the state. Given the urgent need to turn profitable, in line with lending policies approved by their governance bodies, the state-recapitalized banks will not engage in lending at below-the interest rate on loans which the bank itself takes plus a reasonable margin.

22. **To address the problem of bad loan work-outs, we will focus on creating a framework that properly recognizes and facilitates the resolution of impaired loans.** We will develop, in consultation with Fund and World Bank staff and representatives of the financial sector, a strategy to pro-actively address the mounting nonperforming loans in the banking system by identifying barriers to their effective resolution and any necessary changes to the existing legislation and regulations. The necessary amendments to laws and regulations will be enacted by end-June 2011 (structural benchmark), including amendments to the Law of Ukraine "On restoring the solvency of the debtor or announcing him/her bankrupt" and related laws and regulations to speed up the insolvency process, make it more transparent, and facilitate out-of-court restructuring, including through an expedited court approval of restructuring agreements negotiated out-of-court. We will request the Fund's technical assistance in developing amendments to the insolvency law to include procedures for expedited approval of restructuring plans negotiated out-of-court and resolving tax and other related issues.

23. **We will undertake other measures to strengthen the banking system.** We will submit the amendments to existing legislation to implement consolidated supervision (by end-September 2010), and will develop supporting regulatory framework within 6 months of its enactment. We will submit necessary legal amendments to enhance disclosure of ultimate controllers of banks, consistent with Fund advice and EU guidelines by end-September, 2010. We will continue to strengthen the existing regulations for the classification of loans and provisions against loan-related losses. We will continue to work on concluding Memoranda of Understanding (MoUs) with foreign banking supervisory authorities in countries where banks have significant presence in Ukraine. In coordination with the IMF and the World Bank staff, we will also take measures to further strengthen the bank resolution framework, improve regulation and supervision, and facilitate consolidation of the banking system. The current draft NBU Resolution on "sanation bank" will be withdrawn and redrafted to include the "bridge bank" concept to be a failing bank resolution tool.

## IV. Growth-Enhancing Reforms

24. **To pave the way towards robust sustainable growth and reduction in poverty in the medium and long term, our program includes reforms aimed at a reduction of state involvement in the economy and measures to attract external and domestic investments to serve as a source of such growth.** In particular, our focus will include the following areas.

- *Government procurement.* In consultation with the World Bank and the EU, we have enacted a new Law on Government Procurement, in broad compliance with EU best practices.

- *Deregulation and investment.* We will cooperate with OECD and World Bank experts to identify and prioritize removal of key regulatory and infrastructure bottlenecks that are obstacles to enhancing inflows of investment into Ukraine. Any government-led investment initiatives will be fully accounted for in the budget.

- *Social protection.* In undertaking our reforms, we will ensure protection of the poorest and most socially vulnerable groups of the population, drawing on the advice from International Financial Institutions.

## V. Safeguards

25. **We recognize the importance of completing an update to the safeguards assessment of the NBU by the first review of the standby arrangement.** To facilitate this we will authorize the NBU's external auditors to provide IMF staff with all necessary information, including management letters for 2008–09, and to hold discussions directly with Fund staff. We also commit to receiving a safeguards mission, and to provide that mission with all necessary information requested without delay, including information related to correspondent banks and foreign reserve placements. We will also address outstanding issues from the 2008 safeguards assessment of the NBU, including legal amendments to strengthen the NBU's independence, governance, and financial reporting practices; introduction of audit oversight by adoption of an action plan to address the recurring accounting and control weaknesses observed by the NBU's external auditor, and completion of an external review of the internal audit function.

## VI. Program Monitoring

26. **The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural benchmarks.** The phasing of purchases under the arrangement and the review schedule are set out in Table 1 of this memorandum. The prior actions and structural benchmarks are set out in Table 2; and the quantitative targets for end-September 2010, and end-December 2010, and continuous performance criteria, are set out in Table 3. The understandings between the

Ukrainian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this memorandum are further specified in the technical memorandum of understanding (TMU) attached to this memorandum.

Appendix Table I.1. Access and Phasing Under a Proposed Stand-By Arrangement

| Date | Amount of purchase: Millions of SDRs | Amount of purchase: Percent of quota | Conditions |
|---|---|---|---|
| July 28, 2010 | 1,250 | 91.1 | Board approval of arrangement |
| November 30, 2010 | 1,000 | 72.9 | First review and end-September 2010 performance criteria |
| March 15, 2011 | 1,000 | 72.9 | Second review and end-December 2010 performance criteria |
| June 15, 2011 | 1,000 | 72.9 | Third review and end-March 2011 performance criteria |
| September 15, 2011 | 1,000 | 72.9 | Fourth review and end-June 2011 performance criteria |
| December 15, 2011 | 1,000 | 72.9 | Fifth review and end-September 2011 performance criteria |
| March 15, 2012 | 1,000 | 72.9 | Sixth review and end-December 2011 performance criteria |
| June 15, 2012 | 1,000 | 72.9 | Seventh review and end-March 2012 performance criteria |
| September 15, 2012 | 1,000 | 72.9 | Eighth review and end-June 2012 performance criteria |
| December 15, 2012 | 750 | 54.7 | Ninth review and end-September 2012 performance criteria |
| Total | 10,000 | 728.9 | |

Source: IMF staff estimates.

Appendix Table I.2: Ukraine: Prior Actions and Structural Benchmarks

| Measure | Target Date |
| --- | --- |
| ***Prior Actions*** | |
| 1. Enact a supplementary budget with fiscal measures of UAH 16 billion, consistent with a general government deficit of 5.5 percent of GDP in 2010 and the commitments included in the MEFP, paragraph 10. | |
| 2. Increase gas tariffs for all households and utility companies by 50 percent (MEFP, paragraph 12). | |
| 3. Enact amendments to the NBU law in line with IMF recommendations (MEFP, paragraph 16). | |
| 4. Amend Resolution 47 in line with IMF recommendations (MEFP, paragraph 17). | |
| 5. Adopt legislation transferring the authority for setting heating tariffs for communal utilities to a new independent regulator (MEFP, paragraph 12). | |
| ***Structural Benchmarks*** | |
| 1. Pass legislation to revoke the Law “On Temporary Ban to Levy Penalties on Ukraine’s Citizens For Overdue Payments of Utility Bills” so that any arrears on utility payments accumulated after October 1, 2010 are subject to penalties (MEFP, paragraph 12). | End-September 2010 |
| 2. Agree with Fund staff on a schedule for phasing out existing restrictions on the foreign exchange market (MEFP, paragraph 18). | End-October 2010 |
| 3. Complete the audit for Nadra Bank before any decision on its resolution and in line with commitments in the MEFP, paragraph 20. | End-October 2010 |
| 4. Enactment of legislation on pension reforms consistent with commitments in the MEFP, paragraph 10. | End-December 2010 |
| 5. All banks should meet capital requirements and capital deficient banks should increase their capital in line with the approved plans (MEFP, paragraph 20). | End-December 2010 |
| 6. Complete due diligence of state-owned banks in line with paragraph 21 of the MEFP. | End-December 2010 |
| 7. Initiate the implementation of the reform and restructuring strategy for Naftogaz in accordance with the principles of the Brussels declaration (MEFP, paragraph 13). | End-December 2010 |
| 8. Amend the law "On surcharges for the purposes of mandatory state pension insurance" 400/97-BP to permanently eliminate the surcharge on non-cash purchase and sales of foreign currency (MEFP, paragraph 10). | End-December 2010 |
| 9. Formulate a comprehensive public administration reform plan aiming to improve the cost efficiency of public service delivery (MEFP, paragraph 11). | End-March 2011 |
| 10. Adopt amendments to the Law of Ukraine “On restoring the solvency of the debtor or announcing him/her bankrupt” and related regulations to speed up the process, make it more transparent, and facilitate out-of-court restructuring (MEFP, paragraph 22). | End-June 2011 |

Appendix Table I.3. Ukraine: Quantitative Program Targets 1/

(End of period; millions of Ukrainian hryvnias, unless otherwise indicated)

| | 2010 | | |
|---|---|---|---|
| | Jun. Outcome | Sep. Target | Dec. Target |
| **I. Quantitative performance criteria** | | | |
| Ceiling on the cash deficit of the general government (- implies a surplus) 2/ | … | 47,000 | 60,000 |
| Ceiling on the cash deficit of the general government and Naftogaz (- implies a surplus) 2/ | … | 56,000 | 71,000 |
| Floor on cumulative change in net international reserves (in millions of U.S. dollars) 3/ | 19,172 | -915 | -2,860 |
| Ceiling on cumulative change in net domestic assets 3/ | 67,913 | 9,916 | 25,733 |
| Ceiling on publicly guaranteed debt 2/ | … | 15,000 | 15,000 |
| **II. Continuous performance criterion** | | | |
| Non-accumulation of external debt payments arrears by the general government | 0 | 0 | 0 |
| **III. Indicative Targets** | | | |
| Ceiling on cumulative change in base money 3/ | 219,506 | 5,040 | 5,454 |
| Ceiling on stock of VAT refund arrears | … | 3,000 | 0 |

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

1/ Definitions and adjustors are specified in the Technical Memorandum of Understanding (TMU).
2/ Data are cumulative flows from January 1 of the corresponding year.
3/ Data are cumulative flows from July 1 of the corresponding year. Data for June, 2010 is a stock.

## UKRAINE: TECHNICAL MEMORANDUM OF UNDERSTANDING

July 16, 2010

1. This Technical Memorandum of Understanding (TMU) sets out the understandings between the Ukrainian authorities and IMF staff regarding the definitions of the variables subject to quantitative targets (performance criteria and indicative targets) for the economic program supported under the Stand-By Arrangement, as described in the authorities' Letter of Intent (LOI) dated July 16, 2010 and the attached Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in the LOI, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

2. The quantitative performance criteria are shown in Table 3 of the MEFP. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. Prior actions and structural benchmarks are listed in Table 2 of the MEFP. The official exchange rate is defined in Section II. Reporting requirements are specified in Section III.

3. For the purposes of the program, all exchange rates used to evaluate reserve levels and monetary aggregates are the official exchange rates determined by the National Bank of Ukraine (NBU) as of June 30, 2010. In particular, the Swiss Franc is valued at 0.9200 dollar, the Euro is valued at1.2198 dollars, Pound Sterling is valued at 1.5052 dollars, and the Japanese yen is valued at 0.0113 dollars. The accounting exchange rate for the SDR will be 1.4789 per dollar. Official gold holdings were valued at 1,236.00 dollars per fine ounce. These program exchange rates are kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing monetary aggregates does not imply that there is any target exchange rate for policy purposes.

## I. QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILINGS, AND CONTINUOUS PERFORMANCE CRITERIA

### A. Floor on Net International Reserves of Ukraine (Performance Criterion)

#### Definition

4. Net international reserves (NIR) of Ukraine are defined as the dollar value of the difference between usable gross international reserve assets and reserve-related liabilities to

nonresidents, evaluated at program exchange rates. On June 30, 2010, the NIR of Ukraine amounted to US$19,172 million (in equivalent).

5. Usable gross international reserves comprise all readily available claims on nonresidents denominated in convertible foreign currencies as well as Russian rubles, consistent with the Balance of Payments Manual (Fifth Edition) and the Special Data Dissemination Standard (SDDS) (Table A, item 1). Excluded from usable reserves, *inter alia*, are:

- any assets denominated in foreign currencies held at, or which are claims on, domestic institutions (i.e., institutions headquartered domestically, but located either domestically or abroad, or institutions headquartered abroad, but located domestically). Also excluded are all foreign currency claims of the NBU on domestic banks, and NBU deposits held at the Interbank Foreign Currency Exchange Market and domestic banks for trading purposes;

- any precious metals or metal deposits, other than monetary gold and gold deposits, held by the NBU;

- any assets that correspond to claims of commercial banks in foreign currency on the NBU and any reserves assets that are: (i) encumbered; or (ii) pledged as collateral (in so far as not already included in foreign liabilities, or excluded from reserve assets); or (iii) frozen; and

- any reserve assets that are not readily available for intervention in the foreign exchange market, *inter alia*, because of lack of quality or lack of liquidity that limits marketability at the book price.

6. For the purpose of this program, reserve-related liabilities comprise:

- all short-term liabilities of the NBU vis-à-vis nonresidents with an original maturity of one year or less;

- the stock of IMF credit outstanding; and

- the nominal value of all derivative positions[7] of the NBU and government, implying the sale of foreign currency or other reserve assets against domestic currency.

[7] This refers to the notional value of the commitments, not the market value.

Table A. Components of Net International Reserves

| Type of Foreign Reserve Asset or Liability[8] | NBU Balance Sheet and memorandum Accounts |
|---|---|
| 1. **International reserves** | |
| Monetary gold in vault | 1100, 1107 |
| Foreign exchange in cash, including Russian rubles | 1011, 1017 |
| Demand deposits at foreign banks | 1201, 1202 |
| Short-term time deposits at foreign banks | 1211 |
| Long-term deposits at foreign banks | 1212 |
| SDR holdings and Reserve Position in the IMF | IMF, Finance Department[9] |
| Securities issued by nonresidents | 1302, 1305, 1307, 1308, minus 1306 |
| 2. **Short-term liabilities to nonresidents** *(in convertible currencies)* | |
| Correspondent accounts of nonresident banks | 3201 |
| Short-term deposits of nonresident banks | 3211 |
| Operations with nonresident customers | 3230, 3232, 3233 |
| Use of IMF credit | IMF, Finance Department |

## Adjustment mechanism

NIR targets will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) in program disbursements relative to the baseline projection (Table B). Program disbursements are defined as external disbursements from official multilateral creditors (World Bank, European Commission, European Investment Bank, and European Bank for Reconstruction and Development), official bilateral creditors (net), and external bond placements that are usable for the financing of the overall central government budget.

[8] The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on June 30, 2010. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

[9] Before receiving the monthly data from the IMF's Finance Department, these components will be calculated on the basis of preliminary data from the NBU and memorandum accounts.

Table B. NIR/NDA Adjustment

| Cumulative flows from end-June 2010 1/ | In millions of US dollars at program exchange rate |
|---|---|
| **Program disbursements** (technical assumption for the adjuster purpose) | |
| End-September 2010 | 1,850 |
| End-December 2010 | 750 |

1/ In Q3, 2010 these include: Euro bond placement of $1.3 billion, EC disbursement of $0.15 billion, EBRD disbursement of $0.3 billion and others disbursement of project financing of $0.1 billion. In Q4, 2010 these include: World Bank disbursement of $0.5 billion, EU disbursement of $0.3 billion, and others project financing of $0.1; as well as $2 billion repayment of the Russian bridge loan.

## B. Ceiling on Net Domestic Assets of the NBU (Performance Criterion)

### Definition

7. Net domestic assets (NDA) of the NBU are defined as the difference between the monetary base (as defined below) and the NIR of Ukraine (as defined above). For the purpose of computing the NDA target, the NIR is valued at the program exchange rate of UAH 7.9070 per dollar and expressed in hryvnia. On June 30, 2010, the NDA of the NBU amounted to UAH 67,913 million.

### Adjustment mechanism

Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted downward (upward) by the full amount of the cumulative excess (shortfall) in program disbursements relative to the baseline projection (Table B) and evaluated at the program exchange rate.

## C. Ceiling on Monetary Base of the NBU (Base Money) (Indicative Target)

### Definition

8. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,[10] and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at

[10] The definitions set out here will be modified to include any other accounts that may be identified or created in the future in connection with domestic currency issue and the deposit money banks' deposits at the NBU.

deposit money banks (DMBs) (DMB accounts 1001A:1005A, and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts 3230, 3232, 3233, 3234, 3250, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency (NBU liability account 3238). On June 30, 2010, the NBU's monetary base amounted to UAH 219,506 million.

## D. Ceiling on Cash Deficit of the General Government (Performance Criterion)

### Definition

9. The general government comprises the central (state) government, all local governments, and all extrabudgetary funds, including the Pension, Employment, Social Insurance for Temporary Disability, State Material Reserve, Occupational Accident and Sickness Insurance, State Property Fund, and the Road Fund (UkrAvtoDor). The budget of the general government comprises: (i) the state budget; (ii) all local government budgets; and (iii), if not already included in (i), the budgets of the extrabudgetary funds listed above, as well as any other extrabudgetary funds included in the monetary statistics compiled by the NBU. The cash deficit of the general government is measured from below the line as:

- total net treasury bill sales as measured by the information kept in the NBU registry of treasury bill sales (net treasury bill sales are defined as the cumulative total funds realized from the sales of treasury bills at the primary auction and treasury securities issued for recapitalization purpose, less the cumulative total redemption of principal on treasury bills), excluding bonds issued to recapitalize Naftogaz—these are included in the calculation of Naftogaz' cash deficit when they are used (as collateral for a loan, or as an outright sale) by the latter to obtain financing; plus

- other net domestic banking system credit to government as measured by the monetary statistics provided by the NBU (this consists of all non-treasury-bill financing in either domestic or foreign currency extended to the government by banks less the change in all government deposits in the banking system) as well as any financing extended by entities not reflected by the monetary statistics provided by the NBU; plus

- total receipts from privatization received by the State Property Fund and local governments (including the change in the stock of refundable participation deposits); plus

- the difference between disbursements and amortization on any bond issued by the government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus
- the difference between disbursements of official foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of official foreign credits by the general government (including of on-lent project loans, and excluding offset-based amortization with Russia); plus
- the net sales of SDR allocation in the SDR department; plus
- the net change in government deposits in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the general government.

10. For the purposes of measuring the deficit of the general government, all flows to/from the budget in foreign currency will be accounted in hryvnias at the official exchange rate established as of the date of the transaction.

**Adjustment mechanism**

The ceiling on the cash deficit of the general government is subject to an automatic adjuster based on deviations of external project financing (defined as disbursements from bilateral and multilateral creditors to the consolidated general government for specific project expenditure) from program projections (Table C). Specifically, if the cumulative proceeds from external project financing (in hryvnia evaluated at actual exchange rates):

a) exceed program projections, the ceiling on the consolidated general government deficit will be adjusted upward by 100 percent of the excess in external project financing; and

b) fall short of program projections, the ceiling on the consolidated general government deficit will be adjusted downward by 100 percent of the shortfall in external project financing.

Table C. External Project Financing Adjustment

| Cumulative flows from end-December 2009 | In millions of hryvnia |
|---|---|
| **External project financing** (technical assumption for the adjuster purpose) | |
| End-September 2010 | 1600 |
| End-December 2010 | 2400 |

The ceiling on the cash deficit of the general government is subject to an automatic adjuster corresponding to the upfront budgetary costs associated with the recapitalization of banks (excluding subsequent interest payments on the securities or other instruments issued for recapitalization purpose). The ceiling on the cash deficit of the general government will be adjusted upward by (but not exceed) a maximum of UAH 20 billion in 2010.

The ceiling on the cash deficit of the general government is subject to an automatic adjuster on the stock of budgetary arrears on social payments. Budgetary arrears on social payments comprise all arrears of the consolidated budget on wages, pensions, and social benefits owed by the Pension Fund, the central, or local governments. Budgetary arrears are defined as payments not made thirty days after they are due. Wages are defined to comprise all forms of remuneration for work performed for standard and overtime work. Pension obligations of the Pension Fund comprise all pension benefits and other obligations of the Pension Fund.

The ceiling on the cash deficit of the general government is subject to an automatic upward adjustment for the full amount of bonds used to pay VAT refunds (VAT bonds). At the same time, the ceiling on the cash deficit of the general government will be automatically adjusted downward by (i) the difference between the total amount of bonds used as payments for VAT refunds and the amount of VAT refunds arrears at end-2009 (UAH 16.4 billion) and (ii) the accumulation of any VAT refund arrears since January 1, 2010 (as defined in section E) in excess of the ceiling on VAT refund arrears as set in section E.

## E. Ceiling on VAT Refund Arrears (Indicative target)

11. The ceiling on VAT refund arrears is set to UAH 3 billion at end-September 2010 and zero for all other test dates under the program. The stock of VAT refund arrears is defined as those claims that have not been settled (through a cash refund, netting out against obligations of taxpayers, payment with a government bond (VAT bond) or an official decision to reject the claim) within a specified time period after the VAT refund claim has been submitted to the STA. This time period is 60 days, allowing for verification of the validity and payment processing of claims. VAT refund claims that have been rejected by the STA but for which an appeal has been registered in courts are not considered to be in arrears. According to this definition, the stock of VAT refund arrears as of December 31, 2009 was UAH 16.4 billion.

## F. Ceiling on Cash Deficit of the General Government and Naftogaz (Performance Criterion)

### Definition

12. The cash deficit of the General Government and Naftogaz is the cash deficit of the General Government as defined above plus the cash deficit of Naftogaz.

13. Naftogaz is defined as the national joint stock company "Naftogaz of Ukraine". The cash deficit of the Naftogaz is measured from below the line as:

- net domestic banking system credit to the company (this consists of all financing in either domestic or foreign currency extended to the company by banks less the change in company deposits in the banking system); plus
- the difference between disbursements of private foreign loans to Naftogaz (including private placements) and the amortization of private foreign loans (including private placements); plus
- the difference between disbursements of official foreign credits to Naftogaz (including project loans) and the amortization of official foreign credits (including project loans); plus
- the disbursements of trade credits from Gazprom to import gas; plus
- the difference between disbursements and amortization on any bonds issued by the company; plus
- the difference between disbursements of loans from the Single Treasury Account and the amortization of loans from the Single Treasury Account; plus
- the net change in deposits of the company in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the company; plus
- total receipts from sale of assets received by the company (including recapitalization or other form of treasury securities issued to the company); plus
- any other forms of financing of the company not identified above.

14. For the purposes of measuring the deficit of Naftogaz, all flows in foreign currency will be accounted in hryvnias at the official exchange rate established as of the date of the transaction.

**Adjustment mechanism**

The ceiling on the cash deficit of the general government and Naftogaz will be adjusted upward by the amount of financing by multilateral institutions and official bilateral creditors disbursed to Naftogaz for investment projects. The baseline under the program assumes no such financing for Naftogaz.

### G. Ceiling on the Non-Accumulation of External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

15. For the purposes of the program, an external debt payment arrear will be defined as a payment by the general government, which has not been made within seven days after falling due (including grace period, if any). The performance criterion will apply on a continuous basis throughout the program period.

### H. Ceiling on Publicly Guaranteed Debt (Performance Criterion)

**Definition**

16. The ceiling on publicly guaranteed debt will apply to the amount of guarantees issued in 2010 by the central (state) government to the non-financial private sector and public enterprises. The program exchange rate will apply to all non-UAH denominated debt. State guarantees in 2010 will amount to no more than UAH 15 billion.

### I. Other Continuous Performance Criteria

17. During the period of the Stand-By Arrangement, Ukraine will not (i) impose or intensify restrictions on the making of payments and transfers for current international transactions; (ii) introduce or modify multiple currency practices; (iii) conclude bilateral payment agreements that are inconsistent with Article VIII; and (iv) impose or intensify import restrictions for balance of payments reasons.

## II. Official Exchange Rate

**Determination of the official exchange rate**

18. The NBU will, on a daily basis, set the official rate at the average transaction-weighted rate of the preceding day (with intraday adjustments if necessary to keep it within 2 percent of the market rate).

## III. Reporting Requirements

### A. National Bank of Ukraine

19. The NBU will continue to provide to the IMF on a monthly basis, no later than the 25th day of the following month, an aggregate balance sheet for the NBU and a consolidated balance sheet for the deposit money banks.

20. The NBU will provide to the IMF, on a weekly basis, with daily data the stock of net international reserves, at both actual and program exchange rates. In addition, it will provide on a weekly and monthly basis, no later than the 25th of the following month, the full breakdown of NBU accounts included in net international reserves (defined in Table A above).

21. The NBU will provide the IMF on a daily basis with information on official foreign exchange interventions. In this context, it will also provide the detailed results of the foreign exchange auctions, in the format agreed with the IMF staff.

22. The NBU will continue to provide on its web site the weekly report on the primary treasury bill market, reports on each treasury bill auction, and provide to the IMF the monthly report on treasury bills. It will also provide a breakdown of treasury bills amortizations by type of T-Bill holders (central bank, other public institutions, and private sector).

23. The NBU will provide the daily holdings of treasury bills broken down by type of holders (including state-owned banks and private banks) at primary market and balance sheets prices.

24. The NBU will provide information on daily transactions (volumes and yields) on the secondary market treasury bills (including over the counter transactions).

25. The NBU will provide the IMF, on a weekly basis, with daily data on the total financing (including refinancing) issued by the NBU to commercial banks, broken down by original maturity of the financing, as well as transactions to absorb liquidity from the banking system (including CD issuance).

26. Every 10 days, the NBU will continue to provide the IMF with the operational monetary survey of the NBU, including any additional information that is needed for the IMF staff to monitor monetary policy and developments in the banking sector.

27. The NBU will provide to the IMF, on a monthly basis, the net domestic assets data based on the monthly balance sheets within three weeks following the end of the month.

28. The NBU will continue to provide to the IMF the daily operational balance sheets of the NBU and commercial banks on a daily basis according to standard reporting forms, including detailed information on loans of the banking sector provided to the general government, with weekly detailed breakdown of this information by indebtedness of the central (state) government and local budgets, including in national and foreign currency, by loan and by security.

29. The NBU will provide to the IMF, on a monthly basis, projections for external payments falling due in the next twelve months. The data on actual settlement of external

obligations, reflecting separately principal and interest payments as well as actual outturns for both the public and private sectors, shall be provided on a quarterly basis, within 80-days following the end of the quarter.

30. The NBU will provide to the IMF, on a quarterly basis, the stock of short- and long-term external debt (including arrears) for both public and private sectors.

31. The NBU will provide to the IMF on a daily basis aggregated data on main currency flows, including government foreign receipts and payments by currencies as well as currency breakdown of interbank market operations. The NBU will continue to provide daily information on exchange market transactions including the exchange rate.

32. The NBU will provide to the IMF reports N 381.25; 381.26 with information on reserve requirements and reports on CD operations when performed.

33. The NBU will continue to provide on a monthly basis, no later than 25 days after the end of the month, banking system monitoring indicators in an agreed format. This includes inter alia data on nonperforming loans (substandard, doubtful, and loss criterion).

34. The NBU will provide to the IMF consolidated banking sector data and aggregated data (without specifying the names of the banks) for the largest banks (accounting for at least 80 percent of the total banking system assets) on a quarterly basis, no later than 30 days after the end of the quarter: (i) balance sheet; (ii) loan classification (standard, watch, substandard, doubtful, loss); (iii) provisions for all assets (required and actual) (iv) foreign currency denominated lending and deposits; (v) capital adequacy ratios for normative and regulatory capital (Tier II and I), normatives H2 and H3; weighted averages based on banks' total assets; and (vi) liquidity normatives H5 and H6; weighted averages based on banks' total assets.

35. The NBU will continue to provide detailed quarterly balance of payments data in electronic format within 80 days after the end of the quarter.

36. The NBU will provide data on credit to nongovernment units that are guaranteed by the NBU on a monthly basis no later than 25 days after the end of the month.

37. The NBU will inform IMF staff if the Treasury does not pay interest or principal on treasury bills due to the NBU, deposit money banks, or nonbank entities and individuals. In such case, the NBU will provide information on outstanding interest and principal payments.

38. The NBU will inform IMF staff of any changes to reserve requirements for deposit money banks.

39. The NBU will communicate (electronically) to the IMF staff any changes in the accounting and valuation principles applicable to the balance-sheet data and will notify the

staff before introducing any changes to the Charts of Accounts and reporting forms of both the NBU and the commercial banks.

40. The NBU Internal Audit Department will continue to provide an assurance report and an audited income statement to the Fund, no later than six weeks after each test date, confirming that: (i) the monetary data are in accordance with program definitions and have been verified and reconciled to accounting records, and (ii) that there have been no changes to the chart of accounts or valuation methods that would impact the data reporting.

41. The NBU will continue to provide the Fund with a copy of the annual management letter from the external auditor within six weeks of completion of each audit. As required under the Fund's safeguard policy, this will remain in effect for the duration of the arrangement and for as long as credit remains outstanding.

## B. Ministry of Finance

42. The Treasury will continue to provide to the IMF its report on daily operational budget execution indicators, on a 10-day basis data on revenue of the state, local government, and consolidated budget revenues.

43. The Treasury will continue to provide to the IMF in electronic form monthly and quarterly treasury reports, no later than 25 and 35 days after the end of the period respectively. The Treasury will continue to provide to the IMF in electronic form the final fiscal accounts at the end of each fiscal year, no later than March of the following year. Inter alia, these reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications. In addition, quarterly reports will contain standard information on budget expenses to cover called government guarantees.

44. The Ministry of Finance will continue to provide monthly reports 1.P0 on actual tax revenue and 1.P6 on tax arrears, no later than 25 days after the end of each month.

45. The Ministry of Finance will report monthly data on the public wage bill in line with the template agreed with the IMF staff. It will also provide monthly reports on the execution of the Stabilization, Agrarian, and Road Fund.

46. The Ministry of Finance will report to the IMF on a monthly basis, no later than 15 days after the end of the month, the cash deficit of the general government, with details on budget execution data for privatization receipts of the state and local governments; disbursements of external credits (including budget support and project loans for on-lending) to the consolidated budget and amortization of external debt by the consolidated budget; net domestic borrowing of the general government, including net t-bill issuance, issuance of other government debt instruments, and change in government deposits.

47. The Ministry of Finance will also provide, on a monthly basis, information on the borrowing (disbursements, interests and amortization) for the following state-owned companies or agencies: Naftogaz, UrkAvtoDor, State Mortgage Institution and the National Agency in Charge of preparation and Conduction of Euro-2012 Soccer Championship, in line with the format agreed with IMF staff.

48. The Ministry of Finance will provide data on the stock of all budgetary arrears on a monthly basis, no more than 25 days after the end of the month, including separate line items for wages, pensions, social benefits, energy, communal services, and all other arrears on goods and services. The Treasury will report monthly data on accounts payable for state and local budgets (economic and functional classification).

49. The Ministry of Finance will provide monthly information, no later than 25 days after the end of each month, on the amounts and terms of all external debt contracted or guaranteed by the general government.

50. The Ministry of Finance will provide to the IMF in electronic form on a monthly basis, no later than 25 days after the end of the month, (a) data on the outstanding stock of domestic and external debt of the state and local budgets (including general and special funds), (b) the standard files planned and actual external debt disbursement, amortization, and interest payments (including general and special funds), broken down in detail by creditor categories as agreed with Fund staff, and (c) the report on external debt amortization and interest payments by days and currencies. The Ministry of Finance will also report the accumulation of any budgetary arrears on external and domestic debt service.

51. The Ministry of Finance will provide to the IMF monthly debt (domestic and external) amortization schedules updated on a weekly basis.

52. The Ministry of Finance will provide data on external and domestic credit to nongovernment units that is guaranteed by the government (amount of sovereign guarantees extended by executive resolutions and actually effectuated; total amount of outstanding guarantees and list of their recipients) on a monthly basis no later than 25 days after the end of the month.

53. The Ministry of Finance will provide data on the approved budgets and quarterly operational data (daily for the Pension Fund only) on the revenue, expenditures, and arrears, and balance sheets of the Pension Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Social Insurance Fund, Employment Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Occupational Accident and Sickness Insurance Fund, and any other extrabudgetary funds managed at the state level no later than 50 days after the end of each quarter (each month in case of the Pension Fund). Any within-year amendments to the budgets of these funds will be reported within a week after their approval. The Ministry of Finance will also report the annual financial statement including the final fiscal

accounts of those funds at the end of each fiscal year, no later than April of the following year.

54. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central (state) and local budgets, starting from January 2010. After any public sector wage increase, the Ministry of Finance will provide an estimate of its costs for the current and two subsequent fiscal years, for the state and local government budgets.

55. The Ministry of Finance will provide, no later than 15 days after the end of each month, monthly data on the budgetary costs associated with the recapitalization of banks. This cost includes the upfront impact on the cash deficit of the general government of the recapitalization of banks as well as the costs associated with the payment of interests.

56. The Ministry of Finance and the Treasury will provide, in line with the template agreed with the IMF staff, weekly data on the outstanding balance of the single Treasury account (including its foreign exchange component) compartmentalized into funds ascribed to (a) general fund of the state budget; (b) special fund of the state; (c) local budgets; and (d) other funds as well as data on net outstanding temporary loans to Pension Fund and local budgets.

## C. State Tax Administration

57. The State Tax Administration (STA) will provide monthly data, no later than 25 days after the end of the month, on tax arrears, inclusive of deferred payments, interest and penalties outstanding, in the following format:

| | Beginning Stock | | | | Netting out during month | **IV.** Deferrals during month | Write- -offs (arrears written off during month) | Collections of outstanding debt at beginning of month | New Arrears (tax liabilities becoming overdue during month) | Ending Stock |
|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Principal | Interest | Penalties | | | | | | |
| Tax arrears | | | | | | | | | | |

58. The STA will continue to provide on a quarterly basis, no later than 2 months after the end of the quarter, a listing of all tax exemptions granted, specifying the beneficiary the exemption provided, the duration, and the estimated subsequent revenue loss for the current fiscal year.

59. The STA will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund requests; (ii) refund requests paid in cash; (iii) refunds netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock of requests;

and (vii) stock of VAT refund arrears according to the definition in paragraph 16 (unsettled VAT refund claims submitted to the STA more than 60 days before the end-of-period; (viii) the percentage of VAT refund claims that has been in arrears for less than 30 days (refund claims submitted to STA less than 90 days before the end-of-period), the percentage of VAT refund claims that has been in arrears for more than 30 days but less than 90 days (refund claims submitted to STA more than 90 days but less than 150 days before end-of-period), and the percentage of VAT refund claims that has been in arrears for more than 90 days (refund claims submitted to STA more than 150 days before the end-of-period; and (ix) the percentage of VAT refund arrears that are under investigation, but has not yet been officially rejected. It is understood that while monthly data could be operational, quarterly figures will be subject to verification and will be final.

## A. Ministry of Economy and Ministry of Fuel and Energy

60. The Ministry of Economy will provide quarterly information on actual levels of communal service tariffs in all regions for major services (heating, water supply, sewage and rent) and their level of cost recovery. In addition, the Ministry of Economy, the Ministry of Housing and Municipal Economy of Ukraine, and the National Energy Regulatory Commission will provide the methodology underlying the tariff calculations for full cost recovery, including electricity and gas.

61. For each month, no later than the 25th of the following month, the government (based on information by the Ministry of Fuel and Energy, the Ministry of Economy, STA, MoF, NERC, and *Naftogaz*) will provide IMF staff with information in electronic form (in an agreed format) on financial indicators in the gas, electricity and coal sectors, including sales, tariffs, arrears, payments to the budget, subsidies, and debt.

62. For each month, no later than the 25th of the following month, the Ministry of Fuel and Energy (based on information by Naftogaz) will provide IMF staff with information in electronic form (in an agreed format) on the cash deficit of the company, as defined above.

## B. State Statistics Committee

63. The state Statistics Committee and *Naftogaz* will provide to the IMF, on a monthly basis, no later than 45 days after the end of the month, data on prices, volumes, and payments for imported and exported oil and natural gas by country of origin and destination.

INTERNATIONAL MONETARY FUND

# Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Lorenzo Giorgianni

July 21, 2010

**This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Ukraine and its effects on the Fund's liquidity, in accordance with the policy on exceptional access**.[1] The authorities are requesting a 29-month SBA with access of SDR 10 billion (729 percent of quota). Disbursements are largely evenly phased with a marginally larger first purchase of SDR 1,250 million (91 percent of quota) upon approval of the arrangement, followed by eight quarterly disbursements of SDR 1,000 million (73 percent of quota) each, commencing with the first review five months after approval of the SBA. The final purchase of SDR 750 million (55 percent of quota) is scheduled for December 2012 following the completion of the ninth review (Table 1). Most of the first two scheduled purchases (US$2 billion or approximately SDR 1.3 billion) will go to the Ministry of Finance as budget support—evenly split between the purchase on approval and the first review purchase in November 2010, with the balance of each drawing going to the National Bank of Ukraine (NBU). All subsequent purchases will be made by the NBU.

**Table 1. Ukraine: Proposed SBA—Access and Phasing**

| | | | Percent of quota | |
|---|---|---|---|---|
| Availability | Date 1/ | SDR mn | Purchase | Cumulative |
| 2010 | July (approval) | 1,250.0 | 91.1 | 91.1 |
| | November | 1,000.0 | 72.9 | 164.0 |
| 2011 | March | 1,000.0 | 72.9 | 236.9 |
| | June | 1,000.0 | 72.9 | 309.8 |
| | September | 1,000.0 | 72.9 | 382.7 |
| | December | 1,000.0 | 72.9 | 455.5 |
| 2012 | March | 1,000.0 | 72.9 | 528.4 |
| | June | 1,000.0 | 72.9 | 601.3 |
| | September | 1,000.0 | 72.9 | 674.2 |
| | December | 750.0 | 54.7 | 728.9 |
| | Total | 10,000.0 | 728.9 | 728.9 |

Source: Finance Department.

1/ Starting November 2010 purchases will depend on the completion of a review.

[1] See *The Acting Chair's Summing Up of the Review of Access Policy Under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy*.

## I. BACKGROUND

1. **Ukraine has had an extensive financial relationship with the Fund since becoming a member in September 1992 (Table 2).** GRA credit outstanding to Ukraine is currently at a historic peak of SDR 7 billion. Ukraine's performance under its past programs with the Fund has been mixed. Most recently, the heavily frontloaded 2008 SBA went off track a year into the program as a result of weak policy implementation and stalled reforms against the background of a difficult economic environment and a complex political situation. Despite the fact that only the first two reviews were completed, Ukraine drew SDR 7 billion of the total of SDR 11 billion available under the SBA. The previous program, a one-year 2004 precautionary SBA arrangement designed to establish a track record, quickly went off-track, reflecting weak ownership of the program.[2] Ukraine has repurchased Fund resources in a timely fashion.

**Table 2. Ukraine: IMF Financial Arrangements, Purchases and Repurchases, 1994–2015**

**(In millions of SDRs)**

| Year | Type of New Arrangement | Date of Arrangement | Date of Expiration or Cancellation | Amount of New Arrangement | Amount Drawn | Purchases | Repurchases | Fund Exposure 1/ |
|---|---|---|---|---|---|---|---|---|
| 1994 | STF 2/ | 26-Oct-1994 | | 498.6 | 498.6 | 249.3 | 0.0 | 249.3 |
| 1995 | SBA | 7-Apr-1995 | 6-Apr-1996 | 997.3 | 538.7 | 788.0 3/ | 0.0 | 1,037.3 |
| 1996 | SBA | 10-May-1996 | 23-Feb-1997 | 598.2 | 598.2 | 536.0 | 0.0 | 1,573.3 |
| 1997 | SBA | 25-Aug-1997 | 24-Aug-1998 | 398.9 | 181.3 | 207.3 | 0.0 | 1,780.6 |
| 1998 | EFF | 4-Sep-1998 | 3-Sep-2002 | 1,920.0 | 1,193.0 | 281.8 | 77.3 | 1,985.0 |
| 1999 | | | | | | 466.6 | 407.0 | 2,044.6 |
| 2000 | | | | | | 190.1 | 643.5 | 1,591.2 |
| 2001 | | | | | | 290.8 | 361.2 | 1,520.7 |
| 2002 | | | | | | 0.0 | 140.7 | 1,380.0 |
| 2003 | | | | | | 0.0 | 144.5 | 1,235.5 |
| 2004 | SBA | 29-Mar-2004 4/ | 28-Mar-2005 | 411.6 | 0.0 | 0.0 | 201.8 | 1,033.7 |
| 2005 | | | | | | 0.0 | 202.8 | 830.9 |
| 2006 | | | | | | 0.0 | 279.0 | 551.9 |
| 2007 | | | | | | 0.0 | 279.0 | 272.9 |
| 2008 | SBA | 5-Nov-2008 5/ | | 11,000.0 | 3,000.0 | 3,000.0 | 215.6 | 3,057.3 |
| 2009 | | | | | 7,000.0 | 4,000.0 | 57.3 | 7,000.0 |
| *2010 6/* | *SBA* | *28-Jul-2010* | | *10,000.0* | *2,250.0* | *2,250.0* | *0.0* | *9,250.0* |
| *2011 6/* | | | | | *6,250.0* | *4,000.0* | *0.0* | *13,250.0* |
| *2012 6/* | | | | | *10,000.0* | *3,750.0* | *2,234.4* | *14,765.6* |
| *2013 6/* | | | | | | | *3,656.3* | *11,109.4* |
| *2014 6/* | | | | | | | *3,140.6* | *7,968.8* |
| *2015 6/* | | | | | | | *3,718.8* | *4,250.0* |

Sources: Finance Department.

1/ As of end December, unless otherwise stated.
2/ The Systemic Transformation Facility (STF) was created in April 1993 and allowed to lapse in April 1995.
3/ Includes a second drawing under the 1994 STF of SDR 249.3 million.
4/ One-year, precautionary SBA designed to establish a track record "quickly" went off track due to fiscal accommodation; none of the structural performance criteria were observed.
5/ Off-track since the third review in November 2009. Last purchase made at second review in July 2009.
6/ Figures under the proposed program in italics.

[2] See *Ukraine—Ex Post Assessment of Longer-Term Program Engagement* (IMF Country Report No. 05/415).

## Table 3. Ukraine: External Debt Structure, 2004-2010

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | Proj. 2010 2/ |
|---|---|---|---|---|---|---|---|
| | (In billions of US$) | | | | | | |
| Total External Debt | 31 | 40 | 55 | 80 | 102 | 103 | 108 |
| Public | 12 | 12 | 12 | 12 | 17 | 24 | 30 |
| Short-term 3/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Long-term | 12 | 12 | 12 | 12 | 17 | 24 | 30 |
| Private | 19 | 28 | 43 | 68 | 85 | 79 | 77 |
| Short-term | 10 | 11 | 15 | 21 | 20 | 19 | 20 |
| Long-term | 8 | 17 | 27 | 47 | 65 | 60 | 57 |
| | (In Percent of GDP) | | | | | | |
| Total External Debt | 47 | 46 | 50 | 56 | 56 | 88 | 79 |
| Public | 18 | 14 | 11 | 9 | 9 | 20 | 22 |
| Short-term | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Long-term | 18 | 14 | 11 | 9 | 9 | 20 | 22 |
| Private | 29 | 32 | 40 | 47 | 47 | 68 | 57 |
| Short-term | 16 | 13 | 14 | 14 | 11 | 16 | 15 |
| Long-term | 13 | 20 | 25 | 33 | 36 | 51 | 42 |
| *Memorandum items:* | | | | | | | |
| Short-term external debt (billions of US$) | 10 | 11 | 15 | 21 | 20 | 19 | 20 |
| Short-term external debt (% of GDP) | 16 | 13 | 14 | 14 | 11 | 16 | 15 |
| Total public sector debt (% of GDP) | 25 | 18 | 15 | 12 | 14 | 34 | 40 |

Source: Ukraine Authorities and IMF staff estimates.

1/ End of year unless otherwise indicated.
2/ Staff projections for end-2010.

2. **While public external debt remains relatively low, Ukraine's total external debt has increased to high levels in recent years (Table 3)**. This was mainly due to the sharp increase in foreign borrowing by banks and corporations. While expected to decline in 2010, Ukraine's total external debt is about 80 percent of GDP, placing it at the higher end relative to recent exceptional access cases (Figure 1, Panel A).[3] External debt is primarily long-term and over 70 percent is private sector debt. Ukraine's public external debt is projected to rise to 22 percent of GDP by end-2010, close to the median of recent exceptional access cases (Figure 1, Panel B). However, over 60 percent of this debt represented obligations to the Fund in 2009, reflecting limited access to financial markets or other official creditors. Ukraine has not placed an international bond since 2007. Total public sector debt, which has risen rapidly over the past two years on account of consistent budget deficits, remains moderate compared with other exceptional access cases (Table 3; Figure 1, Panel D).[4]

3. **Ukraine's external debt service burden is high.**[5] The external debt service to export ratio has deteriorated dramatically since 2008 reflecting rising external debt, but mostly falling exports due to the global crisis.[6] This increased Ukraine's external debt service to

[3] Throughout the paper recent exceptional access cases refer to arrangements since September 2008.

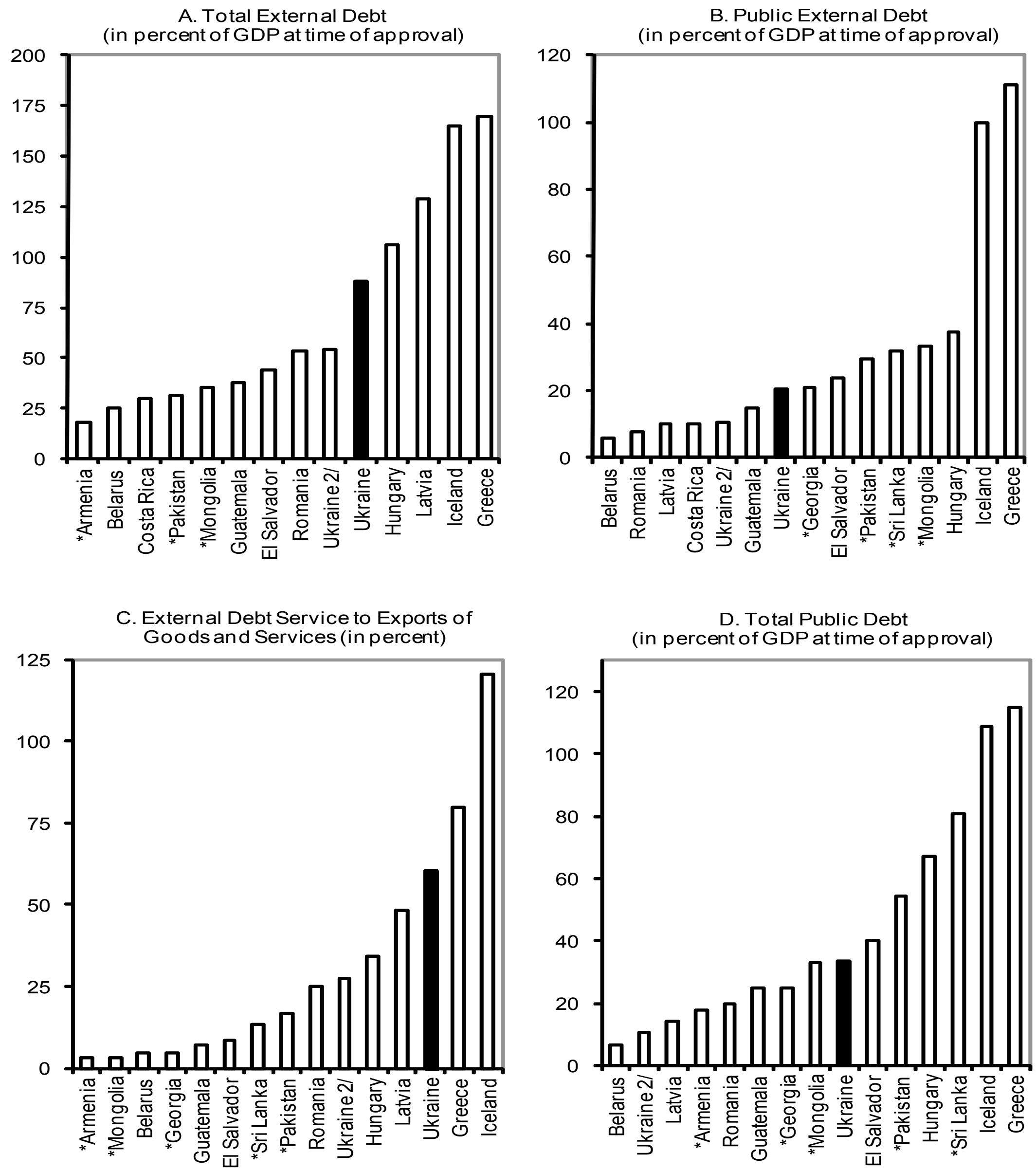
[4] Ukraine's general government deficit, including Naftogaz, was 8.7 percent of GDP in 2009 and projected to be 6.5 percent this year (Staff Report).

[5] External debt service excludes amortization of short-term external debt.

[6] Ukraine's nominal exports fell 40 percent in 2009 (Staff Report).

export ratio to a relatively high level among exceptional access cases, below only Greece's and Iceland's (Figure 1, Panel C). This debt service to export ratio is also significantly higher than the corresponding one for the 2008 SBA.[7]

**Figure 1. Ukraine: Debt Ratios for Recent Exceptional Access Arrangements 1/**




Source: Ukraine Authorities and IMF staff estimates, and World Economic Outlook.

1/ For arrangements approved since September 2008, estimates as reported in each staff report on the request of the Stand-By Arrangement. For Ukraine ratios reflect end-2009 data. Asterisks indicate PRGT eligible countries.
2/ Ukraine's 2008 Risk Assessment (IMF Country Report No. 08/384).

[7] *Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position* (IMF Country Report No. 08/384)

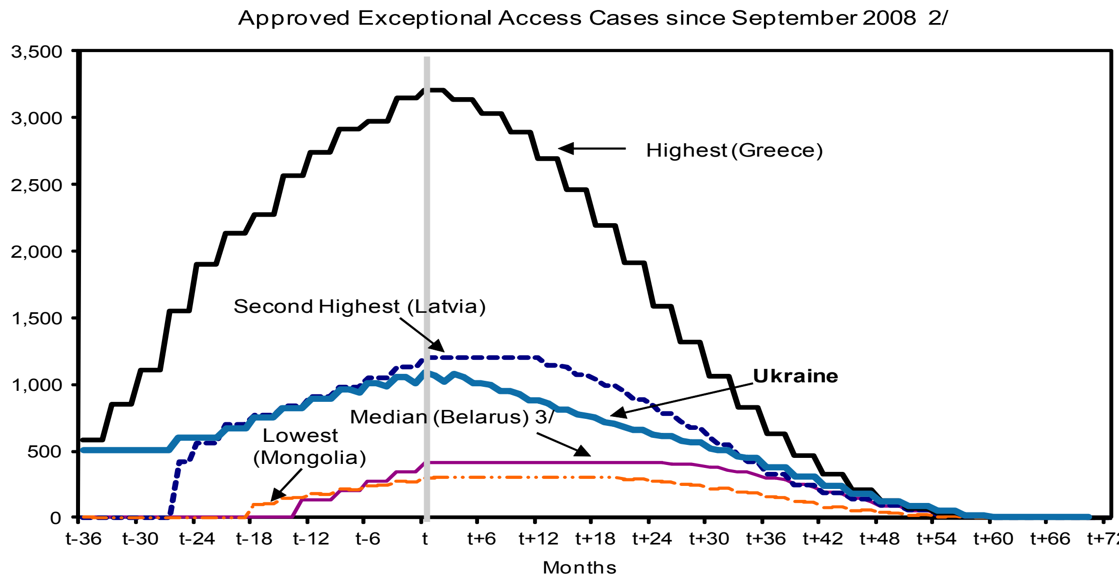
## II. The New Stand-By Arrangement—Risks and Impact on Fund's Finances

### A. Risks to the Fund

4. **Access under the proposed arrangement would exceed both annual and cumulative access limits and would be among the highest on a number of indicators:**

- If all purchases were made as scheduled, Ukraine's outstanding use of GRA resources would rise from about 500 percent of quota currently to peak at nearly 1,100 percent of quota in September 2012 (Figure 2). This level of access relative to quota would be the fourth highest after Greece, Latvia, and Iceland—and well above the median case of Belarus.

**Figure 2. Credit Outstanding in the GRA around Peak Borrowing 1/**
**(In percent of quota)**




Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing 't' is defined as the highest level of credit outstanding for a member.
2/ Including precautionary arrangements.
3/ Median credit outstanding at peak is 419 percent of quota; average is 785 percent of quota.

- If all purchases were made as scheduled, the Fund's exposure to Ukraine in terms of GDP would peak at a level second only to Iceland, exceeding exposure to Greece (Figure 3, Panel A). As a share of total external debt, peak exposure would be second only to Armenia and would be just over half of reserves. All three of these exposure ratios are more elevated compared with the ones reported in the risk assessment for the 2008 SBA.[8]

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[8] *Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position* (IMF Country Report No. 08/384)

5. **Front-loaded budget support represents additional risks to the Fund.** Total budget support of US$2 billion or about SDR 1.3 billion (about 100 percent of quota) is scheduled to be disbursed in the first two purchases—after several key prior actions but before the implementation of other critical structural reforms.[9] Budget support under the 2008 SBA amounted to about SDR 3.1 billion (about 240 percent of quota).[10] These amounts represent an increased repayment risk in the context of a heavy fiscal adjustment.

6. **If all purchases under the proposed arrangement were made as scheduled, Ukraine's peak debt service burden would be quite high.[11]** For comparability with other risk assessments of past exceptional access cases, Table 4 shows debt service due on GRA credit projected assuming that the SDR interest rate remains at its current level. Ukraine's projected debt service to the Fund would peak at about SDR 4.1 billion in 2013 (Table 4). This would be equivalent to 8.7 percent of government revenues and almost three-quarters of public external debt service, 3.6 percent of GDP, 14.3 percent of gross international reserves, and 7.0 percent of projected exports of goods and services. Ukraine's total external debt service for 2013 is projected to amount to 21.3 percent of GDP and 41.3 percent of exports of goods and services.

7. **If all purchases under the proposed agreement were made as scheduled, the Fund would be Ukraine's primary external creditor.** Outstanding GRA credit to the Ukraine is projected to peak at SDR 14.8 billion in 2012 (Table 4), equivalent to about 53 percent of total public sector external debt and about 18 of total external debt.

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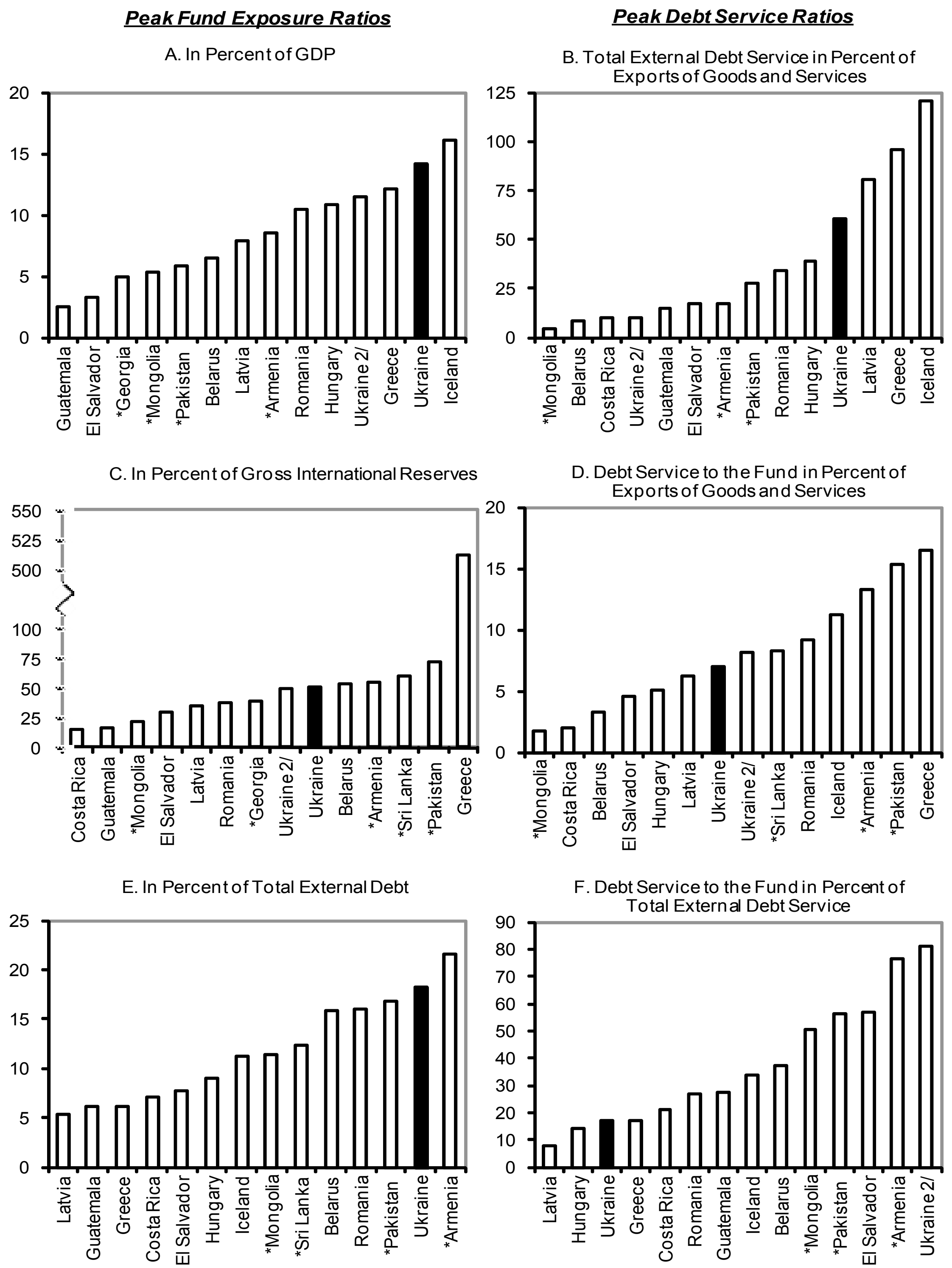
[9] The first review will be based on end-September 2010 performance criteria and the target date for several critical structural reform benchmarks is December 2010.

[10] SDR 1 billion of the second disbursement (totaling SDR 1.875 billion) and nearly all of the third disbursement or SDR 2.117 billion went towards financing the budget deficit.

[11] Debt service to the Fund is calculated assuming that all repurchases are made as scheduled, i.e., each purchase is repurchased in 8 quarterly installments beginning in 3¼ years after each purchase and ending after 5 years. Surcharges apply to outstanding credit above 300 percent of quota.

**Figure 3. Peak Fund Exposure and Debt Service Ratios for Recent Exceptional Access Cases**




Source: Ukraine authorities and IMF staff estimates, and World Economic Outlook.

1/ Asterisks indicate PRGT eligible countries.
2/ Ukraine's 2008 Risk Assessment (IMF Country Report No. 08/384).

**Table 4. Ukraine: Capacity to Repay Indicators 1/**

| | Jul-10 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| **Exposure and Repayments (In SDR millions)** | | | | | | | |
| GRA credit to Ukraine 2/ | 1,250.0 | 9,250.0 | 13,250.0 | 14,765.6 | 11,109.4 | 7,968.8 | 4,250.0 |
| (In percent of quota) | 91.1 | 674.2 | 965.7 | 1,076.2 | 809.7 | 580.8 | 309.8 |
| Charges due on GRA credit 3/ | - | 49.3 | 132.5 | 176.4 | 172.8 | 128.7 | 90.2 |
| Debt service due on GRA credit 4/ | - | 98.0 | 279.4 | 2,650.4 | 4,111.4 | 3,448.9 | 3,899.2 |
| **Debt and Debt Service Ratios 5/** | | | | | | | |
| In percent of GDP | | | | | | | |
| Total external debt | 88.0 | 79.0 | 77.8 | 77.6 | 71.4 | 67.4 | 64.5 |
| External debt, public | 20.5 | 22.2 | 25.7 | 26.4 | 20.2 | 15.7 | 11.5 |
| GRA credit to Ukraine | 1.7 | 10.1 | 13.2 | 14.1 | 9.8 | 6.5 | 3.2 |
| Total external debt service 6/ | 27.9 | 20.6 | 19.8 | 21.3 | 21.3 | 19.8 | 19.1 |
| Public external debt service 6/ | 2.3 | 2.7 | 1.4 | 3.7 | 5.0 | 4.7 | 4.8 |
| Debt service due on GRA credit | - | 0.1 | 0.3 | 2.5 | 3.6 | 2.8 | 3.0 |
| In percent of Central Government Revenues | | | | | | | |
| Public external debt service 6/ | 5.4 | 6.3 | 3.5 | 8.9 | 12.0 | 11.2 | 11.4 |
| Debt service due on GRA credit | - | 0.3 | 0.7 | 6.1 | 8.7 | 6.7 | 7.1 |
| In percent of Gross International Reserves | | | | | | | |
| Total external debt | 389.8 | 354.9 | 302.1 | 278.7 | 280.7 | 284.9 | 286.8 |
| External debt, public | 90.6 | 99.9 | 99.9 | 95.0 | 79.5 | 66.5 | 51.2 |
| GRA credit to Ukraine | 7.5 | 45.4 | 51.3 | 50.7 | 38.6 | 27.5 | 14.3 |
| Debt service due on GRA credit | - | 0.5 | 1.1 | 9.1 | 14.3 | 11.9 | 13.1 |
| In percent of Exports of Goods and Services | | | | | | | |
| Total external debt service 6/ | 60.3 | 43.0 | 41.0 | 41.9 | 41.3 | 37.9 | 35.8 |
| Public external debt service 6/ | 5.0 | 5.6 | 3.0 | 7.3 | 9.7 | 8.9 | 8.9 |
| Debt service due on GRA credit | - | 0.2 | 0.6 | 5.0 | 7.0 | 5.4 | 5.5 |
| In percent of Total External Debt | | | | | | | |
| GRA credit to Ukraine | 1.9 | 12.8 | 17.0 | 18.2 | 13.7 | 9.6 | 5.0 |
| In percent of Total External Debt Service | | | | | | | |
| Debt service due on GRA credit | - | 0.5 | 1.4 | 11.9 | 17.0 | 14.2 | 15.5 |
| In percent of Total Public External Debt | | | | | | | |
| GRA credit to Ukraine | 8.2 | 45.5 | 51.4 | 53.3 | 48.5 | 41.3 | 28.0 |
| In percent of Total Public External Debt Service | | | | | | | |
| Debt service due on GRA credit 6/ | - | 4.0 | 19.3 | 68.2 | 72.6 | 60.3 | 62.2 |

Sources: Ukraine, Finance Department, and IMF staff estimates.

1/ Assumes full drawings.
2/ Repurchases are assumed to be made as scheduled.
3/ Includes GRA basic rate of charge, surcharges and service fees.
4/ Includes charges due on GRA credit and payments on principal.
5/ Staff projections for external debt, GDP, gross international reserves, debt servicing, and exports of goods and services, as used in the staff report that requests the proposed SBA. For July 2010, the figures use stock values as of end-December 2009.
6/ Interest on and amortization of medium and long-term debt.

## B. Impact on the Fund's Liquidity Position and Risk Exposure

8. **The impact of the proposed arrangement on the Fund's liquidity and credit risk exposure would be significant in several areas:**

- **The proposed arrangement would reduce Fund liquidity by about 4 percent (Table 5).** Commitments under the proposed arrangement would reduce the one-year forward commitment capacity (FCC) of SDR 148 billion as of July 1, 2010 by

SDR 6 billion.[12] While the envisaged program is for the amount of SDR 10 billion, the net figure of SDR 6 billion takes into account the unused portion of SDR 4 billion under the 2008 SBA which is being cancelled.

**Table 5. Ukraine—Impact on GRA Finances**

(millions of SDR unless otherwise noted)

| | as of 7/8/2010 |
|---|---|
| **Liquidity measures** | |
| One-year Forward Commitment Capacity (FCC) 1/ | 148,300 |
| Impact on FCC on approval 2/ | -6,000 |
| **Prudential measures** | |
| Fund GRA commitment to Ukraine | |
| in percent of current precautionary balances | 137 |
| in percent of total GRA credit outstanding 3/ | 21 |
| Fund GRA credit outstanding to top five borrowers | |
| in percent of total GRA credit outstanding 3/ | 70 |
| in percent of total GRA credit outstanding including first Ukraine purchase | 71 |
| Ukraine's annual GRA charges in percent of the Fund's residual burden sharing capacity for 2010 | 221 |
| **Memorandum items** | |
| Fund's precautionary balances (as of April 30, 2010) 4/ | 7,320 |
| Fund's Residual Burden Sharing Capacity 5/ | 22.2 |

Sources: Ukraine authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

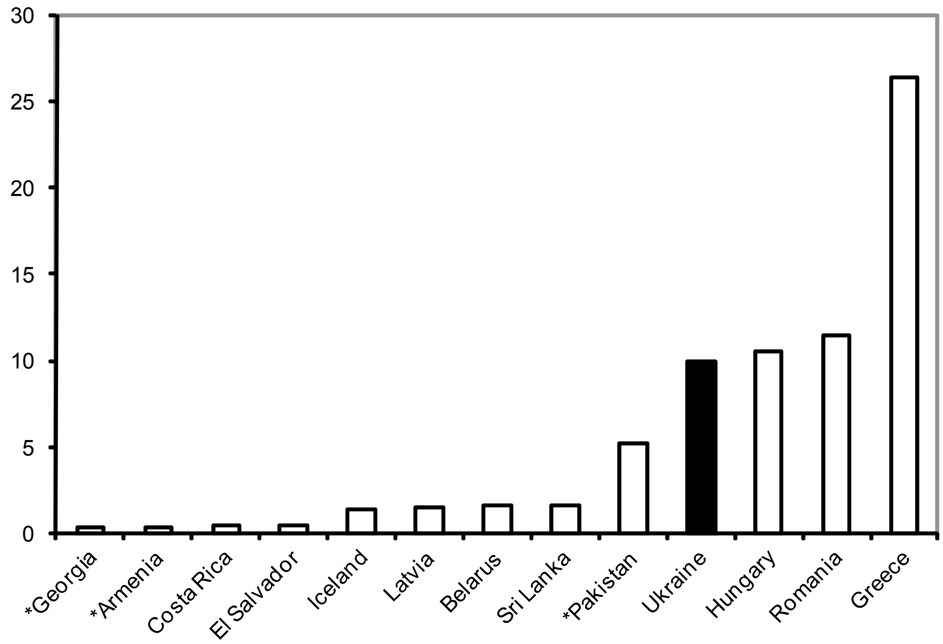
1/ May-July 2010 FTP. The FCC is defined as the Fund's stock of usable resources less undrawn balances under existing arragements, plus projected repurchases during the coming 12 months, less repayments of borrowing due one year forward, less a prudential balance.
2/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
3/ As of July 7, 2010, not including unpurchased balances from previous program or expected Ukraine purchases.
4/ These amounts exclude gold profits in Special Reserves attributable to limited sales.
5/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

- **If the first purchase was made, Ukraine would become one of the two largest debtors to the Fund (Figure 4, Panel B).** After the first disbursement, Ukraine would become one of the largest two debtors to the Fund (along with Romania) at SDR 8,250 million or 17.2 percent of total GRA credit outstanding, given the already existing credit outstanding of SDR 7 billion. In terms of size, the proposed program would be the fourth largest of the current arrangements after Greece, Romania and Hungary (Figure 4, Panel A). The share of the top five borrowers of total outstanding credit would remain virtually unchanged at just over 70 percent (Table 5).

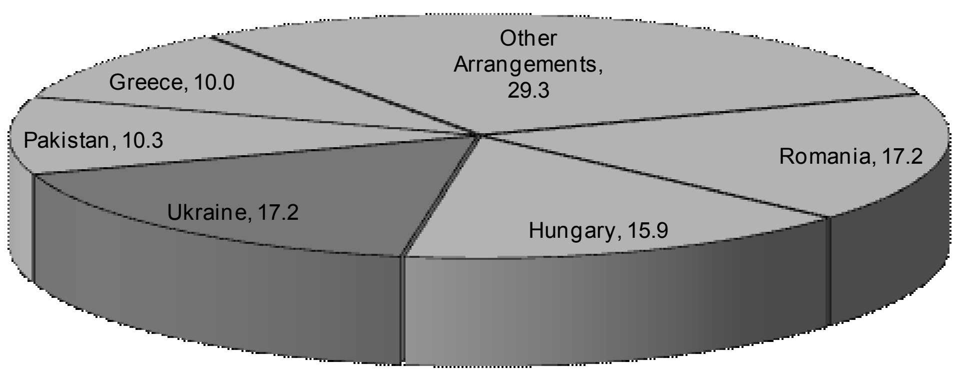
[12] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months.

## Figure 4. Exceptional Access Levels and Credit Concentration

A. Total Access of Recent Exceptional Access Arrangements 1/
(In billions of SDRs)




B. Credit Concentration of Fund GRA Exposure 2/
(As a percentage of total credit outstanding)




Source: Finance Department.

1/ Does not include FCL arrangements. Asterisks indicate PRGF eligible countries.
2/ Credit outstanding as of July 2, 2010 plus expected first purchase under the proposed arrangement with Ukraine.

- **Potential GRA exposure to Ukraine would exceed the Fund's current level of precautionary balances (Table 5).**[13] The GRA commitment to Ukraine represents 21 percent of total GRA credit outstanding and 137 percent of the Fund's current level of precautionary balances. Given the already high level of credit outstanding to Ukraine, Fund exposure to Ukraine (assuming that all purchases will be made as scheduled) will exceed the current level of precautionary balances through 2014 and will peak at over 200 percent of the current level of precautionary balances in 2012.

- **Were Ukraine to accrue arrears on charges under the proposed arrangement, the Fund's burden sharing capacity would be severely strained (Table 5).**[14] In 2010, GRA charges on Ukraine's arrangement would be more than double the residual burden sharing capacity of the Fund. Charges would peak at about 781 percent of the Fund's current residual burden sharing capacity in 2011 if purchases were made as scheduled.

## III. Assessment

9. **The proposed program aims at a sustained economic recovery and includes deep structural reforms.** The restoration of confidence and fiscal sustainability requires a strong fiscal adjustment—bolstered by significant structural reforms related to the pension system and the energy sector. The 29-month SBA is to play a key role in filling Ukraine's financing needs and in catalyzing official financing from other sources. Moreover, it is envisaged that Ukraine will be able to rebuild its international reserves and regain access to private capital markets during the program.

10. **There are considerable financial risks associated with the proposed arrangement for Ukraine.** Access under the program is large and will make Ukraine one of the two largest debtors to the Fund. Moreover, GRA credit outstanding to Ukraine is already at a historical peak in the absence of a new arrangement. Credit outstanding to Ukraine will far exceed the Fund's precautionary balances for several years to come and any default would severely strain the Fund's burden-sharing mechanism. Potential risks to the program are large and include:

[13] As discussed in the *Review of the Fund's Income Position for FY 2010 and FY 2011*, precautionary balances exclude amounts in Special Reserves attributable to profits on gold sales.

[14] Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to compensate the Fund for a loss in income when debtors do not pay charges. Under current Board decisions, no burden sharing adjustments can be made that would result in a rate of remuneration below 85 percent of the SDR interest rate. While this limit could be changed, under the Articles the rate of remuneration cannot be below 80 percent of the SDR interest rate (Article V, Section 9(a)). No corresponding ceiling applies to the rate of charge.

- **Worsened external conditions:** The uneven recovery in Europe and still volatile financial markets could adversely affect Ukraine, inter alia through a shortfall in foreign financing and more broadly, prospects for normalizing access to international capital markets—the latter being critical for the success of the program.

- **Domestic policy risks:** Ukraine's economy is fragile and so far the recovery is narrowly based. Specific risks include rising non-performing loans in the banking sector, structural fiscal rigidities, and Naftogaz's financial viability. Consistent implementation of the adjustment program is critical to generating the growth needed to sustain Ukraine's debt-servicing capacity. Failure to successfully deal with these issues could quickly lead to a loss in confidence and derailment of a program.

- **Inability of the budget to service obligations to the Fund:** A significant portion of the obligations to the Fund will be serviced by the central government. The central government's ability to purchase foreign exchange needed for this purpose from the NBU hinges on strong fiscal adjustment—adding an additional dimension to the repayment risk.[15]

- **Weakened political commitment to reform:** Political pressures to weaken program implementation could emerge, especially with local elections on the horizon and parliamentary elections in the fall of 2012. This would pose serious risks for the fundamental reforms and consistent implementation required for a successful program. In this light, the decisive implementation of prior actions is an encouraging sign, despite the very uneven record under previous arrangements.

11. **These risks may adversely affect Ukraine's capacity to repay the Fund.** The proposed access is significant in terms of both Fund resources and the debt service burden on Ukraine. The authorities' commitment to consistent implementation of the program, prompt response to changes in underlying conditions, and continued strong political commitment will be key to mitigating these risks and safeguarding Fund resources.

[15] From the legal point of view, it is always the member, i.e., the government that has the obligation to repay the Fund.

INTERNATIONAL MONETARY FUND

UKRAINE

**Request for Stand-By Arrangement and Cancellation of Current Arrangement—Informational Annex**

Prepared by the European Department
(In consultation with other departments, the World Bank, and the European Bank for Reconstruction and Development)

July 23, 2010

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II. Relations with World Bank ....................5
III. Relations with the EBRD ....................7

## APPENDIX I: UKRAINE—FUND RELATIONS

(As of June 30, 2010)

**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 | 8,372.00 | 610.20 |
| Reserve position in Fund | 0.02 | 0.00 |

| **III. SDR Department:** | **SDR Million** | **%Allocation** |
|---|---|---|
| Net cumulative allocation | 1,309.44 | 100.00 |
| Holdings | 7.22 | 0.55 |

| **IV. Outstanding Purchases and Loans:** | **SDR Million** | **%Quota** |
|---|---|---|
| Stand-By Arrangements | 7,000.00 | 510.20 |

**V. Latest Financial Arrangements:**

| Type | Approval Date | Expiration Date | Amount Approved (SDR million) | Amount Drawn (SDR Million) |
|---|---|---|---|---|
| Stand-By | 11/05/08 | 11/04/10 | 11,000.00 | 7,000.00 |
| 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 |

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

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Principal | | | 2,234.38 | 3,500.00 | 1,265.63 |
| Charges/Interest | 75.36 | 150.11 | 134.50 | 53.35 | 11.10 |
| Total | 75.36 | 150.11 | 2,368.88 | 3,553.35 | 1,276.73 |

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

## VII. 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 intervened regularly to limit fluctuations to a small band, first around Hrv 5.33 per U.S. dollar, and from March 2005, around Hrv 5.05 per U.S. dollar. It was classified as a de facto peg. Reflecting greater flexibility in the exchange rate since April 2008, the exchange rate arrangement has been reclassified as a managed float with no predetermined path for the exchange rate. As of December 29, 2008, the NBU fixed the official exchange rate of the hryvnia against the dollar at HRV 7.7 per U.S. dollar and resorted to interventions with the aim of keeping the market exchange rate close to the official rate. Effective February 2, 2009, the classification of the de facto exchange rate arrangement has been changed from managed floating with no predetermined path for the exchange rate to other managed arrangement, retroactively to April 30, 2008, due to the revision of the classification methodology. This classification was reaffirmed in April 2010.

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 restrictions on current international transactions were introduced in September 1998, and were removed in March 1999. In October 2008, a number of new exchange controls were introduced, many of which were removed by May 2010.

## VIII. 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) was considered by the Executive Board as part of the 2008 Article IV consultation.

## IX. 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).

## X. SAFEGUARD ASSESSMENT

The most recent safeguards assessment of the NBU was completed on April 16, 2009 under the Stand-By Arrangement (SBA) approved on November 5, 2008. That assessment concluded that the NBU continues to publish externally audited financial statements and has strengthened aspects of its safeguards framework since the 2004 assessment, in particular the internal audit function. The ongoing economic crisis has significantly increased the NBU's financial and operational risks, however, and independence has been impaired by ad hoc legislation. Weaknesses in the governance structure, lack of independent audit oversight, and non-transparent decision-making add further safeguards risks. To address the reputational concerns caused by the non-transparent decision-making, an external review of the NBU's liquidity support and foreign exchange operations during the fourth quarter of 2008 was recommended and subsequently conducted by Ernst & Young Kiev. Enactment of legal revisions was proposed to strengthen independence and the governance structure, provide for independent audit oversight, and ensure consistency in the financial reporting. To safeguard data integrity and compliance with program definitions, the Internal Audit Department was tasked with reviewing monetary data for the program test dates and report its findings to the Fund.

In accordance with safeguards policy requirements, a new assessment will be completed by the first review of the successor SBA.

## APPENDIX II: UKRAINE—RELATIONS WITH THE WORLD BANK

(July 2010)

**Country Partnership Strategy**

The World Bank Country Partnership Strategy (CPS) for Ukraine was endorsed by the Bank's Board of Directors on December 6, 2007. It covers fiscal years 2008–11 and has the objectives of: improving competitiveness, reforming public finances and the public sector, and improving service delivery. In the context of the economic downturn of 2009, the CPS progress review focused its policy priorities to support fiscal (particularly structural measures and reforms), business climate (particularly business entry), and banking sector reforms for the reminder of the CPS. At the same time, and given the large needs for public investments to support private sector growth, the CPS continued its support to large public infrastructure projects, particularly in the transport and energy sectors.

Taking into account Ukraine's substantial financing needs the current CPS envisions a lending range of US$2 to US$6 billion over the four-year CPS period to be applied within a flexible operational framework based on the principles of selectivity, flexibility and partnerships. Up to 50 percent of this envelope is planned through direct budget support (policy lending) operations.

**World Bank Program**

The Bank concluded a series of **Development Policy Loans** in late 2008, and will initiate a new series focusing on fiscal and investment climate structural reforms. The first operation of the new series is tentatively sized at US$500 million. In parallel, the Bank will continue with the **PFRL** policy lending series on banking sector reform. A first operation was disbursed in 2009 (for US$400 million) and a second one is being prepared (initially sized at US$350 million). Both policy lending operations are subject to agreement with the authorities on key structural reforms to be supported.

The Bank continues to be active on project financing. Among the projects in the **public sector** are a Public Finance Modernization Project (US$50 million), a State Tax Service Modernization Project (US$40 million), and a Statistical System Modernization Project (US$32 million). In the area of **rural development**, the World Bank supports the establishment of a secure registration system to enable land transactions to be efficiently processed and protected under the Rural Land Titling and Cadastre Development Project (US$101.5 million).

The Bank's support for the **energy** sector has been significant and has increased with a sequence of sector investment loans. The Hydropower Rehabilitation Project and additional financing (US$166.0 million) were approved in June 2005 and November 2009, respectively, and the Power Transmission Project (US$200 million) was approved in August 2007. The Bank is also preparing a new Energy Efficiency Project (US$250 million). Further investment operations are envisaged in support of a long-term Energy Reform and Development Program based on the country's own action plan for stabilization in the energy sector.

In **infrastructure**, the Bank approved a Roads and Safety Improvement project in 2009 for US$400 million (currently under implementation). The Bank also has an Urban Infrastructure Project (US$140 million), designed to provide financing to local governments and utilities for priority investments in water and wastewater. Other projects in the pipeline include a Railways Modernization project (US$500 million).

**In the financial sector,** the Second Export Development Project (EDP2; US$54 million), building on the success of the first project, will continue to promote the export sector access to finance. Additional financing for the EDP2 (US$150 million) is being considered.

The Bank has devoted considerable resources to **social sector** assistance. The Bank has been supporting the modernization of administering social benefits through a Social Assistance System Modernization project (US$99 million) since November 2005. An Equal Access to Quality Education project (US$45.3 million) aims to improve the efficiency and quality of the education system and to better prepare students to compete in a knowledge economy.

The Bank has also provided direct sub-national assistance to the authorities and other stakeholders in Zaporizhiya oblast to collaboratively take action to reduce health impacts of air pollution caused by the largest industrial polluters in Zaporizhiya. The Bank also continues to assist the country to take advantage of benefits from transactions under International Emissions Trading and Joint Implementation resulting from the Kyoto Protocol.

The Bank carries out an extensive on-going program of **economic and sector work** in a broad range of areas, including growth, trade, expenditure policy (with particular emphasis on efficiency and budget reallocation issues), tax policy, intergovernmental fiscal relations, agriculture policy, energy policy, and social sector expenditure and policy.

**Bank-Fund Collaboration**

Fund and Bank staff collaborate closely in a number of key areas, and are in broad agreement on the division of labor relating to macro-critical sectoral issues. This collaboration is oriented around supporting the Government’s reform program and coordinating Fund-Bank policy advice to the Ukrainian authorities. Bank analysis is shared with the Fund and is used as inputs to the fiscal framework—this includes structural reform measures that have important fiscal implications, such as pension reform, energy sector reform, and better targeting of social assistance programs. Collaboration is particularly close in the following areas:

- Fiscal: (i) revenue administration; (ii) tax policy; and (iii) public financial management.
- Energy: gas and utility sector reforms.
- Financial sector: (i) bank recapitalization program; (ii) reforms to consolidated supervision; (iii) reforms to ultimate controllers framework; (iv) reforms to strengthen the bank resolution framework; and (v) measures to facilitate consolidation of the banking system.

World Bank Contact: Martin Raiser, Country Director (Tel.: 380-44-490-6671).

## APPENDIX III: UKRAINE—RELATIONS WITH THE EBRD
(July 2010)

Ukraine joined the EBRD in 1992, and since then the EBRD has been active in supporting Ukraine's transformation toward a market economy. The Bank's current country strategy for Ukraine, 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. A new strategy for Ukraine is expected to be considered by the EBRD Board in early 2011.

As of end-May 2010, EBRD's portfolio in Ukraine reached €3.1 billion, most of it in the private sector. The Bank's exposure in Ukraine is the second largest after Russia, accounting for 1/8$^{th}$ of the Bank's overall portfolio. Financial sector and industry are two largest sectors of operations in Ukraine, accounting for 4/5$^{th}$ of the total operating assets. Operations in the infrastructure and energy sectors are also significant.

The EBRD's main contribution in Ukraine has been through funding of projects with significant transition impact potential in the private and public 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.

In 2008-9, the EBRD responded to the financial crisis in Ukraine. A country specific crisis response program for Ukraine was developed in November 2008 in coordination with various stakeholders, including the authorities, other IFIs and international donors. Despite the increased country risk, in 2009 the EBRD invested €1.1 billion in Ukraine, a record level for the country. Almost two-thirds of the total was invested in the banking sector helping to support its stability and confidence. The Bank provided senior and subordinated debt to subsidiaries of the major European banking groups (including Raiffeisen, Unicredit, BNP Paribas, OTP, and Commerzbank) with the view to supporting their stability and continued commitment to Ukraine. The state-owned Ukreximbank benefited from subordinated and syndicated loans. Several medium-sized local client banks were also supported during the crisis. Megabank, for example, received an equity injection and a subordinated loan.

During the crisis, the EBRD also undertook a complete reassessment of business needs in the corporate sector, which suffered from a terms-of-trade shock and financial sector de-leveraging, resulting in investments of over €250 million in 2009. A further €220 million was invested in the infrastructure and energy sectors. All in all, in 2009, the EBRD invested over €600 million in form of equity and subordinated capital, assisting in restructuring and strengthening of balance sheets of banks and enterprises.

Over the years, the Bank has been active in **developing of the local private sector and encouraging FDI**. The Bank supported a number of medium and large local clients, including Obolon, Astarta and Centravis. Small and medium enterprises have been reached via credit lines offered to them via the partner banks. The Bank has actively participated in financing of several leading international investors (including Lafarge, Bosch and Louis Dreyfus) as well as cross-border transactions with sponsors from other countries of operation. In May 2010, the Bank rolled out in Ukraine its hallmark Business Advisory Services (BAS) Programme, which is expected to help private enterprises to adapt to the demands of a market economy and undertake restructuring after the crisis.

The Bank has worked to promote the **development of domestic capital markets**, including by helping to successfully establish KievPrime, a credible local currency inter-bank index. It is engaged in policy dialogue with the authorities and other IFIs on market-friendly policies for encouraging longer-term lending in hryvnia after the crisis.

The Bank continues to pursue its strategic goal of supporting **environmental protection and energy efficiency and security**. The EBRD supported local private business in the oil and gas sector by financing, and more recently taking an equity position, in downstream operator Galnaftogas. A number of banks have benefited from the energy efficiency credit lines and related capacity building support. In the power and energy sectors, the Bank has helped support the implementation of the March 2009 EU-Ukraine memorandum of understanding, which is the cornerstone of EU-Ukraine cooperation in the field of energy. In particular, the Bank is expected to assist with the modernization and rehabilitation of the main trans-European energy networks of Ukraine. It also plans to invest in modern and energy efficient generation, transportation and distribution of energy. The Bank will also support the diversification of the supply sources and promote alternative fuels. These aims will be complemented by support to reforms in the energy sector to advance its liberalization and promote private sector involvement. Together with other IFIs, the EBRD continues to explore mechanisms for supporting the authorities as they pursue the modernization of Ukraine's gas transit system. In the area of nuclear safety, the Bank is working to improve the safety standards at the existing nuclear power plants (NPPs), the safe decommissioning of Chernobyl NPP and the creation of a safe confinement for its Unit 4.

In the **infrastructure** area, important recent projects include municipal transport projects in the capital (including Kiev Metropolitain and Kiev municipal bus company) and regional centers, the development of the Odessa sea port, the modernization of the pan-European road network and the first investment in the media and telecommunications sector in favor of Volia cable operator.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 10/305
FOR IMMEDIATE RELEASE
July 28, 2010

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Executive Board Approves US$15.15 Billion Stand-By Arrangement for Ukraine**

The Executive Board of the International Monetary Fund (IMF) today approved a 29-month SDR 10 billion (about US$ 15.15 billion) Stand-By Arrangement (SBA) for Ukraine in support of the authorities' economic adjustment and reform program.[1] An initial disbursement equivalent to SDR 1.25 billion (US$ 1.89 billion) is available immediately, with subsequent disbursements subject to quarterly reviews. The SBA entails exceptional access to IMF resources, amounting to 728.9 percent of Ukraine's quota in the Fund.

Following the Executive Board's discussion of Ukraine, Mr. Lipksy, First Deputy Managing Director and Acting Chair, made the following statement:

"Ukraine is emerging from a difficult period during which the economy was severely hit by external shocks and exacerbated by domestic vulnerabilities. The authorities are committed to addressing existing imbalances and putting the economy on a path of durable growth, through important fiscal, energy, and financial sector reforms.

"At the core of the authorities' economic program is a comprehensive consolidation strategy to safeguard fiscal sustainability. Fiscal adjustment will start in 2010 and deepen in 2011–12 backed by robust structural reforms of the pension system, public administration, and the tax system. The financial position of the gas sector will be strengthened, including through domestic price hikes and broader reforms supported by other multilateral institutions, which will help eliminate energy subsidies and create a more modern and viable sector, while protecting the most vulnerable with better targeted social assistance programs.

"Reforms are also underway to rehabilitate the financial system and enhance the National Bank of Ukraine's independence and accountability. The planned recapitalization of banks and steps to strengthen the supervisory and institutional framework are essential to restore

[1] The Board also noted cancellation of the SBA for Ukraine that was approved on November 5, 2008 (see Press Release No 08/271).

financial stability, tackle the mounting problem of impaired assets, and eliminate impediments for robust economic recovery.

“Sustained implementation of these reforms will help Ukraine entrench macroeconomic stability, boost confidence, facilitate access to capital markets, and emerge with more balanced and robust growth.

“The Executive Board also reviewed a report from the Managing Director on the provision of data on net international reserves, which led to two noncomplying purchases in 2009 and a breach of obligation under Article VIII, Section 5 of the IMF’s Articles of Agreement. Given the minor economic effect of the deviation and that action has already been taken to change the NIR definition under the new Stand-By Arrangement, the Board agreed to grant waivers of nonobservance of the performance criterion and that no further remedial action is required”.

**ANNEX**

**Recent Economic Developments**

The global economic financial crisis hit Ukraine hard in late 2008 and 2009. As a major steel exporter and borrower in international markets, Ukraine’s economy was severely hit by the decline in demand for steel products and reduced access to capital markets—the impact of which was magnified by pre-existing economic and financial vulnerabilities. Confidence in the currency and the banks waned, causing a system-wide run on deposits; real GDP collapsed, along with domestic demand; and falling fiscal revenues strained public finances.

Notwithstanding the toll of the crisis on Ukraine’s economy, the 2008 program managed to restore macroeconomic and financial stability. The sharp adjustment was to an extent unavoidable given the large pre-existing imbalances. However, measures to restore banking system confidence helped stabilize deposits and exchange rate pressures eased over time. By mid-2009, an incipient recovery was under way.

Against a difficult economic environment and a complex political situation, the program eventually went off track as policies weakened and reforms stalled in the run up to the Presidential elections.

**Program Summary**

Key objectives of the authorities’ program are to consolidate public finances, restore banking system soundness, and develop a more robust monetary policy framework. To help achieve this, the government will implement reforms and institutional changes, including tax and expenditure policies, pension and energy sector reforms, and measures to strengthen central bank independence and rehabilitate the banking system. Strict adherence to these policies will help deepen market access, facilitating exit from Fund financial support.

The economic reform program aims to support the authorities' agenda in four key areas:

- Restore confidence and fiscal sustainability by reducing the general government deficit to 3.5 percent of GDP in 2011 and 2.5 percent in 2012 and setting public debt firmly on a downward path below 35 percent by 2015;

- Initiate reforms to modernize the gas sector and eliminate Naftogaz's deficit starting from 2011, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. A new gas law adopted in early July will improve efficiency through unbundling production, transit, and distribution to end-users, and allowing new entrants and investment into the domestic gas sector;

- Restore and safeguard banks' soundness through completion of recapitalization plans by end-2010 and strengthened supervision, and;

- Develop a more robust monetary policy framework focused on domestic price stability under a flexible exchange rate regime to be implemented by a more independent National Bank of Ukraine.

Ukraine joined the IMF as a member on September 3, 1992. Its quota is SDR 1,372 million (about US$2,078.4 million).