July 2002
IMF Country Report No. 02/146

Ukraine: 2002 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ukraine

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 22, 2002,** 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 March 29, 2002.** 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 **April 18, 2002,** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 24, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Ukraine.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

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

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Washington, D.C.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation

Approved by Gérard Bélanger and Michael T. Hadjimichael

March 29, 2002

Discussions for the 2002 Article IV consultation were held in Kyiv during October 31–November 14, 2001 and January 30–February 8, 2002, and concluded in Washington during February 19–22, 2002.

The staff team met with President Kuchma, Prime Minister Kinakh, First Vice Prime Minister Dubina, Vice Prime Minister Rohovoy, Chairman of the Board of the National Bank of Ukraine (NBU) Stelmakh, Ministers of Finance Mitiukov and Yushko, Minister of the Economy Shlapak, as well as representatives of parliament, the business sector, and trade unions.

The staff participating in the discussions were J. Berengaut (head), E. van der Mensbrugghe (head), E. De Vrijer, K. Elborgh-Woytek, M. Lewis, P. Lõhmus, and T. Lookadoo (Admin. Assistant), all EU2, as well as V. Moissinac (FAD) and C. Mulder (PDR). L. Figliuoli, B. Lissovolik, I. Shpak, and M. Kryshko of the Resident Representative's office in Ukraine assisted in the discussions. J. Odling-Smee (Director, EU2) participated in the discussions during November 2–3, 2001 and February 19, 2002. Y. Yakusha, the Alternate Executive Director for Ukraine, also attended some of the meetings. The staff team cooperated closely with the World Bank.

The extended arrangement under the Extended Fund Facility (EFF) for Ukraine was approved on September 4, 1998, in an amount equivalent to SDR 1,919.95 million (139.9 percent of quota). In 2000, the arrangement was extended by one year, and the fifth and sixth reviews under the arrangement were completed on September 20, 2001. The nine purchases made thus far amount to SDR 1,193.0 million. At end-January 2002, Ukraine's total outstanding debt to the Fund was SDR 1,520.74 million, equivalent to 110.8 percent of quota. The discussions on the seventh and eight reviews under the extended arrangement, based on performance through end-December 2001 and including policy understandings for 2002, have not yet been concluded.

Ukraine has accepted the obligations of Article VIII, sections 2, 3, and 4 of the Fund's Articles of Agreement, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Relations with the Fund, the World Bank, and the EBRD are summarized in Appendices II–IV.

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EXECUTIVE SUMMARY

- **Economic developments in 2001 turned out better than foreseen.** Real GDP growth increased to 9 percent while annual inflation declined sharply to about 6 percent. The external current account surplus is estimated to have narrowed in 2001. The exchange rate remained stable and gross international reserves increased to a level equivalent to almost eight weeks of imports.

- **Program implementation in 2001 was broadly satisfactory, but there were some slippages in revenue collection and delays in implementing structural reforms.**

- **The economic outlook for 2002 is for a continuation of the economic recovery but at a more moderate pace than in 2000–01.** The main risks relate to the strength of external demand; uncertainties about implementation of measures to close the fiscal gap; instability of the demand for money, possibly leading to inflationary pressures; and political uncertainties in the context of the parliamentary elections planned for March 2002.

- **Fiscal policy in 2001 was broadly on track**, although profit tax and VAT performance deteriorated in the second half of the year. The accumulation of payments arrears on VAT refunds helped meet the program fiscal targets. **The budget for 2002 aims at maintaining a tight fiscal policy stance.** However, in view of expected shortfalls in revenue and privatization proceeds, as well as the emergence of unfunded social expenditure mandates, additional measures are needed. Furthermore, the government is urged to repay all overdue VAT refunds.

- **Monetary aggregates continued to expand rapidly in 2001**, accommodating a further increase in money demand. For 2002, the NBU needs to keep inflation under a close watch and stand ready to tighten money market conditions and manage the exchange rate flexibly to safeguard the inflation target.

- **Some progress was made in the structural area in 2001.** For 2002, it is important to step up structural reforms, in particular by eliminating tax privileges and exemptions; removing the roadblocks hampering privatization; further increasing payments discipline in the energy sector; addressing forcefully the vulnerabilities in the financial system; improving the business environment; and strengthening transparency and governance.

I. Introduction

1. **In concluding the last Article IV consultation on December 19, 2000, Executive Directors welcomed the achievement of positive economic growth in 2000 and the progress made in several policy areas**, notably the reduction of the budget deficit, the implementation of structural improvements in the fiscal area, the increase of cash collection ratios in the energy sector, and the adoption of a privatization law. However, Directors expressed concern that inflation had been higher than projected and regretted that no large enterprise had yet been privatized in a transparent manner. Directors urged the authorities to implement vigorously the 2001 government budget and to ensure that expenditure policies are flexible enough to accommodate possible shortfalls in budgeted privatization proceeds. Directors emphasized the need to keep monetary aggregates under control with a view to slowing inflation and urged the authorities to accept greater exchange rate flexibility. Directors also noted that high priority should be accorded to promptly addressing weaknesses in the banking system, to implementing structural reforms in the energy sector, and to enhancing the transparency of the privatization process.

2. A new government headed by Prime Minister Kinakh was appointed in late May 2001. Parliamentary elections are scheduled for late-March 2002.

3. The quality of Ukraine's **economic and financial database** has further improved since the last Article IV consultation but substantial weaknesses remain, particularly in the areas of the national accounts, the balance of payments, and private sector external debt. However, these weaknesses do not prevent a meaningful assessment of economic policies, and core data are provided to the Fund on a timely basis.[1] The authorities expect to subscribe to the Special Data Dissemination Standard (SDDS) by July 2002, and a mission to prepare the data module of the Report on Standards and Codes (ROSC) is scheduled for April 2002. The Fund continues to provide technical assistance in statistics, as well as in public finance, central bank accounting and internal auditing, and banking supervision. Statistical issues are discussed further in Appendix I, and the Fund's recent technical assistance to Ukraine is summarized in Appendix II.

II. Recent Developments

4. **Economic developments in 2001 turned out better than foreseen.** Real GDP growth is estimated to have increased from almost 6 percent in 2000 to about 9 percent in 2001. The increase was mainly the result of double-digit growth of industrial output and a good grain harvest, the latter resulting from favorable weather and the lessening of government involvement

[1] As noted in EBS/00/177 (8/23/00) and EBS/00/252 (12/5/00), a fiscal data issue arose regarding the reporting of disbursements on government-guaranteed credit to nongovernmental units over the 1997–99 period. It now appears that, partly owing to the ambiguity of the TMU in effect at the time, the full coverage of disbursements was effectively unmonitorable, and that despite the fullest cooperation of the authorities, much of the data needed to resolve the issue conclusively is unavailable. Accordingly, no case of misreporting has arisen. To resolve the problems of monitoring guarantees, the granting of guarantees has been centralized and strictly limited to loans from specific international agencies.

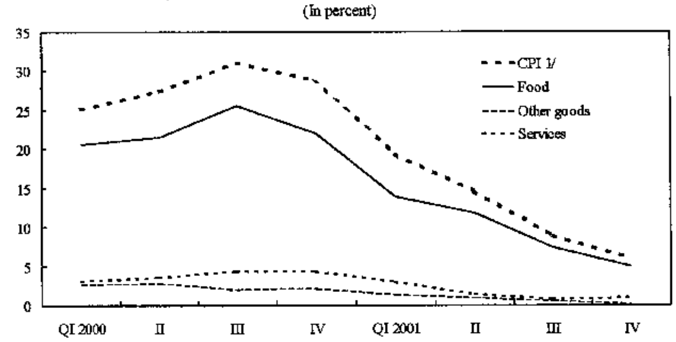
in agriculture (Tables 1 and 3). The continued economic recovery in 2001 was made possible by: (i) considerable idle capacity; (ii) improved competitiveness of the Ukrainian economy in the wake of the real exchange rate depreciation in 1998–99, and, through the first half of the year, further expansion of Ukraine's main export markets, in particular Russia; and (iii) the strengthening of domestic demand as a result of wage and pension increases granted in 2000–01; and (iv) the clearance of wage and pension arrears. Annual inflation, as measured by the consumer price index (CPI), declined sharply during the year to a rate of about 6 percent, well below the target of 12⅓ percent (Figure 1). This reflected the impact of the good harvest on food prices, some delays in increasing administered prices—including for electricity—as well as the stable exchange rate.

Table 1. Ukraine: Key Economic Indicators, 2001-02

	2001		2002
	Rev. Prog.	Prel.	Proj.
	(Percent change)		
Real GDP	6.2	9.1	5.0
Consumer prices, eop	12.3	6.1	9.8
Broad money	23.7	42.0	25.0
	(In percent of GDP)		
Consolidated government budget balance, cash basis	-1.7	-1.6	-1.8
Current account balance	2.7	3.5	1.5

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

Figure 1. Ukraine: Contributions to CPI Changes, 2000-01
(In percent)



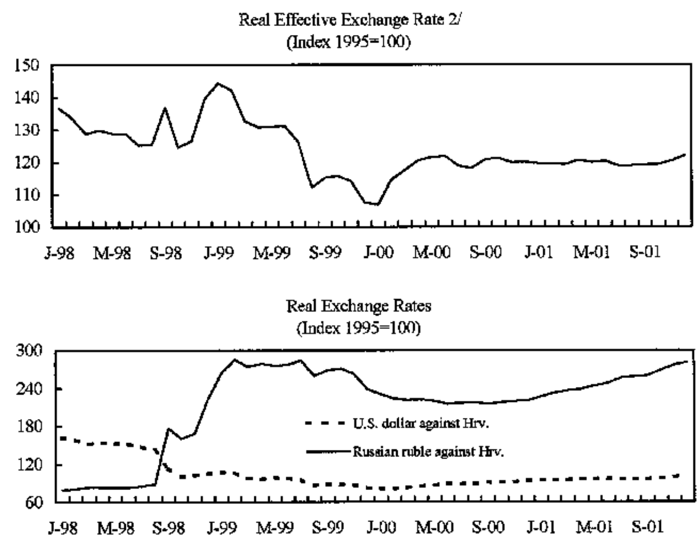
Sources: Ukrainian authorities; and Fund staff estimates.

1/ End-of-period annual change.

5. **The external current account surplus is estimated to have narrowed from 4¾ percent of GDP in 2000 to 3½ percent in 2001**. This owed mainly to strong import growth of almost 13 percent in volume terms, which was driven by the expansion of domestic demand. Export growth remained vigorous but slowed over the course of the year. As a result of the debt-rescheduling agreement with Paris Club creditors concluded in July 2001, the debt-service burden has been eased. Ukraine has also started to benefit from transfers, including in the form of World War II compensation payments, and from increasing inflows of foreign direct investment, although these remain low by comparison with Central European countries.

6. **The exchange rate remained stable in 2001, standing at about Hrv 5.3 per U.S. dollar at end-December**. The real effective exchange rate has remained broadly stable since mid-2000, after an appreciation of some 13½ percent over the first half of 2000, which partly reversed the real depreciation of 23 percent during 1999 (Figure 2).

Figure 2. Ukraine: Real Exchange Rate Developments, January 1998 - December 2001 1/

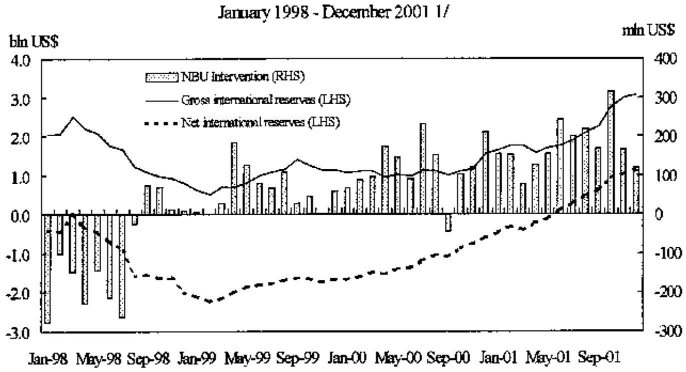


Sources: Ukrainian authorities; and Fund staff estimates.

1/ A decrease indicates depreciation.
2/ INS calculation based on relative consumer prices.

7. **With the NBU continuing its extensive purchases of foreign exchange on the interbank market, Ukraine's official gross international reserves climbed to $3.1 billion at end-December 2001**, equivalent to almost 8 weeks of imports, and net international reserves turned positive, reaching $1.1 billion (Figure 3). Spreads for Ukrainian eurobonds are now at about 650 basis points, some 800 basis points below their levels in the first half of 2001 (Figure 4).

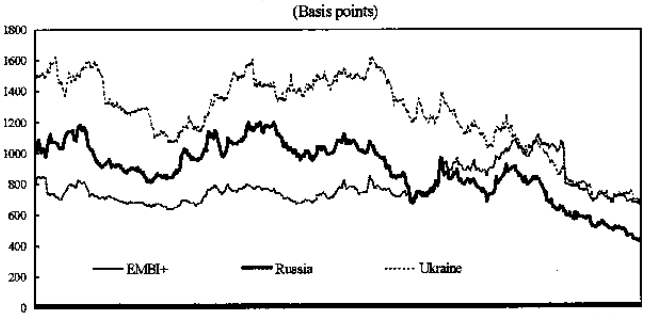
Figure 3. Ukraine: International Reserves and NBU Intervention
January 1998 - December 2001 1/



Sources: Ukrainian authorities; and Fund staff estimates.

1/ From December 1998 defined as gross usable reserves.

Figure 4. Ukraine: Spreads on Ukraine, Russian and Emerging Markets
Eurobond Index,
April 2000 - February 2002
(Basis points)



Sources: Bloomberg for Eurobonds; J.P.Morgan for EMBI+.

8. **Program implementation in 2001 was broadly satisfactory but there were some slippages in revenue collection and delays in implementing structural reforms** (Tables 4 and 5).[2] All performance criteria under the program for end-September and end-December 2001 were met, except for the end-December criterion on non-earmarked state cash revenue. Base money significantly exceeded its indicative targets, reflecting the impact of the largely unsterilized foreign exchange purchases by the NBU. The quantitative structural benchmarks concerning cash collections in the electricity and gas sectors were met.[3] However, the completion of the second stage audit of the national gas company (Naftogaz) was delayed to end-December and the single account of the State Treasury of Ukraine was only partially implemented.

9. **Budget execution in 2001 was broadly on track, but the accumulation of arrears on VAT refunds—estimated at about ½ percent of GDP—helped meet the program fiscal targets**. The consolidated cash deficit was kept at 1.6 percent of GDP, below the limit of 3 percent of GDP set in the 2001 budget law, because of lower-than-expected privatization proceeds (Table 6). While local taxes and payroll tax collections were boosted by the increase in real incomes and the repayment of wage arrears, enterprise profit tax and VAT performance deteriorated in the second half of the year. Tax collection was undermined by the tax amnesty granted in early 2001, tax loopholes created by the ad hoc extension of privileges to industries, and the rapid accumulation of new tax arrears, notably of the energy sector (Box 1). During 1998–2001, tax revenue (excluding payroll contributions) declined continuously from 24 percent

Box 1. Tax Amnesty

Ukraine's Law on Payments to the Budget, enacted on April 1, 2001, modernized the existing system of tax collection enforcement; however, it also provided for a broad tax amnesty.[1] Both tax arrears and fines and penalties accrued prior to January 1, 2000, were written off, while unmet tax obligations accrued throughout 2000 were eligible for restructuring (the repayment period is up to 60 months with no interest). All legal entities and self-employed entrepreneurs were eligible for the tax amnesty, and all tax and non-tax arrears were subject either to writing-off or restructuring. The total amount of gross claims subject to the amnesty is estimated at Hrv 20 billion (about 10 percent of GDP).

Over the course of the year, a number of troubling aspects of the amnesty became apparent. An example concerns VAT arrears: while taxpayers' gross debts were forgiven, the budget liabilities, in the form of unpaid VAT refunds, remained valid, including to the beneficiaries of the tax amnesty. Another troubling aspect of the amnesty is the implicit encouragement of nonpayments. As of December 31, 2001, new tax arrears accumulated since the launch of the tax amnesty reached Hrv 6.3 billion, or 12 percent of the consolidated budget revenues collected by that date. For the state budget alone, these figures are Hrv 5.6 billion and 18 percent, respectively.

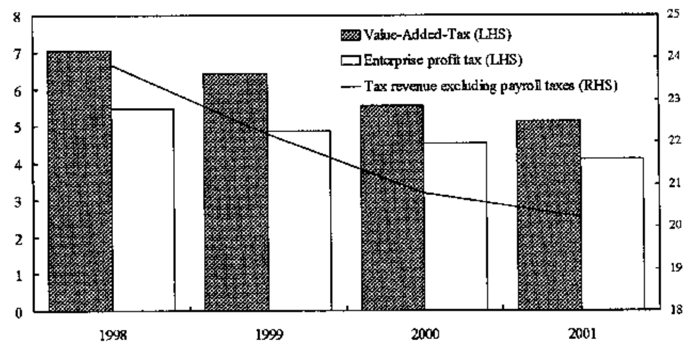
1/ The amnesty was opposed by the Cabinet of Ministers; a subsequent effort by the President to scale down the extent of the amnesty was voted down by parliament.

[2] For a broader assessment of the stance of structural policies, see Chapter III.C and Box 3.

[3] The Ministry of Fuel and Energy provides data on cash collection ratios for electricity, which are verified by the monthly reconciliations of the central transit account and regional settlement accounts. All gas sector data are provided by Naftogaz, and are not independently verifiable, although the key variables are published.

of GDP to 20 percent, without major changes in tax rates (Figure 5). The stock of arrears on VAT refunds reached Hrv 2.1 billion (1 percent of GDP) at year-end. Spending policies were kept under control until the last quarter of 2001. However, in the last quarter expenditure policies failed to adjust fully for the shortfall in privatization proceeds, resulting in some additional domestic financing. Most wage arrears accumulated by local governments in the second quarter of 2001 were cleared by year-end, and the reduction in social arrears exceeded the target. The stock of payments arrears on energy and other utilities remained at 1 percent of GDP.

Figure 5. Ukraine: Tax Revenue of the Consolidated Budget, 1998-2001
(In percent of GDP)

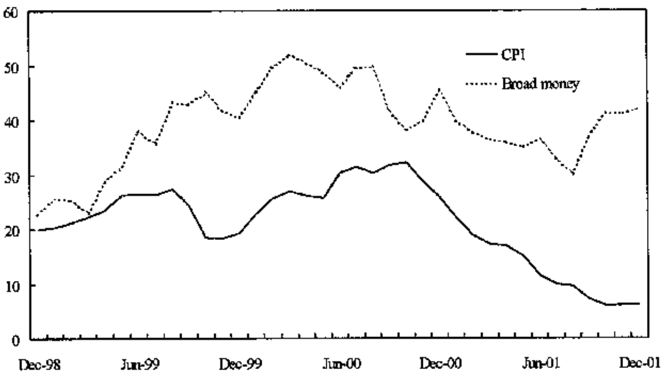


Sources: Ukrainian authorities; and Fund staff estimates.

10. **The authorities put in place several important budget and tax administration reforms**. The Budget Code was enacted in July 2001 (see also EBS/01/152; 9/4/2001). Tax collection methods were overhauled by replacing the Kartoteka II system with modern procedures to seize delinquent taxpayers' assets, and an inventory of all existing tax exemptions and privileges was completed. However, tax incentives continued to be actively used as an instrument of industrial policy. While tax privileges for joint-ventures with foreign investment were canceled in December 2001, tax breaks to the metallurgical and engineering sectors were renewed. In addition, the administration of the VAT came under pressure because of the shortfall in gross revenue and the accumulation of overdue VAT-refund requests.

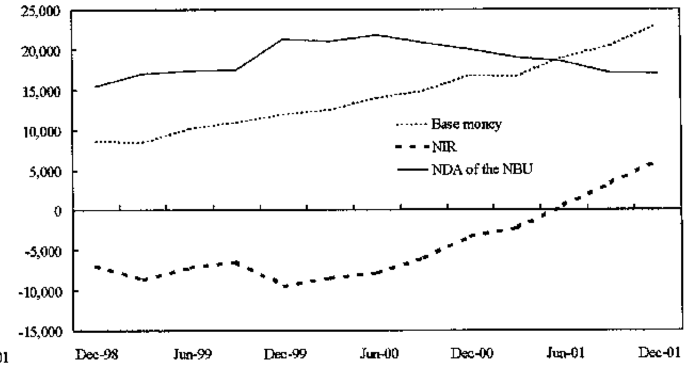
11. **Monetary aggregates continued to expand rapidly in 2001**. Base and broad money grew by 37 percent and 42 percent, respectively, while the share of foreign currency deposits in broad money continued to fall (Tables 7 and 8, and Figure 6). The strong money growth accommodated a further increase in money demand as evidenced by the balance of payments surplus, and in line with the economic growth, the continuing remonetization of the economy, and the return of confidence in the hryvnia. The rise in monetary aggregates in 2001 was fueled by largely unsterilized foreign exchange market intervention by the NBU (Figure 7); foreign exchange purchases through end-December totaled $2.1 billion. The intervention was only partly sterilized by the NBU and by a temporary accumulation of government deposits at the NBU. The liquidity inflows allowed the banks to further boost their lending to the private sector, with credit to the economy rising by 41 percent over the year.

Figure 6. Ukraine: Inflation and Broad Money Growth, 1998-2001
(12 month changes, in percent)



Sources: Ukrainian authorities.

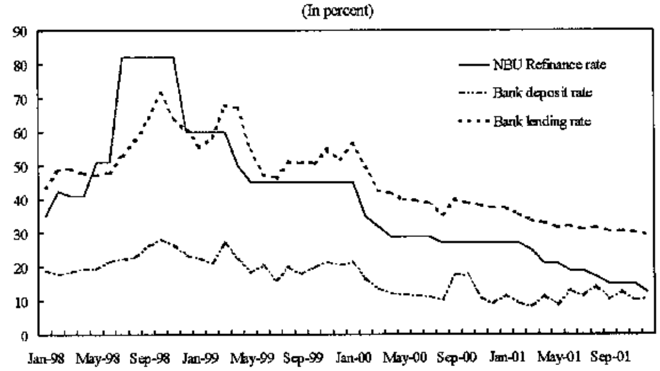
Figure 7. Ukraine: Components of Base Money, 1998-2001
(In millions of hryvnias)



Source: National Bank of Ukraine.

12. **Nominal interest rates fell during 2001 but, with the sharp decline in inflation, remained high in real terms**. The NBU steadily lowered the discount rate from 27 percent at end-2000 to 11½ percent as of March 11, 2002. The interbank market remains underdeveloped with interest rates fluctuating widely. While the weighted average interest rate for retail hryvnia loans dropped from about 37 percent at end-2000 to 30 percent at end-January 2002, interest rate spreads remained at 19 percentage points (Figure 8). In April 2001, the authorities introduced a system of differential reserve requirements ratios; the weighted average ratio was reduced from 14 percent to 12.4 percent as of December 10, 2001, and further to 11.6 percent as of March 1, 2002.

Figure 8. Ukraine: Interest Rates, January 1998 - December 2001
(In percent)



Sources: National Bank of Ukraine.

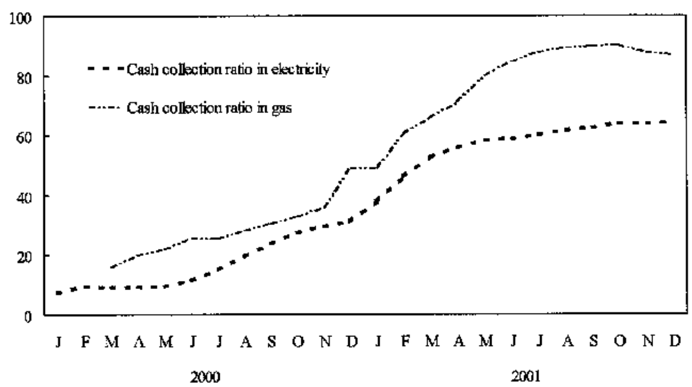
13. **The health of the banking sector improved—the banking sector as a whole reported profits for 2001, after recording losses in 2000—but weaknesses remain.** At end-December 2001, 19 out of 153 operating banks were not complying with one or more prudential regulations and the share of nonperforming loans in the total loan portfolio amounted to 13 percent (comprises loans classified as problem, past-due, and doubtful). The level of financial intermediation was still comparatively low, although the total banking sector loan portfolio increased rapidly for the second year in a row. The NBU made some progress in improving banking supervision by implementing new regulations in accordance with international standards based on the new Law on Banks and Banking Activity. The Law on the Household Deposit Guarantee Fund was enacted in September 2001, increasing the insured amount per depositor from Hrv 500 to Hrv 1,200.

14. **The situation of a few commercial banks is worrisome.** These banks do not comply with minimum capital requirements and are undergoing rehabilitation programs. The NBU has undertaken on-site inspections of such banks, some of which had been delayed since mid-2001. Household deposits and loans portfolios continue to grow rapidly in some of these banks, notably to the agricultural and energy sectors. There have been instances of political appointments to the Supervisory Councils of banks.

15. **The authorities' progress in implementing their privatization program has been limited**. Total privatization receipts amounted to Hrv 2.6 billion in 2001, considerably short of the target of Hrv 5.8 billion. Despite the successful sale of six electricity distribution companies (oblenergos), only 23 out of a total of 68 tenders for large companies were successful, with low bidders' interest, asset stripping, and some political interference constituting the main obstacles. An independent review of privatizations completed in the first nine months of 2001 indicates that compliance with transparency criteria was satisfactory. The list of companies excluded from privatization (negative list) was reduced and parliament adopted a law banning asset-stripping of state-owned enterprises.

16. **In the energy sector, payments discipline continued to improve as a result of adequate budget allocations for energy consumption and stricter implementation of cut-off policies** (Figure 9). Average cash collection ratios for the electricity and gas sectors in 2001 increased to 65 percent and 87 percent, respectively, and in the gas sector exceeded the program target. Electricity tariffs for the privatized oblenergos were increased in line with the agreed procedures.

Figure 9. Ukraine: Cash Collection Ratios in Electricity and Gas Sectors, 2000-01
(In percent of total sales)



Sources: Ukrainian authorities.

However, no progress was made in resolving the existing electricity sector debt, estimated to total $2 billion. The completion of the second-stage audit of Naftogaz, a benchmark under the program for September 2001, was largely achieved by year-end. However, the audit report contains a large number of qualifications that significantly impair a financial assessment and did not include combination procedures to obtain the consolidated view of the gas-related assets of Naftogaz, as required by the terms of reference. The provision of information to the auditor by Naftogaz was the main problem in this area.

III. Policy Discussions[4]

17. **As performance under the 2001 program was broadly satisfactory, staff and the authorities agreed on the need to consolidate the progress made in stabilizing the economy, but failed to reach full understandings on economic and financial policies for 2002**. The main outstanding issues concerned the timing of elimination of VAT refunds arrears and the uncertainty surrounding implementation of a number of measures that the government intended to take to close the 2002 fiscal gap. In addition, the policy discussions focused on measures needed to sustain the ongoing recovery, based on a shared assessment that the economic growth so far has stemmed from increased capacity utilization in traditional sectors (Box 2) and that sustainable economic growth would require a broad-based acceleration of structural reforms (Box 3).

Box 2. Interim Assessment of Growth in Ukraine

The recovery started in late 1999. The timing appears to have been related to the prior achievement of macroeconomic stability; it was less clearly associated with acceleration of structural reforms (see Box 3).

Key factors underlying the recovery:

- From the production side, the strong rebound of industrial production (especially metals, food, and chemical processing) was the predominant factor; from the expenditure side, the main growth factor (at least through mid-2001) was net exports.
- Judging from a comparative perspective relative to other BRO countries, there was substantial overshooting in the adjustment of output to post-Soviet prices and trading patterns. Accordingly, at the outset of the recovery, there was ample idle, though potentially profitable, industrial capacity. At the level of individual industries, the extent of recovery is positively associated with the extent of the earlier output collapse.
- External factors were critical, especially in 2000 when both competitiveness (owing to the earlier real depreciation) and strong external demand played a major role.
- Real wages fell sharply in the period through 1999; this was one of the main mechanisms that offset at least in part the "legacy" inefficiencies embodied in the Soviet-era capital stock.
- Another process that had an important role in setting the stage for the recovery was "learning by doing" in adjusting production to market requirements (advertising, packaging, etc.).
- The key policy issue is how to channel the recovery, thus far based primarily on increasing capacity utilization, into an expansion based on productivity growth, which can only be brought about by private (including foreign) investment.

[1] A staff team is carrying out a study of the recent growth experience of Ukraine; the results are expected to be published as an IMF Working Paper by mid-2002.

[4] The Article IV consultation discussions took place in the context of the seventh and eighth reviews under the extended arrangement.

Box 3. Progress with Structural Reforms

Ukraine has made slow but steady progress with structural reforms. In 2001, the country's progress on the EBRD's transition indicator scale was among the highest in the region. Ukraine's institutional developments score (the unweighted average of indicators for large-scale privatization, governance and enterprise reform, competition policy, finance and infrastructure) now stands at 2.3, only slightly below the regional average of 2.4.[1]

In the area of large-scale privatization, Ukraine's achievements reflect the average of transition countries. However, corporate restructuring has been slow and major unresolved issues regarding corporate governance remain, despite significant steps to harden budget constraints. More than 25 percent of large-scale enterprise assets are now in private hands or in the process of being privatized. Ukraine has implemented a nearly comprehensive program of small-scale privatization. Ukraine's private sector share of GDP in mid-2001 amounted to 60 percent, in line with the average for all transition countries.

Ukraine has made substantial progress in liberalizing prices and largely phased out state procurement at non-market prices, in line with most other countries in the region. Although almost all quantitative and administrative import and export restrictions have been removed, liberalization of trade and foreign exchange has been less decisive than in most other transition countries, 13 of which are by now members of the WTO. While legislation and institutions have been set up to strengthen competition, entry restrictions have not yet been reduced substantially, leaving Ukraine's indicator on external liberalization at a level somewhat below average.

Ukraine's pace of reforms in the banking sector and security markets has been slower than average, although liberalization of interest rates and credit allocation has been significant. Substantial progress in the establishment of bank solvency and of a framework for prudential supervision and regulation remains to be achieved. While securities exchanges, market makers, and brokers have been established, the issuance of securities by private enterprises remains limited.

Ukraine's progress with electricity sector restructuring has been somewhat better than the regional average, as legislation providing for full-scale restructuring of the industry has been passed; some progress has been made with tariff reform and revenue collection; and private sector involvement has begun. With the exception of the roads sector, progress in other areas of infrastructure, including telecommunications, has been less than in other transition countries.

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[1]Based on indicators presented in the EBRD Transition Report 2001. "Transition countries" and all averages refer to the 27 countries of Central and Eastern Europe, the Baltics, and the CIS. EBRD's average transition indicator score advanced only marginally between 1997 and 2000, but improved in 2001. The indicator scores progress in transition on a scale from 1 to 4, with 1 meaning no reforms and 4 meaning full transition to a market economy.

18. **The macroeconomic framework for 2002 envisages a continuation of the economic recovery but at a more moderate pace than in 2000–01.** The staff projects real GDP growth to diminish to 5 percent in 2002, reflecting lower growth of industrial output and the impact of a return of normal weather conditions on agricultural production.

Economic growth in 2002 would be led by increasing domestic demand, resulting from further gains in disposable incomes and higher investment. Export growth is expected to continue but at a significantly lower rate than in previous years, owing to lower economic growth in Ukraine's main trading partners, as well as anti-dumping actions and other restrictions against Ukrainian exports. Imports are projected to increase in line with domestic demand. As a result, the external current account surplus is expected to narrow from 3½ percent of GDP in 2001 to 1½ percent in 2002 (Tables 9 and 10). Annual inflation is expected to edge up in 2002, reflecting the rebound of food prices and some planned administrative price hikes, but is targeted to remain below 10 percent.

19. The **main macroeconomic projections and objectives for 2002–06** are to: (i) maintain real GDP growth at a rate of at least 4 percent per year; (ii) keep annual inflation in single digits; and (iii) gradually strengthen the gross reserves position of the NBU to at least three months of import cover by 2006. The consolidated budget deficit would need to be kept at around 2 percent of GDP, in order to reduce the public-debt-to-GDP ratio to close to 30 percent (Box 4). The objective for economic growth is based on boosting private sector activities and productivity gains from implementing structural reforms. Gross nongovernment investment would increase from an estimated 18½ percent of GDP in 2001 to at least 19½ percent from 2002 onward. The external current account surplus is projected to narrow from 3½ percent of GDP in 2001 to about ¾ percent by 2006.

A. Fiscal Policy

20. **The enacted 2002 budget law envisages a consolidated government deficit of 1.6 percent of GDP to be financed by privatization proceeds with a net domestic debt repayment of 0.3 percent of GDP** (Table 2).[5] This target is in line with the fiscal sustainability strategy, whereby privatization proceeds are to be used increasingly to retire public debt (Box 4). However, **a fiscal gap of almost 3½ percent of GDP has emerged since the budget was approved** because of (i) an incipient shortfall in tax collection; (ii) the need to settle all VAT refunds arears; (iii) the presence of unfunded social expenditure mandates; and (iv) an expected shortfall in privatization receipts. To close this gap, the

Table 2. Ukraine: Consolidated Government Finances, 2002

	Budget	Projection w/o measures
	(In percent of GDP)	
Revenue	34.6	33.1
o/w: payment of overdue VAT refunds	0.0	0.8
Expenditure	36.2	37.5
Deficit	-1.6	-4.4
Gap to be filled	0.0	3.4
Financing	1.6	1.1
Net external	-0.5	-0.5
Net domestic	-0.3	0.5
Privatization	2.5	1.1

Sources: Ukrainian authorities; and Fund staff estimates.

[5] The staff estimated that the pension increases originally planned by the government would allow a surplus in the financial position of the Pension Fund of 0.2 percent of GDP. However, a recent presidential decree calls for additional pension increases. On this basis, the staff projection assumes the Pension Fund to be in financial balance in 2002.

Box 4. Fiscal Sustainability Analysis, 2001–10

In 2001, Ukraine's public debt position improved in the context of high real economic growth, the real appreciation of the hryvnia vis-à-vis the dollar, sound fiscal performance, and the Paris Club agreement.[1] Looking ahead, under the baseline scenario prepared by staff, the debt-to-GDP ratio is projected to decline from 40 percent in 2001 to 32 percent in 2010, assuming 4 percent real GDP growth, a primary balance, limiting privatization revenue as a source of budget financing over the medium-term, and assuming current fiscal policies remain in place. Given a projected overall deficit, nominal debt is rising but declines relative to GDP.

Several different scenarios were considered to examine possible vulnerability factors:

- External vulnerability through a depreciated exchange rate and higher interest rate on external debt;
- A fragile domestic economy, with higher real domestic interest rates; and
- Other vulnerabilities, including the impact of lower economic growth and deteriorated primary deficit of 2 percent of GDP as a result of a deficit in the Pension Fund and delays in adjusting expenditure to the possible revenue losses resulting from changes in the tax system.

As shown in the table below, Ukraine's public debt situation is more vulnerable to domestic shocks than to external shocks. Low real GDP growth rates together with imprudent fiscal policies could impair the fiscal position in the long run. This result underlines the importance of avoiding a primary deficit (a balanced primary deficit corresponds to an overall budget deficit of around 2 percent of GDP). This will allow the debt-to-GDP ratio to stabilize at about 30 percent over the medium term.

Fiscal Sustainability Analysis: Vulnerability Factors

	2001	2002	2005	2010
Key assumptions in baseline scenario				
Primary surplus (percent of GDP)	0.5	-0.1	0.0	0.0
Overall cash balance (percent of GDP)	-1.6	-1.8	-2.5	-2.2
Inflation rate (average, in percent)	12.0	7.6	8.2	6.0
Nominal interest rate on domestic debt (weighted average)	7.2	12.1	14.7	12.3
Nominal interest rate on external debt (weighted average)	5.6	6.0	6.2	5.5
Real GDP growth (in percent)	9.1	5.0	4.0	4.0
		(Debt in percent of GDP)		
Baseline Scenario	39.8	36.5	32.8	32.0
Sensitivity analysis				
Exchange rate depreciation (10 percent annually) and higher foreign interest rates (by 5 percentage points)	39.8	36.5	35.1	40.3
Higher real domestic interest rates (20 percent)	39.8	36.5	34.8	47.1
Zero real GDP growth	39.8	36.5	36.9	44.3
Lower primary surplus (by 2 percentage points of GDP)	39.8	36.5	39.0	50.2

[1]Public debt includes official domestic and external debt, state contingent liabilities, and social and utility arrears. It does not include Naftogaz arrears to Gazprom.

government indicated it will take a number of measures. First, it is taking administrative measures to better enforce revenue collection and tighten the eligibility for social privileges, which are estimated to reduce the gap by 0.7 percent of GDP. Second, the government intends to propose new legislation to reduce tax privileges for agriculture, increase excise taxes, tax military wages, and eliminate unfunded social privileges (estimated impact: 1.6 percent of GDP). The authorities also indicated that they intend to step up their efforts to fully implement the 2002 privatization program. To deal with the inevitable privatization uncertainties, the authorities are in the process of identifying possible cuts of almost ½ percent of GDP in discretionary expenditures that they intend to execute in the second half of 2002 (mainly capital outlays, expenditures on equipment, and sectoral subsidies). The staff welcomed these efforts, but considered that additional measures are required to eliminate the residual gap of about ½ percent of GDP. In the staff's view, this gap could be covered through additional spending cuts; stepped-up efforts to recover tax arrears, notably from the energy sector; and a higher budget deficit, financed by drawing down government bank deposits or issuing short-term government debt instruments. However, in the absence of an approved revised budget, there remained considerable uncertainty on the actual stance of fiscal policy.

21. **Staff stressed that all overdue VAT refunds need to be repaid by year-end.** The authorities indicated that the accumulation of VAT refunds arrears was a complex issue and were also concerned about a tight cash-flow situation and meeting their revenue targets. Therefore, they favored a gradual approach consisting of administrative and legislative improvements, while extending the settlement of these arrears into 2003. The FAD technical assistance mission that visited Kyiv at the authorities' request in February 2002 concluded that all overdue VAT refunds had been duly verified and that government financial management rather than technical difficulties was at the root of the problems. In view of the serious distortions that characterize the Ukrainian tax system, and to avoid further undermining tax compliance and weakening export incentives, the staff stressed the need for the expeditious repayment of all overdue refund claims. Staff agreed with the authorities, however, that refunds owed to enterprises with outstanding tax or debt servicing obligations and (provided relevant legislation is passed) to beneficiaries of the 2001 tax amnesty, could be written off or restructured up to the amount of the existing or amnestied tax debt. In addition, the staff recommended that interest be paid on overdue refunds in accordance with the VAT law, both to compensate taxpayers for late payment and to encourage prompt processing of refund claims.

22. **The authorities broadly agreed with staff's view that the Ukrainian tax system suffers from serious distortions and noncompliance as a result of widespread exemptions and privileges, as well as successive tax amnesties.** To create a more equitable tax system, the staff stressed the need to drastically reduce tax exemptions. The authorities explained that the elimination of existing exemptions was feasible only in the framework of the new Tax Code, which passed its second parliamentary reading in November 2001 for implementation in 2003. The draft Tax Code envisages a sharp reduction of tax rates, including lowering the VAT rate from 20 percent to 17 percent, the rate of enterprise profit tax from 30 percent to 25 percent, and the highest rate of personal income taxation from 40 percent to 25 percent. The draft Tax Code also aims to broaden the base for personal income taxation and to suppress significant VAT privileges, with an estimated yield

equivalent to ¾ percent of GDP. As the elimination of tax exemptions embedded in the current version of the draft Tax Code would be insufficient to ensure revenue-neutrality, the staff reiterated the need for a gradual approach to lowering tax rates and additional base-broadening measures, or, alternatively, enduring expenditure savings reforms.

23. **Noninterest expenditures of the consolidated government are budgeted to remain about constant at 34½ percent of GDP in 2002**, but spending policies have been reoriented toward sectoral subsidies, notably to agriculture and mining, and general public services. The overall wage bill is to increase by 15 percent (or 7 percent in real terms). Pensions were raised by 10 percent as of January 1, and any additional increases would need to be limited in a way that ensures that the pension fund remains in balance. The repayment of social arrears, consisting mostly of Chernobyl-related benefits, is limited to 0.1 percent of GDP, in light of the particular scrutiny required to detect fraudulent claims.

24. **Discussions on fiscal reforms centered on improving tax collection and implementing ongoing projects in expenditure management**. New collection enforcement procedures replacing the Kartoteka II system became effective in October 2001, and, starting in early 2002, the State Tax Administration (STA) was in position to seize the assets of delinquent taxpayers who were formally notified but did not pay their tax arrears in 2001. A seventh large taxpayer office was established in Kyiv in early 2002, and steps are being taken to strengthen collection enforcement for state-owned enterprises, including by introducing special treasury accounts for VAT payments of the coal, gas, and electricity sectors. On the expenditure side, the 2002 budget provides for the full implementation of the formula-based system of transfers to local governments, a structural benchmark under the EFF-supported program for end-December 2001. On the other hand, only partial progress has been achieved in implementing a fully functioning treasury single account. The authorities envisage developing the current system into a full-fledged treasury single account in 2002, by merging all existing regional treasury accounts at the NBU into a unified central account. The full implementation of the treasury single account will in turn help other reforms at the treasury, such as the development of a commitment control system.

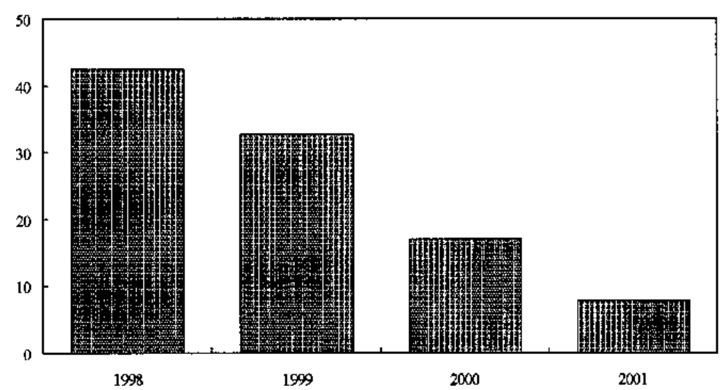
25. **Discussions of medium-term expenditure policies focused on redefining the scope of government and the fiscal costs of pension reforms**. The mission welcomed the development by the authorities of a three-year fiscal framework for the state budget, with the aim of recasting the role of the state toward the social sectors. Draft laws on pension reform have passed their first parliamentary reading. The reform envisages raising benefits in an equitable and sustainable manner, while gradually introducing a mandatory accumulation scheme based on individual accounts, as well as a voluntary non-state pension system. The staff is concerned, however, that the reforms would pose a fiscal risk because the envisaged minimum retirement age is to remain quite low, and the new benefit formula would apply to existing pensioners as well as new ones. Preliminary estimates indicate that the costs of the reform could amount to almost 1½ percent of GDP annually, and that the pension fund would be in deficit for a number of years.

B. Monetary and Exchange Rate Policies

27. **The authorities are committed to continuing to build up the official external reserves position while keeping the monetary expansion under control.** In discussing the monetary policy stance for 2002, the authorities emphasized the virtual absence of any inflationary pressures thus far and the need to accommodate further monetization of the economy. They also noted that a substantial increase of sterilization operations could prove difficult in light of the limited instruments available. The staff cautioned against overshooting the inflation target in light of the rapid monetary expansion in the last quarter of 2001, the recent boost in wages and pensions, and the lower economic growth. In the event, it was agreed that the NBU would aim to keep base and broad money growth at the lower end of the range it had envisaged for 2002.

28. **Monetary policy in 2002 aims at limiting the growth of base and broad money to 21 percent and 25 percent, respectively.** The expected drop in velocity, from 5.2 in 2001 to 4.6 in 2002, is smaller than in previous years, in view of the more limited scope for reducing the share of noncash transactions in the economy following the significant gains achieved since 1998 (Figure 10). The limited increase in net credit to the government in 2002 leaves room for an adequate expansion of credit to the economy. The money multiplier is projected to increase slightly in 2002 as the recent move to larger cash holdings—reflecting the reduction of wage and pension arrears and the arrival of WWII compensation payments—is expected to be partly reversed. The staff also cautioned that any reduction of reserves requirements ratios, which the authorities indicated they intend to do gradually in 2002, should take into account the NBU's limited money market instruments, and noted that base money targets would need to be correspondingly decreased.

Figure 10. Ukraine: Barter Share in Industry, 1998-2001
(In percent of total sales)



Source: Ukrainian authorities.

29. **The authorities expressed their continuing satisfaction with the functioning of the foreign exchange market, as they have sought to limit fluctuations in the exchange rate while building up external reserves.** The staff stressed that the rise in money demand is likely to taper off, and that the NBU should stand ready to expand its sterilization operations, raise its interest rates, and allow greater exchange rate flexibility if foreign exchange inflows continue and inflation shows signs of picking up. The authorities are aware of these risks and stressed their willingness to manage the exchange rate flexibly and to let the foreign exchange market intervention by the NBU be guided primarily by its external reserves target. To expand the range of sterilization instruments available to the NBU, the staff urged the authorities to continue their efforts to develop the domestic treasury bill market through the timely servicing of all outstanding obligations.

30. **The NBU remains committed to strengthening its risk management practices and enhancing the transparency of its operations.** An asset-liability committee comprising senior staff of the NBU has been established that will define the risk and investment parameters for the bank, in particular for reserves management. Risks will be evaluated on a daily basis by the risk monitoring unit that was set up in 2001. The internal audit department of the NBU is being strengthened, and a separate information technology audit division will be created. The NBU also intends to prepare and publish a single set of financial statements for the year 2001 that is consistent with International Accounting Standards (IAS). The net international reserves of the NBU will continue to be audited on a quarterly basis by international auditors at least through the end of the period of the extended arrangement.

C. Structural Policies

31. **The discussions on the structural reforms agenda focused on areas where progress is necessary as a matter of priority**. In particular, the staff stressed the need to revive the privatization program in a transparent manner; further improve payments discipline in the energy sector and reform the coal sector; and ensure full compliance with prudential regulations by all banks while pushing ahead with the restructuring of the remaining state-owned banks. More decisive efforts are needed to improve public and corporate governance, including in the gas sector; deregulate business activities; and provide a stable legal environment needed for a market economy. Ukraine should also further liberalize its external sector to smooth the path to WTO accession.

32. Preparations for the **privatization** of the remaining state-owned oblenergos have been resumed, in an effort to privatize nine of these enterprises in the second half of 2002. This process needs to be supported by the resolution of electricity sector debts. The new law on the telecommunications sector, scheduled to be passed by mid-2002, and the subsequent establishment of a regulatory framework for the sector are expected to facilitate the privatization of Ukrtelecom. In the meantime, preparations for its privatization continue with the assistance of financial advisors. The authorities intend to adopt an action plan to implement the recommendations of the independent review of privatizations carried out in the first nine months of 2001. Regular evaluations of the privatization process by the privatization advisory group, which includes the World Bank and other donors, will be continued in order to further enhance transparency. The authorities intend to take measures to improve the overall investment climate; in this context, the recent adoption of the new Land Code, which allows for private ownership of land in the medium term, was a crucial step.

33. In the **energy sector**, the authorities envisage further improvements in payments discipline, in order to reduce the sizable tax arrears of the energy sector, increase transparency, and make energy utilization more efficient. To this end, they intend to ensure adequate budgetary allocations for government energy consumption. The policy of keeping energy and other communal tariffs at cost-recovery levels will be maintained, while the methodology for evaluating the cost structure will be reviewed in cooperation with the World Bank. The staff is concerned that prices for gas are too low.

34. The discussions on the **banking sector** focused on measures needed to shore up the financial position of some banks, and a corresponding medium-term strategy will be developed in close cooperation with the World Bank. The authorities stressed that the situation of these banks is being followed closely, and that the work program to increase provisions against bad loans to the required levels is on track. The staff argued for immediate actions to curtail the excessive growth of lending by these banks and to improve corporate governance. To this end, the government is preparing amendments to the Law on Banks and Banking Activity.

35. **The staff expressed concern that the high credit growth of recent years has not been matched by adequate profitability of lending operations, which has undermined the capital position of the banking system**. In this context, staff stressed the need for the NBU to enforce more strictly the existing supervisory regulations, including those pertaining to capital adequacy and arms-length lending. The authorities responded that the banks are increasing their capital to the levels required by the Law on Banks and Banking Activity. However, as of end-February 2002, 30 banks have not yet brought their statutory capital to the level required for countrywide banking operations (Euro 5 million). The NBU intends to further develop the regulatory framework to implement the Basel Core Principles for Effective Banking Supervision. The authorities expected to proceed, in close cooperation with the World Bank, with establishing a Mortgage-Land Bank, which is envisaged in the recently adopted Land Code. Ukraine is scheduled to participate in the Financial Sector Assessment Program (FSAP) in 2002, and the FSAP mission is planned to visit Kyiv in May, following a preliminary mission in April. The FSAP is expected to provide the authorities with a framework for developing their financial sector policies and for identifying priority technical assistance needs.

36. In other **structural areas**, the authorities have widened the areas under Free Economic Zones, notwithstanding the moratorium on establishment of new free zones. The implementation of regulations based on the recently adopted laws on certification and standardization is under preparation and will, over the medium term, facilitate Ukraine's WTO accession as well as its integration into the European market. In preparation for WTO accession, a number of protocols have been signed with member states of the Working Party.

IV. Medium-Term External Sector Outlook

37. **The external current account surplus is expected, under the baseline scenario, to dissipate over the medium term as imports of non-energy products continue to grow at a rapid clip.** Exports are projected to continue to grow, despite anti-dumping measures and other restrictions against Ukrainian products (Box 5). The gross external reserves build-up is projected to taper off after approaching a level equivalent to three months of imports

Box 5. Anti-Dumping Measures and Other Trade Restrictions

After rapidly increasing in 2000, Ukraine exports have been confronted with an increasing number of anti-dumping actions, including from Ukraine's main trading partners Canada, the EU, Russia, and the US. Products affected by anti-dumping measures are in particular steel, rubber and fertilizer. Moreover, while some anti-dumping investigations started by India and Mexico in 2000 ended without measures, a number of further anti-dumping investigations are still ongoing, including an investigation by the US on steel wire rods and an investigation by Brazil into ammonium nitrogen fertilizer.

Canada and the EU have begun treating Ukraine as a market economy in their antidumping investigations, whereas the US has not. The latter implies that instead of using evidence of the country itself on the cost structure of the companies involved in the exports, evidence of the cost structure of alternative or substitute countries is used. This has led to relatively high tariffs and has effectively closed the US market for a number of Ukrainian products. For example, with tariffs of 90 percent, exports of hot rolled steel to the US declined from 202,000 tons in the first half of 2000 to 19,000 tons in the first half of 2001. Rubber exports declined from 175,000 tons to about zero over the same period. In response, Ukrainian steel manufacturers have been examining alternative markets, especially in Asia and Africa. Russia, which is not a WTO member, imposed limits on imports of steel pipes, although Russia's domestic pipe production was expanding—damage to the domestic industry is a requirement under WTO for launching anti-dumping procedures.

A number of voluntary agreements to curb exports are in place as well, including for exports of seamless pipes into the EU (in force since 1991), cut-carbon steel to the US (since 1997) and limits on pipe exports to Russia starting in 2001. Quotas on textile exports to the EU were cancelled in early 2001 following the negotiation of a package to harmonize tariffs and trade conditions on textile trade with the EU.

Anti-Dumping Tariffs Imposed on Ukraine Products
(In percent unless otherwise indicated)

	US	Canada	EU	Russia
Hot rolled steel	90.33	169 1/		
Rubber	41.69	15.7		
Ammonium nitrogen	156.29		33.25 Euro/ton	
Urea	68.26		8.85-16.84 Euro/ton 2/	
Urea-ammonium-nitrogen mixture			26.17 Euro/ton	
Pipes				20, 40 3/

Source: Ukrainian authorities.
1/ Under review
2/ Company-specific tariff.
3/ Replaced by a quota limiting exports from 780,000 tons in 2000 to 620,000 tons in 2001.

Ukraine imposes no quantitative restrictions on imports, but uses import tariffs to limit certain imports from other countries. The weighted average tariff as of May 1, 2001, is 7.02 percent, down from 7.5 percent in 1998. Effective import duty collection was much lower in 2001, due to widespread exemptions, and tariffs on industrial products are low (with a weighted average tariff of 5.35 percent). The highest ad-valorem tariff is 25 percent, with a number of higher (specific) rates for agricultural products.

by 2006. Net international reserves, which turned positive in 2001, are envisaged to continue to increase.

38. **Ukraine's external position has become less vulnerable in recent years** (Table 11). Several factors have contributed to this outcome. First, the strong balance-of-payments position and the positive momentum in export and import-substituting industries provide a cushion; second, while still modest, the level of external reserves has improved substantially; third, external debt repayment obligations have declined significantly following the debt rescheduling agreements with creditors in the London Club and the Paris Club. Ukraine is also fairly resilient to energy price changes, because, if oil prices increase, the country benefits through higher exports to its main export market Russia, partly offsetting the increase in the import bill. In case the world economy would experience a more serious slowdown in 2002–03, the impact on the external current account balance and international reserves would also be limited. The reason is that imports of energy would decline in price and non-energy import growth would come down, as overall demand and output growth would slacken.

39. **Agreement has been reached with the government of the Russian Federation on the settlement of gas arrears of Naftogaz to Gazprom**, and on an annually renewable contract for transit of Russian gas to Western Europe (for details see Chapter III of the Selected Issues and Statistical Appendix (to be issued). With regard to the **Paris Club** debt rescheduling, progress has been made in negotiating the six bilateral agreements: data have been reconciled and one agreement has been completed. The Paris Club has agreed to extend the deadline for the signature of bilateral agreements to end-May 2002. The risks of nonpayment to the Fund are low as repayment obligations form a small proportion of export proceeds and the official reserve position of the NBU has strengthened substantially (Table 12).

40. **Following agreements to reschedule all major components of Ukraine's external public debt, the authorities have started to review their medium-term debt strategy.** For 2002, no commercial external public borrowing is envisaged, but the authorities are considering a modest return to the markets in 2003 to offset the large repayments falling due. Chapter IV of the Selected Issues and Statistical Appendix (to be issued) discusses the factors that are expected to affect market access, based on a review of sovereign credit ratings. The staff has advised the authorities to improve the database and meet the SDDS prescriptions on external debt, in order to further rebuild their credibility and to allow access to international capital markets. In particular, the lack of reliable data on private external debt and the inability to assess the adequacy of official external reserves in relation to overall external short-term debt hamper assessment of Ukraine's position.

V. Transparency and Governance

41. **The authorities are continuing their efforts to deepen transparency and strengthen governance in Ukraine**, including by greater dissemination of government documents and the increased use of audits. In this context, they have published the staff

report for the fifth and sixth reviews under the Extended Arrangement (EBS/01/152; 9/4/01) and the letter of intent attached thereto.

42. At the **NBU**, the annual financial statements are audited by an external auditor and published, and external audits of net international reserves continue to be conducted. In the **fiscal area**, transparency in budgetary operations has been enhanced with the adoption of the Budget Code in early 2001. For the first time, the Ministry of Finance submitted to the Fund annual government finance statistics (GFS), and these data were published in the IMF's 2001 *GFS Yearbook*. A new functional classification of expenditure for the 2002 budget in line with the GFS classification has been developed. However, the State Tax Administration has only made limited progress in reporting on the costs of tax exemptions, as well as on tax arrears and amnesties.

43. The authorities are continuing their efforts to enhance the **transparency of privatizations**. In particular, they intend to adopt an action plan based on the recommendations of an independent review of privatization operations conducted in the first nine months of 2001. In the energy sector, the authorities plan to develop the terms of reference for the third stage **audit of Naftogaz** in line with IAS and appoint an auditor by end-March 2002. In the **electricity sector**, monthly reconciliations of the central transit account and regional settlement accounts will continue to be carried out.

44. In the **financial sector**, the authorities indicated that they have moved to address concerns raised by the Financial Action Task Force on Money Laundering (FATF) and are revising their anti-money laundering legislation. They also stated that key measures include the creation of a financial investigative unit to examine potential instances of money laundering. To boost confidence in the banking system, banks are now obliged to publish their quarterly and annual balance sheets together with income statements in specified newspapers during the month following the reporting quarter, in line with the new Law on Banks and Banking Activity.

VI. Staff Appraisal

45. **Ukraine's strong economic performance has continued and the combination of high growth, low inflation, and a strong external position is particularly welcome against the backdrop of a less favorable outlook for the world economy**. While some temporary factors contributed to the better-than-foreseen outcome in 2001, the importance of the authorities' contribution—chiefly, protecting the macroeconomic stabilization gains—was considerable.

46. **Looking ahead, the authorities realize that they face a difficult challenge in sustaining the recent positive trends**. The country's basic problems remain to be resolved—a huge output loss since independence, widespread poverty, uncertain political consensus in favor of deep structural reforms required for integration with Western Europe, and a difficult business environment. In this context, the staff considers that the authorities' medium-term strategy of building on the progress that has been achieved, while addressing the key weaknesses affecting the business climate, is appropriate. The staff would stress,

nevertheless, that, given the range and the seriousness of the weaknesses, the authorities will need to redouble their efforts.

47. The **macroeconomic outlook for 2002** envisages a decrease of economic growth; a slight increase in inflation; and a further strengthening of the NBU's foreign reserves position. The staff continues to see downside risks to this projection, mainly because of possibly weaker external demand; uncertainties about implementation of measures requiring parliamentary approval to close the fiscal gap and regarding the VAT base; possible instabilities in the demand for money, which, against the background of rising monetary aggregates, could lead to inflationary pressures and thus possibly to a loss of competitiveness; and political uncertainty in the context of the parliamentary elections scheduled for March 2002. The staff expresses the hope that the outstanding issues preventing completion of the reviews under the extended arrangement can be resolved in the near future.

48. **The authorities faced a difficult task in implementing the fiscal program in 2001.** The original deficit target of 3 percent of GDP was adjusted downward during the year as privatization proceeds fell significantly short of expectations. On the revenue side, developments over the course of the year justified fully the staff's concerns about the adverse effects of the widespread tax amnesty adopted unexpectedly by parliament in early 2001. Strong efforts will be necessary to achieve this year's revenue targets without resorting to measures, such as delaying VAT refunds, that are destructive to the integrity of the tax system and hamper economic growth. Accordingly, **the staff attaches great importance to the need to eliminate arrears on VAT refunds**.

49. **The staff considers the promulgation of a 2002 budget with a deficit of no more than 1¾ percent of GDP to be an important step in achieving fiscal sustainability** based on gradually reducing reliance on privatization proceeds for deficit financing. **However, reaching this objective requires the full implementation of corrective measures** to compensate for expected shortfalls in revenue and privatization receipts, as well as to cover the unfunded social expenditure mandates. The authorities also need to guard against granting additional wage and pension increases that are not incorporated in the budget.

50. **In view of the deteriorating revenue performance over the last years and the disincentives caused by haphazard and uneven tax policy, including tax amnesties, it is necessary to drastically reduce tax distortions and tax privileges and exemptions.** Given the possibility that the new Tax Code will be adopted in 2002, the staff strongly encourages the authorities to take prompt steps to broaden the tax base, in order to compensate for a reduction in tax rates. Moreover, the staff urges the authorities to maintain the momentum on fiscal structural reforms, especially in the area of the single treasury account, where only partial progress has been achieved. Over the medium term, caution will need to be exercised to ensure that the pension reform, which is in its initial stages, does not pose a risk for fiscal sustainability.

51. **In managing monetary policy in 2001, the NBU has so far judged correctly that the strong growth and the sharp expansion of the cash economy have expanded the scope for additional monetization of the economy**. Looking ahead, and given the possibility that foreign exchange inflows will continue, **it will be critically important for the NBU to keep inflation under very close watch and react swiftly to any signs of upward pressures** by either sterilizing its interventions in the foreign exchange market (the potential for which is limited) or allowing greater exchange rate flexibility. In the meantime, the staff urges the NBU to proceed cautiously in reducing reserve requirements.

52. **Banks' lending portfolios have expanded substantially, posing another area where risks will have to be monitored carefully by the NBU**. Such rapid credit growth in the context of poor capitalization of many banks, gaps in the framework of prudential regulations, and a prospective slowdown of growth creates conditions under which impaired assets could rise rapidly. Therefore, the staff urges the authorities to intensify their efforts to strictly enforce existing supervisory regulations and to encourage banks to increase their capitalization and improve loan evaluation procedures. At present, the staff agrees with the NBU that the situation of a few banks is a cause of concern. As regards these banks, the staff endorses the priority of formulating an action plan to bring them in compliance with the prudential regulations. Since, under the current legal framework, these banks suffer from serious governance problems, the staff calls on the authorities to seek the appropriate legislative changes as soon as possible. Ukraine's participation in the FSAP will be instrumental for developing the authorities' financial sector policies.

53. **The large shortfall in privatization proceeds in 2001 has placed significant constraints on fiscal policy**. To some extent, the problem stemmed from a lack of demand, especially on the part of foreign strategic investors. But it was also the result of a hesitant policy stance toward privatization, as evidenced by delays in preparing the Ukrtelecom sale and in resolving the debt problems of regional electricity distribution companies. The staff urges the authorities to remove these roadblocks. The adjustments of electricity tariffs that were agreed to as part of the earlier sales of electricity distribution companies are welcome and the staff calls on the government to allow for further tariff increases to ensure full cost recovery and eliminate distortions. The authorities also need to take comprehensive measures that address the widespread perception that Ukraine's business climate remains very difficult.

54. **The staff commends the authorities for adopting the Land Code and the progress in reducing the extent of nonpayments in the energy sector**, especially with regard to consumer payments to distributors and from importers to foreign suppliers. The staff is concerned that Naftogaz's tax arrears have increased despite the substantial improvement in cash collection ratios and urges the authorities to take measures to reverse this trend. The staff regrets the delays in completing the audit of Naftogaz's end-2000 financial statements and the fact that the scope of the audit is limited due largely to Naftogaz's reticence to provide information to the auditors. The staff strongly urges the government to ensure that the audit of the end-2001 financial statements is timely, comprehensive, and fully in line with international standards. More generally, the case of Naftogaz illustrates the need for greater consistency and persistence in addressing the

problems of broadly-defined governance both within the public sector and at the borderline between the government and the private sector.

55. **The staff welcomes the progress in rescheduling of Ukraine's debt to official and private creditors**. Given the successful Paris Club rescheduling, priority should be given to reaching an agreement with Turkmenistan—a major non-Paris Club creditor. The recent agreement between Naftogaz and Gazprom on regularization of their commercial relations and its ratification by the Ukrainian parliament is especially welcome. **The staff encourages the authorities to move forward swiftly with the actions required for the WTO accession process**. In this context, Ukraine's competitors should provide fair access to their markets.

56. Statistical data are broadly adequate for surveillance purposes. **The staff encourages the authorities to proceed with the SDDS subscription by July 2002**. The staff also urges the authorities to address data weaknesses in the areas of national accounts, balance of payments, and external debt.

57. It is recommended that the next Article IV consultation be held on a regular 12-month cycle.

Table 3. Ukraine: Selected Economic Indicators, 1998–2002

	1998	1999	2000		2001 1/		2002
		Est.	Prog.	Prel.	Rev. Prog.	Prel.	Proj.
GDP							
Nominal GDP (in millions of hryvnia)	102,593	130,442	165,959	170,070	210,000	201,927	235,982
Nominal GDP (in millions of U.S. dollars)	41,829	31,567	30,351	31,262	...	37,597	...
Real GDP (annual change in percent)	-1.9	-0.2	4.2	5.9	6.2	9.1	5.0
Consumer prices							
Percent change, period average	10.5	22.7	28.4	28.2	14.4	12.0	7.6
Percent change, end of period	20.0	19.2	27.1	25.8	12.3	6.1	9.8
Public finance (in percent of GDP)							
Consolidated government budget balance							
Cash basis	-2.8	-2.4	-1.5	-1.3	-1.7	-1.6	-1.8
Of which: Primary balance	-0.4	0.0	1.5	1.8	0.6	0.5	-0.1
Commitment basis 2/	-3.0	-1.4	-0.7	0.2	-1.3	-1.3	-1.8
Revenue	36.0	33.8	34.4	35.1	31.1	35.0	34.2
Expenditure	38.7	36.1	35.9	36.4	32.8	36.6	36.0
Net domestic financing 3/	1.0	2.2	1.9	1.6	1.5	1.2	2.4
Net external financing	1.8	0.2	-0.4	-0.3	0.2	0.4	-0.5
Money and credit (annual change in percent)							
Credit to nongovernment	16.7	38.6	43.5	63.0	23.7	41.0	25.7
Net credit to government	76.9	37.5	7.0	-1.9	-4.7	-4.8	6.6
Base money	21.9	39.2	30.3	40.1	18.6	37.4	21.0
Broad money	25.3	40.4	35.8	45.4	23.7	42.0	25.0
Velocity (M3) 4/	7.3	6.9	6.4	6.3	5.9	5.2	4.6
Balance of payments							
Current account balance (in millions of U.S. dollars)	-1,296	834	1,470	1,481	1,008	1,332	665
Current account balance (in percent of GDP)	-3.1	2.6	4.8	4.7	2.7	3.5	1.5
Gross reserves (end of period)							
In weeks of current year imports of GNFS	2.2	3.7	3.0	4.2	6.8	7.8	10.7
Public external debt (in percent of GDP) 5/ 6/	27.5	39.4	36.2	33.1	28.5	27.5	24.9
Debt service ratio (in percent of exports of GNFS) 7/	11.2	16.6	13.4	10.0	6.3	6.4	6.5
Interest payments (in percent of exports of GNFS)	5.8	5.8	4.5	3.1	2.8	3.0	2.8
Export volume (annual change in percent)	-12.4	-10.2	19.1	21.1	6.3	10.1	5.2
Import volume (annual change in percent)	-14.3	-14.3	9.2	6.6	6.8	12.7	8.0
Terms of trade (annual change in percent)	4.7	9.2	-8.2	-8.2	-0.8	1.4	-0.4
Savings and investment (in percent of GDP) 8/							
Gross domestic savings	16.7	24.2	25.4	23.8	24.0	21.5	21.8
Nongovernment	17.6	24.6	24.9	23.2	25.0	21.5	22.0
Government	-0.9	-0.4	-0.5	0.7	-1.0	0.0	-0.2
Gross domestic investment	19.5	21.1	20.6	19.3	21.7	20.2	22.0
Nongovernment	17.7	19.1	18.6	17.4	19.7	18.5	19.5
Government	1.8	2.0	2.0	1.9	2.0	1.7	2.5
Resource balance	-2.9	3.1	4.8	4.5	2.3	1.4	-0.2
Memorandum items:							
Exchange rate							
Hryvnia per dollar, end of period	3.4	5.2	...	5.4	...	5.3	...
Hryvnia per dollar, period average	2.5	4.1	...	5.4	...	5.4	...
Real effective exchange rate (annual change in percent)	2.3	-23.0	...	11.6	...	1.6	...
Nominal effective exchange rate (annual change in percent)	35.3	-14.4	...	-1.2	...	9.1	...

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

1/ The revised program column refers to the projection shown in EBS/01/152, September 4, 2001.

2/ Cash balance adjusted for the net accumulation of payments arrears on wages, pensions, and social benefits, and, in 2000, for the settlement of interest arrears to the National Bank of Ukraine (NBU).

3/ Domestic financing includes purchases of treasury bills by nonresidents, and privatization proceeds. For 2002, includes gap to be filled of 0.8 percent of GDP.

4/ Annual GDP divided by period-average broad money.

5/ Includes Black Sea Fleet debt swap and repayments, and debt stock and actual payments under the commercial debt rescheduling of April 2000.

6/ Historic debt data are preliminary.

7/ After rescheduling.

8/ From 1999 onward, the savings-investment balance reflects revised gas prices.

Table 4. Ukraine: Quantitative Performance Criteria, Indicative Targets, and Quantitative Structural Benchmarks Under the Extended Arrangement for September 2000-December 2001

(End-of-period; in millions of hryvnia, unless otherwise indicated; cumulative changes from September 29, 2000, unless otherwise indicated)

	2000		2001							
	September	December	March	June	September			December		
	Actual	Actual	Actual	Actual	Revised Program	Rev. Prog. Adjusted	Estimate	Revised Program	Rev. Prog. Adjusted	Preliminary
Performance criteria 1/										
Ceiling on the deficit of the consolidated government budget 2/ 3/	-231	2,175	-831	457	732	732	315	3,500	3,649	3,276
Floor on nonearmarked state cash revenue 3/	17,808	26,019	5,950	12,127	18,891	18,891	19,128	26,413	26,413	26,336
Ceiling on stock of budgetary arrears on wages, pensions and benefits 4/	1,681	1,344	727	762	763	763	639	663	663	621
Ceiling on noncash netting operations on consolidated government obligations arising after December 31, 1999 3/	265	269	0	0	0	0	0	0	0	0
Ceiling on the net domestic assets of the NBU 5/ 6/	20,812	20,025	-20,812	-20,812	-3,527	-3,527	-3,723	-2,548	-2,402	-3,857
Floor on net international reserves of the NBU (in millions of U.S. dollars) 6/ 7/	-1,089	-596	1,089	1,089	1,235	1,235	1,704	1,388	1,361	2,210
Accumulation of external arrears by the government and the NBU 8/	0	0	0	0	0	0	0	0	0	0
Ceiling on nonconcessional external debt contracted or guaranteed by the government or the NBU (in millions of U.S. dollars) 9/										
Maturity over one year	0	175	175	220	2,500	2,500	470	2,500	2,500	470
Of which: credit lines	0	0	0	0	250	250	0	300	300	0
Maturity of one to three years	0	100	100	100	250	250	100	275	275	100
Of which: credit lines	0	0	0	0	100	100	0	125	125	0
Maturity up to one year	0	0	0	0	0	0	0	0	0	0
Indicative targets										
Base money 6/	14,888	16,781	-14,888	-14,888	3,189	3,189	5,546	5,004	5,004	8,167
Quantitative structural benchmarks										
Total cash collection ratio for electricity 10/	49	51	53	59	60	60	63	65	65	65
Total cash collection ratio by Naftogaz 11/	31	49	66	85	60	60	90	65	65	87

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

1/ Unless otherwise noted, targets for end-December 2000, end-March 2001, end-September 2001, and end-December 2001 are performance criteria, while targets for June 2001 are indicative targets.

2/ For the purpose of calculating the adjustor to the deficit defined in the Technical Memorandum of Understanding (TMU) for arrears in the payment of scheduled interest on domestic debt instruments issued by the government, the levels of scheduled interest payments are the following (in millions of hryvnia): 1,191 (December 2000); 524 (March 2001); 834 (June 2001); 1,351 (September 2001); and 1,794 (December 2001).
For the purpose of calculating the adjustor to the deficit for deviations in the level of project loans, the levels of programmed project loans are the following (in millions of hryvnia): 0 (December 2000); 171 (March 2001); 197 (June 2001); 272 (September 2001); and 461 (December 2001). For both adjustors, 2000 figures are cumulative from January 1, 2000; 2001 figures are cumulative from January 1, 2001.

3/ The figures for 2000 are cumulative from January 1, 2000, and the figures for 2001 are cumulative from January 1, 2001.

4/ Ceilings established on the stock.

5/ For the purpose of calculating the adjustor to NDA for deviation in foreign financing (excluding project financing) to the budget defined in the Technical Memorandum of Understanding (TMU), the programmed levels of foreign financing to the budget are the following (cumulative since September 29, 2000; in millions of hryvnia): 388 (December 2000); 602 (March 2001); 707 (June 2001); 1,523 (September 2001); and 2,279 (December 2001).

6/ Amounts for September and December 2000 are outstanding stocks.

7/ For the purpose of calculating the adjustor to NIR defined in the TMU, the programmed levels of medium- and long-term cash foreign financing are the following (cumulative since September 29, 2000; in millions of US dollars): 70 (December 2000); 107 (March 2001); 130 (June 2001); 280 (September 2001); and 419 (December 2001).

8/ The nonaccumulation of the external arrears criterion applies on a continuous basis.

9/ The ceilings on medium- and long-term loans (maturity of over one year) are on debt contracted; the ceiling on short-term loans (maturity of up to one year) applies on a continuous basis. The criterion for maturity up to one year does not apply to contracting of loans by the NBU.

10/ The targets refer to total cash collection ratios for payments to the wholesale electricity market cumulatively since end-June 2000 for 2000, and since January 1, 2001 for 2001.

11/ The targets are for total cash collection ratios by Naftogaz on all its gas sales, cumulative from the beginning of each year. Outcomes include mutual settlements through the banking system. Data are not independently verifiable.

Table 5. Ukraine: Structural Benchmarks Under the Extended Arrangement for September and December 2001

	Date	Status
1. Completion of stage two of the Naftogaz audit.	Sept. 30, 2001	Largely implemented. While the audit was conducted, the report does not include combination procedures in order to obtain the consolidated view of the gas-related assets of Naftogaz, as required by the terms of reference for the audit.
2. Implement the single account of the State Treasury of Ukraine.	Dec. 31, 2001	Partially implemented. The system put in place consists of treasury accounts consolidated at the regional level.
3. Adoption of the formula-based transfers to local governments in the context of the 2002 budget.	Dec. 31, 2001	Implemented.

Table 6. Ukraine: Consolidated Government Finances, 1998-2002

(In millions of hryvnia)

	1998	1999	2000		2001		2002		
			Program	Actual	Rev. Prog.	Prel.	Budget	Proj. 1/ without measures	Proj. 1/ with measures
Revenue and grants	36,892	44,060	57,021	59,717	65,354	70,587	81,686	78,170	80,699
Tax revenue	35,236	41,791	48,901	50,574	56,127	60,025	71,387	66,927	69,456
Taxes on income and profit	9,696	11,584	14,380	14,812	18,172	18,161	22,667	21,733	22,157
of which: Enterprise Profit Tax	5,620	6,352	7,419	7,698	9,556	8,273	11,627	10,377	10,540
Taxes on payroll 2/	10,803	12,839	14,585	15,224	15,770	19,194	22,427	21,891	21,891
of which: Pension Fund	8,930	10,804	12,300	12,890	13,223	15,910	17,933	17,933	17,933
Property taxes	1,105	1,090	1,303	1,376	1,404	1,619	1,670	1,670	1,670
Domestic taxes on goods and services	11,605	14,340	16,360	16,847	18,021	18,265	21,671	18,483	20,589
of which: Value Added Tax	7,238	8,409	9,255	9,441	10,064	10,355	12,888	9,368	11,129
Taxes on international trade	972	1,238	1,503	1,561	1,889	1,934	2,187	2,266	2,266
Other taxes	1,054	699	770	754	871	853	765	883	883
Nontax, capital revenue, and grants	1,656	2,269	8,120	9,142	9,227	10,562	10,299	11,244	11,244
of which: Service fees	...	...	4,626	5,386	5,076	5,540	4,726	5,850	5,850
Expenditure (cash basis) 3/	39,714	47,150	59,553	61,891	68,854	73,862	85,539	88,578	84,977
General public services	1,875	2,035	4,150	4,746	4,550	5,008	6,745	6,745	...
Defense	1,338	1,558	2,408	2,295	2,727	3,045	4,100	4,100	...
Public order and safety affairs	1,602	1,777	2,600	3,015	3,237	4,142	4,368	4,368	...
Education affairs and services	4,483	4,720	6,200	7,085	8,231	9,449	11,306	11,306	...
Health affairs and services	3,620	3,861	4,619	4,976	5,599	6,156	7,287	7,287	...
Social security and welfare affairs 2/	14,411	16,600	20,200	22,780	26,384	28,434	34,215	34,105	...
of which: Pension Fund	8,801	10,757	12,300	13,105	13,223	15,473	17,508	17,933	17,933
pension arrears repayment	...	759	1,007	1,149	0	0	0	0	0
Housing and community services	1,582	1,420	1,367	1,430	1,371	1,962	954	954	...
Recreational, cultural, religious affairs	521	615	839	887	678	1,120	1,371	1,371	...
Energy, agriculture, and industry	4,225	4,446	3,533	4,377	4,957	5,035	10,325	10,325	...
Interest payments	2,424	3,087	5,091	5,292	4,722	4,189	3,953	3,965	3,965
Domestic interest payments	1,663	1,251	1,706	2,385	1,793	1,644	902	1,006	1,006
Foreign interest payments 4/	761	1,837	3,385	2,907	2,929	2,545	3,051	2,959	2,959
Other 5/	3,633	7,032	8,546	5,007	6,399	5,322	914	914	...
Unfunded social mandates	...	...	...	...	...	...	...	3,138	250
Overall cash balance	-2,822	-3,090	-2,532	-2,175	-3,500	-3,276	-3,853	-10,407	-4,278
Net social arrears accumulation 6/	285	-1,250	-1,489	-1,745	-681	-724	-140	-140	-140
Interest arrears accumulation	0	0	0	-724	0	0	0	0	0
Commitment balance 6/	-3,108	-1,840	-1,043	294	-2,819	-2,552	-3,713	-10,268	-4,139
Gap to be filled	0	0	0	0	0	0	...	7,907	1,778
Financing	2,822	3,090	2,532	2,175	3,500	3,276	3,853	2,500	2,500
Net external	1,867	268	-609	-584	494	866	-1,214	-1,214	-1,214
Disbursements	4,650	2,263	381	381	2,430	2,252	2,789	2,789	2,789
Amortization	-2,783	-1,996	-990	-965	-1,936	-1,386	-4,003	-4,003	-4,003
Net domestic	484	2,001	942	469	-494	-152	-758	1,214	1,214
Net nonbank borrowing	...	-280	340	133	345	770	0	0	0
Net bank borrowing	...	2,281	601	336	-839	-922	-758	1,214	1,214
Privatization	471	822	2,200	2,290	3,500	2,562	5,825	2,500	2,500
Memorandum items:									
End-period stock of social arrears	4,339	3,089	1,600	1,344	663	621	481	481	481
Primary balance	-398	-3	2,559	3,117	1,222	913	100	-6,442	-313
Earmarked revenue	13,782	17,398	21,134	23,728	26,264	32,064	32,886	32,350	32,350
Unearmarked cash	...	20,567	35,887	35,988	39,090	38,522	48,800	45,820	48,349
Inflation rate	11	23	28	28	14	12	8.0	7.6	7.6
Nominal GDP	102,593	130,442	165,959	170,070	210,000	201,927	235,982	235,982	235,982

Table 6 (Cont'd). Ukraine: Consolidated Government Finances, 1998-2002

(In percent of GDP)

	1998	1999	2000		2001		2002		
			Program	Actual	Rev. Prog.	Prel.	Budget	Proj. 1/ without measures	Proj. 1/ with measures
Revenue and grants	36.0	33.8	34.4	35.1	31.1	35.0	34.6	33.1	34.2
Tax revenue	34.3	32.0	29.5	29.7	26.7	29.7	30.3	28.4	29.4
Taxes on income and profit	9.5	8.9	8.7	8.7	8.7	9.0	9.6	9.2	9.4
of which: Enterprise Profit Tax	5.5	4.9	4.5	4.5	4.6	4.1	4.9	4.4	4.5
Taxes on payroll 2/	10.5	9.8	8.8	9.0	7.5	9.5	9.5	9.3	9.3
of which: Pension Fund	8.7	8.3	7.4	7.6	6.3	7.9	7.6	7.6	7.6
Property taxes	1.1	0.8	0.8	0.8	0.7	0.8	0.7	0.7	0.7
Domestic taxes on goods and services	11.3	11.0	9.9	9.9	8.6	9.0	9.2	7.8	8.7
of which: Value Added Tax	7.1	6.4	5.6	5.6	4.8	5.1	5.5	4.0	4.7
Taxes on international trade	0.9	0.9	0.9	0.9	0.9	1.0	0.9	1.0	1.0
Other taxes	1.0	0.5	0.5	0.4	0.4	0.4	0.3	0.4	0.4
Nontax, capital revenue, and grants	1.6	1.7	4.9	5.4	4.4	5.2	4.4	4.8	4.8
of which: Service fees	...	...	2.8	3.2	2.4	2.7	2.0	2.5	2.5
Expenditure (cash basis) 3/	38.7	36.1	35.9	36.4	32.8	36.6	36.2	37.5	36.0
General public services	1.8	1.6	2.5	2.8	2.2	2.5	2.9	2.9	...
Defense	1.3	1.2	1.5	1.3	1.3	1.5	1.7	1.7	...
Public order and safety affairs	1.6	1.4	1.6	1.8	1.5	2.1	1.9	1.9	...
Education affairs and services	4.4	3.6	3.7	4.2	3.9	4.7	4.8	4.8	...
Health affairs and services	3.5	3.0	2.8	2.9	2.7	3.0	3.1	3.1	...
Social security and welfare affairs 2/	14.3	12.7	12.2	13.4	12.6	14.1	14.5	14.5	...
of which: Pension Fund	8.6	8.2	7.4	7.7	6.3	7.7	7.4	7.6	7.6
of which: pension arrears repayment	...	0.6	0.6	0.7	0.0	0.0	0.0	0.0	0.0
Housing and community services	1.5	1.1	0.8	0.8	0.7	1.0	0.4	0.4	...
Recreational, cultural, religious affairs	0.5	0.5	0.5	0.5	0.3	0.6	0.6	0.6	...
Energy, agriculture, and industry	1.4	3.4	2.1	2.6	2.4	2.5	4.4	4.4	...
Interest payments	2.4	2.4	3.1	3.1	2.2	2.1	1.7	1.7	1.7
Domestic interest payments	1.6	1.0	1.0	1.4	0.9	0.8	0.4	0.4	0.4
Foreign interest payments 4/	0.7	1.4	2.0	1.7	1.4	1.3	1.3	1.3	1.3
Other 5/	6.0	5.4	5.1	2.9	3.0	2.6	0.4	0.4	...
Unfunded social mandates	...	...	...	...	...	...	...	1.3	0.1
Overall cash balance	-2.8	-2.4	-1.5	-1.3	-1.7	-1.6	-1.6	-4.4	-1.8
Net social arrears accumulation 6/	0.3	-1.0	-0.8	-1.0	-0.3	-0.4	-0.1	-0.1	-0.1
Commitment balance 6/	-3.0	-1.4	-0.7	0.2	-1.3	-1.3	-1.6	-4.4	-1.8
Gap to be filled	0.0	0.0	0.0	0.0	0.0	0.0	...	3.4	0.8
Financing	2.8	2.4	1.5	1.3	1.7	1.6	1.6	1.1	1.1
Net external	1.8	0.2	-0.4	-0.3	0.2	0.4	-0.5	-0.5	-0.5
Disbursements	4.5	1.7	0.2	0.2	1.2	1.1	1.2	1.2	1.2
Amortization	-2.7	-1.5	-0.6	-0.6	-0.9	-0.7	-1.7	-1.7	-1.7
Net domestic	0.5	1.5	0.6	0.3	-0.2	-0.1	-0.3	0.5	0.5
Privatization	0.5	0.6	1.3	1.3	1.7	1.3	2.5	1.1	1.1
Memorandum items:									
End-period stock of social arrears	4.2	2.4	1.0	0.8	0.3	0.3	0.2	0.2	0.2
Primary balance	-0.4	0.0	1.5	1.8	0.6	0.5	0.0	-2.7	-0.1
Earmarked revenue	13.4	13.3	12.7	14.0	12.5	15.9	13.9	13.7	13.7
Unearmarked cash	0.0	15.8	21.6	21.2	18.6	19.1	20.7	19.4	20.5
Noninterest expenditures	36.3	33.8	32.8	33.3	30.5	34.5	34.6	35.9	34.3

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

1/ Assumes the repayment of all VAT refund arrears (Hrv 2,095 million as of Jan. 1, 2002).

2/ Starting with the 2001 fiscal outturn, the accounts of the Accident Insurance Fund, the revenue of which is equivalent to 0.4 percent of GDP, are brought on budget.

3/ Due to a new budget classification introduced for the 2002 budget law, the components of government expenditures in 2002 are not strictly comparable to earlier years.

4/ After debt rescheduling.

5/ Includes the discrepancy between above-the-line and financing data.

6/ The commitment balance is the cash balance adjusted for the net accumulation of arrears on wages, pensions, and benefits (social arrears), and, in 2000, for the settlement of interest arrears to the NBU.

Table 7. Ukraine: Monetary Survey, 1998-2002

	1998	1999	2000	2001				2002
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Dec Projection
				(In millions of hryvnia)				
Net foreign assets	-5,340	-6,334	-33	823	2,797	5,107	6,829	10,756
Net domestic assets	21,059	28,403	32,121	32,206	34,160	34,536	38,726	46,168
Domestic credit	23,464	32,369	39,966	40,604	43,363	43,874	47,507	56,184
Net credit to government	14,336	19,718	19,348	17,801	17,527	16,524	18,427	19,641
Credit to nongovernment	9,128	12,651	20,618	22,803	25,835	27,350	29,080	36,543
In domestic currency	5,431	6,768	12,082	13,639	15,578	16,416	17,365	20,587
In foreign currency	3,697	5,883	8,537	9,164	10,257	10,934	11,715	15,956
Other items, net	-2,405	-3,967	-7,845	-8,397	-9,203	-9,338	-8,780	-10,016
Broad money	15,719	22,069	32,088	33,029	36,956	39,643	45,555	56,924
Hryvnia broad money	12,377	16,532	24,631	25,511	28,847	31,571	37,051	46,507
Foreign currency deposits	3,342	5,537	7,457	7,519	8,109	8,072	8,505	10,417
				(Percentage change from end of previous period) 4/				
Broad money	25.3	40.4	45.4	2.9	11.9	7.3	42.0	25.0
Hryvnia broad money	13.9	33.6	49.0	3.6	13.1	9.4	50.4	25.5
Net domestic credit	47.3	38.0	23.5	1.6	6.8	1.2	18.9	18.3
Credit to nongovernment	16.7	38.6	63.0	10.6	13.3	5.9	41.0	25.7
Real broad money 1/	4.5	17.8	15.6	0.2	9.2	8.9	33.8	13.8
Real credit to nongovernment 1/	-2.8	16.3	29.5	7.7	10.5	7.5	33.0	14.4
				(Ratio)				
Velocity of broad money 2/	7.3	6.9	6.3	5.1	5.1	5.9	5.2	4.6
Velocity of broad money 3/	6.5	5.9	5.3	5.1	4.9	5.7	4.4	4.1

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

1/ Deflated by the CPI.

2/ Period average; for March, June, and September, annualized quarterly GDP divided by the average stock of money during the quarter.

3/ End-of-period; for March, June, and September, annualized quarterly GDP divided by the stock of money at end-quarter.

4/ Figures for March, June, and September refer to changes from previous quarter.

Table 8. Ukraine: Accounts of the National Bank of Ukraine and of Deposit Money Banks, 1998-2002

	1998	1999	2000	2001				2002
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Dec Projection
	(In millions of hryvnia)							
1. NBU								
Net international reserves	-6,892	-9,367	-3,244	-2,288	475	3,345	6,099	10,026
(In millions of U.S. dollars)	-2,011	-1,674	-596	-421	87	615	1,121	1,843
Net domestic assets	15,496	21,345	20,025	19,031	18,523	17,089	16,956	17,872
Net domestic credit	14,381	20,834	20,972	19,833	19,881	18,567	18,232	19,148
Net credit to government	13,479	19,121	19,937	18,765	18,612	17,199	18,509	17,923
Net credit to nongovernment	49	83	92	100	87	99	31	31
Claims on banks	853	1,630	943	969	1,182	1,269	-309	1,193
Other items, net	1,115	511	-947	-803	-1,358	-1,478	-1,276	-1,276
Base money	8,604	11,978	16,781	16,742	18,998	20,434	23,055	27,898
Currency in circulation	7,158	9,583	12,799	12,736	14,487	16,208	19,465	24,022
Banks' reserves	1,447	2,395	3,982	4,007	4,511	4,226	3,590	3,876
2. Deposit Money Banks								
Net foreign assets	1,434	2,677	2,503	2,333	1,549	1,294	664	664
Net domestic assets	7,981	11,448	17,729	18,929	22,102	23,410	25,117	33,431
Domestic credit	9,883	13,133	19,880	21,691	24,607	26,534	28,856	38,119
Net credit to government	858	597	-590	-964	-1,084	-675	-82	1,718
Credit to the economy	9,025	12,535	20,469	22,655	25,691	27,209	28,938	36,402
Banks' reserves	1,447	2,395	3,982	4,007	4,511	4,226	3,590	3,876
Other Items Net	-3,349	-4,079	-6,133	-6,769	-7,015	-7,350	-7,329	-8,564
Banks' Liabilities	9,415	14,125	20,231	21,262	23,652	24,704	25,782	34,095
Credit to banks from NBU	853	1,640	943	969	1,182	1,269	-309	1,193
Deposits	8,561	12,485	19,289	20,294	22,470	23,435	26,091	32,902
	(Percentage change from end of previous period) 1/							
Base money	21.9	39.2	40.1	-0.2	13.5	7.6	37.4	21.0
Net domestic assets of the NBU	117.9	37.7	-6.2	-5.0	-2.7	-7.7	-15.3	5.4
	(Ratio)							
Money multiplier	1.83	1.84	1.91	1.97	1.95	1.94	1.98	2.04

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

1/ Figures for March, June, and September refer to changes from previous quarter.

Table 9. Ukraine: Medium-term Balance of Payments, 1998-2006
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
			Prel.	Rev. Proj.	Projections				
Current account balance 1/	-1,296	834	1,481	1,332	665	420	401	447	432
Merchandise trade balance	-2,584	-482	779	134	-409	-577	-565	-557	-430
Exports	13,699	12,463	15,722	17,047	17,742	18,868	20,362	22,161	24,078
Imports	-16,283	-12,945	-14,943	-16,913	-18,151	-19,445	-20,928	-22,718	-24,508
Of which: Energy	-5,854	-5,163	-5,912	-6,195	-6,252	-6,441	-6,642	-6,949	-7,177
Nonfactor services 2/	1,377	1,479	627	373	325	338	334	310	263
Investment income	-871	-869	-942	-686	-850	-971	-1,031	-1,002	-1,032
Of which: Interest on public debt 6/	-1,020	-947	-655	-605	-611	-644	-660	-656	-655
Current transfers	782	706	1,017	1,511	1,598	1,630	1,663	1,696	1,630
Financial and capital account	505	322	-707	160	170	501	623	812	1,092
Direct investment (net) and capital transfers	744	479	587	748	950	850	865	880	924
Portfolio equity	225	118	-197	--	34	100	156	190	226
Bonds and MLT loans	-510	-52	34	5	30	315	302	425	650
Of which: MLT loans and bonds (official)	-340	-33	-261	-207	-338	-127	-28	73	274
Disbursements	779	544	173	499	560	901	1,016	1,261	1,254
Repayments 2/ 6/	-1,119	-577	-434	-706	-898	-1,027	-1,044	-1,188	-980
Currency and deposits	-125	-117	--	164	-25	-28	-31	-34	-37
Other short-term capital (includes net payables)	171	-106	-1,131	-757	-819	-736	-669	-649	-671
Of which: Gas arrears (net) 3/	679	662	161	--	--	--	--	--	--
Errors and omissions	-810	-954	-151	-198	-198	-198	-198	-198	-198
Overall balance	-1,601	202	623	1,294	637	723	826	1,061	1,325
Financing	1,601	-202	-623	-1,294	-637	-723	-826	-1,061	-1,325
Gross official reserves (- is increase) 4/	1,324	-283	-398	-1,606	-1,458	-542	-573	-806	-853
Net use of IMF resources	277	81	-599	-89	737	-182	-254	-255	-472
Purchases 8/	382	638	251	365	914	--	--	--	--
Repurchases	105	557	850	454	177	182	254	255	472
Official arrears to bi-lateral creditors	--	--	374	--	--	--	--	--	--
Clearance of official arrears to bi-lateral creditors	--	--	--	-374	--	--	--	--	--
Rescheduling 5/	--	--	--	775	85	--	--	--	--
Memorandum items:									
Total public external debt 2/	11,483	12,438	10,350	10,331	10,843	10,563	10,310	10,149	9,950
Public external debt as percent of GDP 2/	27.5	39.4	33.1	27.5	24.9	21.5	19.7	18.4	17.1
Stock of external gas arrears 3/	754	1,416	1,577	...	...	...	...	...	...
Current account as percent of GDP	-3.1	2.6	4.7	3.5	1.5	0.9	0.8	0.8	0.7
Debt service ratio (exports of GNFS), before rescheduling 5/ 6/	11.1	16.6	10.0	8.1	7.1	...	...	...	...
Debt service ratio (exports of GNFS), after rescheduling 5/ 6/	11.1	16.6	10.0	6.4	6.5	7.3	7.3	7.4	6.9
Interest payments as percent of exports of GNFS, after rescheduling 5/	5.8	5.8	3.1	3.0	2.8	2.8	2.7	2.4	2.3
Exceptional financing 7/	385	547	70	310	322	277	300	350	350
Gross international reserves 4/	782	1,090	1,469	3,075	4,533	5,075	5,648	6,454	7,307
In weeks of imports of GNFS	2.2	3.7	4.2	7.8	10.7	11.3	11.7	12.4	13.0
Gross reserves over official debt service	0.3	0.5	0.8	1.7	2.7	2.7	2.9	3.1	3.5
Net reserves	-1,911	-1,706	-632	1,164	1,885	2,608	3,435	4,496	5,821
Net reserves over official debt service excl. repurchases	-0.9	-1.1	-0.6	0.9	1.2	1.6	2.0	2.4	3.6
Export growth rate	-11.1	-9.0	26.1	10.4	4.1	6.3	7.9	8.8	8.7
Import growth rate	-17.0	-20.5	15.4	13.2	7.3	7.1	7.6	8.6	7.9
Export volume growth	-12.4	-10.2	21.1	10.1	5.2	6.0	6.8	7.7	7.5
Import volume growth	-14.3	-14.3	6.6	12.7	8.0	5.5	5.9	6.4	6.1
Terms of trade (percent change)	4.7	9.2	-8.2	1.4	-0.4	-1.2	-0.5	-1.0	-0.5

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

1/ Before 1999, the imports of gas are reported at a decreed price rather than actually observed price.
2/ Includes Black Sea Fleet debt swap and repayments. Includes debt stock and actual payments under the commercial debt rescheduling of April 2000.
3/ As reported by Naftogaz. Assumed rescheduled as of end 2001 under the terms of the preliminary agreement between Ukraine and the Russian Federation.
4/ The definition of gross reserves excludes unusable reserves. Gross reserves at end-1998 were reported as US$949 million before this exclusion.
5/ Rescheduling by the Paris Club and other bilateral creditors (on comparable terms).
6/ Historic debt data are preliminary.
7/ Official external program financing, largely from the World Bank and the European Union.
8/ Assumes that all purchases potentially available under the program are made.

Table 10. Ukraine: Medium-term External Financing Requirements, 1998-2006.
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Merchandise trade balance	-2,584	-482	779	134	-409	-577	-565	-557	-430
Services balance	506	610	-315	-313	-525	-633	-697	-692	-769
Amortization of medium- and long-term credits	-1,119	-577	-434	-706	-898	-1,027	-1,044	-1,188	-980
Other short-term capital (including errors and omissions)	-639	-1,060	-1,282	-955	-1,017	-934	-867	-847	-869
Increase in official reserves (- is increase)	1,324	-283	-398	-1,606	-1,458	-542	-573	-806	-853
Gross financing needs (-)	-2,512	-1,792	-1,650	-3,446	-4,306	-3,713	-3,746	-4,091	-3,900
Current transfers	782	706	1,017	1,511	1,598	1,630	1,663	1,696	1,630
Foreign direct investment, and portfolio equity	969	597	390	748	984	950	1,021	1,070	1,150
Gross medium- and long-term credit before exceptional financing	223	-22	398	401	606	1,066	1,046	1,263	1,280
Currency and deposits	-125	-117	0	164	-25	-27	-31	-34	-37
IMF repurchases	-105	-557	-850	-454	-177	-182	-254	-255	-472
Gross financing gap (-)	-768	-1,185	-695	-1,076	-1,320	-277	-300	-350	-350
IMF purchases	382	638	251	365	914	...	...	...	...
Exceptional financing (World Bank, EU)	385	547	70	310	322	277	300	350	350
Arrears (build-up and clearance) and rescheduling	0	0	374	401	85	0	0	0	0

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

1/ This reflects scheduled debt service. Excludes Black Sea Fleet debt swap and repayment.

Table 11. Ukraine: Indicators of External Vulnerability, 1998-2002
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001 Prel.	2002 Projection
Financial indicators					
Public sector debt (percent of GDP) 1/	38.5	50.9	45.3	37.9	35.0
Broad money (percent change, 12-month basis)	25.3	40.4	45.4	42.0	25.0
Private sector credit (percent change, 12 month basis)	16.7	38.6	63.0	41.0	25.7
External Indicators					
Exports (percent change in US$)	-11.1	-9.0	26.1	10.4	4.1
Imports (percent change in US$)	-17.0	-20.5	15.4	13.2	7.3
Terms of trade (percent change, 12 month basis)	4.7	9.2	-8.2	1.4	-0.4
Current account balance (millions of US$)	-1296	834	1481	1332	665
Capital and financial account balance (millions of US$)	505	322	-707	160	170
Central bank short-term foreign liabilities (change in millions of US$)	-105	-557	-850	-454	-177
Short term foreign assets of the financial sector (in US$)	908	790	917	755	...
Short term foreign liabilities of the financial sector (in US$)	490	312	457	632	...
Financial Market Indicators					
Stock market index (ProU-50 index)	...	24.3	42.3	27.2	...
Spread of benchmark bonds (basis points, end of period)	...	...	1,430	780	...

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

1/ In this presentation, public debt comprises domestic and external debt contracted by the central government.

Table 12. Ukraine: Indicators of Fund Credit, 1998-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Outstanding Fund credit 1/									
In millions of SDRs	1,985.0	2,044.6	1,591.2	1,520.8	2,107.0	1,962.4	1,760.6	1,557.8	1,181.9
In percent of:									
Exports of goods and nonfactor services	15.3	17.2	10.8	9.1	12.1	10.6	8.9	7.3	5.1
Total public external debt	21.7	27.0	20.3	17.6	25.1	23.9	21.8	19.7	15.7
Gross official reserves 2/	344.4	256.5	143.0	62.1	58.4	48.6	39.2	30.3	20.3
GDP	6.4	8.9	6.7	5.1	6.1	5.0	4.2	3.5	2.6
Quota	199.0	149.0	116.0	110.8	153.6	143.0	128.3	113.5	86.1
Debt service due 3/									
In millions of SDRs	162.1	487.8	740.7	429.2	194.1	201.2	253.8	249.2	416.0
Of which: repurchases	77.3	407.0	643.5	361.2	140.7	144.5	201.8	202.8	375.9
In percent of:									
Exports of goods and nonfactor services	1.2	4.1	5.0	2.6	1.1	1.1	1.3	1.2	1.8
Public debt service due	11.2	24.8	50.2	31.8	15.8	14.9	17.5	15.8	26.0
Gross official reserves 2/	28.1	61.2	66.6	17.5	5.4	5.0	5.6	4.9	7.2
GDP	0.5	2.1	3.1	1.4	0.6	0.5	0.6	0.6	0.9
Quota	16.3	35.6	54.0	31.3	14.2	14.7	18.5	18.2	30.3
Memorandum item:									
Quota	997	1,372	1,372	1,372	1,372	1,372	1,372	1,372	1,372

Source: Fund staff estimates.

1/ End of period.
2/ From 1998, this refers to gross usable reserves.
3/ Includes early repurchase on account of misreporting of SDR 72.5 million in 2000.

Table 13. Ukraine: Social and Demographic Indicators

	Ukraine	Europe & Central Asia	Lower-Middle-Income
1999			
Population, mid-year *(millions)*	50.0	475	886
GNP per capita (*Atlas method, US$*)	750	2,150	1,750
Average annual growth, 1993-99			
Population (*%*)	-0.7	0.1	1.1
Labor Force *(%)*	-0.4	0.6	1.5
Most recent estimate (latest year available, 1993-99)			
Poverty (*% of population below national poverty line*)	27	...	...
Urban population (*% of total population*)	68	67	58
Life expectancy at birth *(years)*	67	69	68
Infant mortality (*per 1,000 live births*)	14	22	35
Child malnutrition (*% of children under 5*)	...	8	14
Illiteracy (*% of population age 15+*)	0	3	14
Gross primary enrollment (*% of school-age population*)	100	100	102
Male	100	101	105
Female	100	99	99

Source: World Bank.

UKRAINE: STATISTICAL ISSUES

1. With technical assistance from the Fund and other multilateral and bilateral sources, the authorities have made significant efforts and improvements in the country's statistical systems. The country's IFS page has been published since July 1996, and the Ukrainian authorities are working towards subscribing to the Special Data Dissemination Standard (SDDS) by July 2002. A new Statistics law was approved by parliament in July 2000. Despite progress, however, there remain substantial shortcomings in Ukraine's economic statistics, particularly in national accounts, government finance statistics, and balance of payments data. The IMF Resident Statistical Advisor who assisted the Ukrainian authorities in improving macroeconomic statistics since 1994 finished his assignment in March 2002.

Key statistical data are generally provided in a timely manner, as summarized below. However, real sector data have not been reported to the Fund for the purposes of IFS for several years.

Real sector

2. The national accounts suffer from many weaknesses, including: (i) a large informal economy and inadequate coverage of source data for these activities; (ii) unduly heavy reliance on complete censuses of enterprises as opposed to sample surveys; (iii) insufficient elimination of holding gains on inventories, which leads to an overstatement of the value of recorded production; (iv) lack of a published time series of real GDP showing its level relative to a given reference year; (v) the use of a volume measurement methodology which is liable to conceptual errors for quarterly data, particularly for volume estimates of informal activity prior to the mid-1990s; and (vi) collection of many source data on a cumulative, as opposed to discrete, basis and the ensuing adherence to an inappropriate revision policy. Major initiatives currently underway are to improve the quality of the quarterly national accounts (QNA), and update the methodology of the monthly industrial production index. Missions of the Statistics Department (STA) visited Ukraine in October 1998 and May 1999 and provided recommendations on improvements in these areas.

3. Ukrainian consumer price statistics have benefited from a series of Fund missions. The development of a 26-city monthly CPI has resulted in the availability of a broad-based measure of price change that meets international standards for price collection and index calculation. However, a times series presentation has not yet been adopted. A revised PPI is to be introduced during 2001. A new construction price index using a "model pricing" methodology was to have been implemented early this year, but the work has been delayed. Published external trade data suffer from incomplete coverage, related, in particular, to shuttle trade, smuggling, and valuation issues. The trade data for the balance of payments are corrected for shuttle trade and smuggling by the National Bank of Ukraine (NBU). Development of exports and imports volume and unit value indices has started.

4. Progress on real sector issues is broadly hampered by lack of funds to support further automation of the calculation of the quarterly national accounts estimates and price indices.

Following two STA missions on the consumer price index in 2001, the authorities have begun designing a smaller and more efficient consumer price index sample, which could release some resources for these and other needs.

Government finance

5. The Ministry of Finance (MoF) and the State Treasury of Ukraine (STU) have made considerable progress in the compilation of fiscal data. Monthly data on the operations of the central and regional government are now available within 25 days of the end of the reference period. No government finance data are published in IFS. However, an inter-agency working group was established to assign institutional responsibilities. Since then the Ministry of Finance has taken responsibility for compiling government finance statistics (GFS). As such, it assumes responsibility for developing and maintaining bridge and derivation tables, adjusts data to conform to IMF recommendations, and prepares footnotes to explain remaining deviations from international standards. The MoF has also taken responsibility for the provision of GFS data for their publication in accordance to an advance data release calendar. The State Statistics Committee (SSC) is responsible for the publication and dissemination of GFS data compiled and approved by the MoF. The State Treasury is responsible to accounting and reporting on central and local government budget execution to the MoF, following GFS requirements for coverage and timeliness. The MoF also assumes responsibility for providing GFS to the Fund's Statistics Department. Government finance data was published in the 2001 GFS Yearbook.

6. Starting with the 1998 budget, government finances have been presented in a functional classification, which complies broadly with GFS standards for both the federal and the local governments. Expenditures of the federal budget have been broken down by economic categories and the authorities have been working on an economic presentation of local governments' expenditures. A new functional classification, closer to GFS standards, was introduced for the preparation of the 2002 central government budget. In particular, the number of expenditure categories was reduced from 25 to10.

7. The treasury reports monthly data on revenue, expenditure (in a functional classification) and debt cash transactions to the European II Department (EU2). These data are subsequently adjusted by EU2, which requests additional data to cover the operations of social security funds and brings the data more in line with IMF GFS standards. The treasury started providing monthly expenditure data by economic classification in November 1998.

8. Despite these improvements, there remain serious compilation issues with the data prepared by the treasury. Reporting on arrears, both for receipts and payments, should be improved in terms of coverage and quality. There are important delays in reporting the operations of social special funds, and the recording of certain debt transactions, especially the payments made to settle called guarantees, appears to be misclassified.

Money and banking statistics

9. Ukraine has received extensive technical assistance in money and banking statistics, and substantial improvements have already been made. The most recent technical assistance mission in the area of monetary statistics took place in May 2001. The mission reviewed compilation procedures used by the NBU, and made recommendations to strengthen the compilation framework and improve the analytical quality of monetary data. The mission also prepared an inventory of dissemination practices for financial sector data categories.

10. The monetary data are now compiled in accordance with international statistical standards and are generally of good quality. Unified reporting to EU2 and STA has been established, and data are reported regularly to the Fund with a lag of about three weeks.

External sector

11. Ukraine compiles balance of payments statistics on a quarterly basis with a lag of about six weeks. The principal data sources are a closed ITRS, administrative data sources, and balance of payments surveys of enterprises. Balance of payments data are methodologically sound, based on BPM5 concepts and definitions. Implementation of international accounting standards broadly suitable for compilation, as well as computerized balance of payments data management and processing, have provided a solid basis for data quality improvement.

12. Major data weaknesses exist in the measurement of (short-term) private sector debt (coverage and composition), and in interenterprise arrears (receivables, payables), contributing to sizable errors and omissions. In addition, survey data are subject to bias resulting from large non-response rate and the use of an outdated business register. The lack of comprehensive data on private sector debt and corresponding repayment schedules hampers the analysis of the capital account and external exposure of Ukraine.

13. Over 1992–98, there were six balance of payments statistics missions to Ukraine. Since 1994 multisectoral resident statistical advisors undertake technical assistance in the balance of payments statistics. Currently technical assistance is focused at the following areas: (i) recording of transactions related to the division of the Black Sea fleet; (ii) compilation of international investment position and external debt data; (iii) unrecorded trade estimations; and (iv) coordination of the balance of payments compilation process.

14. The authorities have made progress in compiling international reserves data. The release of monthly data, in line with the Fund's reserve template, is expected to start by mid-2002. Sample data have been provided to the Fund.

Table 1. Ukraine: Core Statistical Indicators
(as of March 22, 2002)

	Exchange rates	International Reserves	Central Bank Balance Sheet	Reserve/Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External debt/debt service
Date of latest observation	March 21	March 20	February 28	March 20	March 20	March 21	February	December	December	January	December	December
Date received	March 22	March 22	March 21	March 22	March 22	March 22	March 4	February 1	February 1	March 5	February 1	February 1
Frequency of data	D	D	M	D	D	D	M	M	Q	M	M	M
Frequency of reporting	D	D	M	D	D	D	M	M	Q	M	M	M
Source of updating	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	C	C	C	C	C
Confidentiality	C	B	B	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	V	M	M	M	M	M	Q	Q	M	M	Q

Explanation of abbreviations:

Frequency of data, reporting and publication: D-daily, W-weekly, M-monthly, V-irregularly in conjunction with staff visits, N/A-none.
Source of date: A-direct reporting by National Bank, Ministry of Finance, Ministry of Statistics and Analysis or other official agency.
Mode of reporting: C-cable or facsimile. Most data are provided to the Resident Representative's office and then forwarded to Headquarters.
Confidentiality: B-for use by the staff and the Executive Board, C-unrestricted us

Ukraine: Fund Relations
(As of January 31, 2002)

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	2,892.74	210.84
Reserve position in Fund	0.00	0.00

III. **SDR Department:**	**SDR Million**	**% Allocation**
Holdings	199.80	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**%Quota**
Stand-by arrangements	57.64	4.20
Extended arrangements	1,193.00	86.95
Systemic transformation	270.10	19.69

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
EFF	09/04/98	09/03/02	1,919.95	1.193.00
Stand-by	08/25/97	08/24/98	398.92	181.33
Stand-by	05/10/96	02/23/97	598.20	598.20

VI. **Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2002	2003	2004	2005	2006
Principal	140.70	144.50	201.80	202.80	279.00
Charges/interest	40.90	37.00	32.30	26.70	20.60
Total	181.60	181.50	234.10	229.50	299.60

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Ukraine (NBU) is subject to the transitional procedures with respect to the ongoing EFF, which was approved on September 4, 1998, and is scheduled to expire on September 3, 2002. The transitional procedures require a review of only the NBU's external audit mechanism. This assessment determines whether the NBU publishes annual financial statements that are independently audited in accordance with internationally accepted standards.

The External Audit assessment was completed on February 3, 2001. The assessment concluded that the NBU's external audit mechanism meets internationally accepted standards, as reported in EBS/01/152, (9/4/01).

VIII. **Exchange Arrangements**:

In September 1996, the authorities introduced the hryvnia (Hrv) at a conversion rate of karbovanets (Krb) 100,000 to Hrv 1. The rate was initially informally pegged to the dollar. In September 1997, the peg was replaced by a formal band of Hrv 1.7–1.9 per U.S. dollar. The limits of the band were moved on several occasions, most recently on February 9, 1999, to Hrv 3.4–4.6 per U.S. dollar. Since March 19, 1999, the exchange rate for the hryvnia has been allowed to be determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention of allowing the free float of the hryvnia. On March 6, 2002 the hryvnia stood at Hrv 5.32 per U.S. dollar. The authorities intervene regularly to limit fluctuations in the exchange rate.

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

IX. **Article IV Consultation:**

Ukraine is on the standard 12-month consultation cycle. The staff report (EBS/00/252, 12/05/00) and the Statistical Appendix (SM/00/274, 12/06/00) were considered by the Executive Board on December 19, 2000.

X. **FSAP Participation and ROSCs**

Module	Date of Issuance	Document number
1. Fiscal Transparency (experimental module)	September 3, 1999	EBS/99/158

XI. Fund Technical Assistance Missions, October 1998–2002
(As of March 15, 2002)

Department	Type of Mission	Timing
FAD	Treasury project	April 25–30, 1999 October 15–20, 2000 April 6–29, 2001
	Tax administration	July 6–16, 1999 May 9–26, 2000 October 2000
	Tax policy	September 21–October 2, 1998
	Fiscal management	November 14–20, 1999
	Expenditure policy and management	January 28–February 11, 2000
	Treasury and budget reforms	April 16–29, 2001
	VAT refund management and selected VAT administrative issues	January 30–February 9, 2002
MAE	Banking supervision, reserve management, operations, foreign exchange market	October 22–November 3, 1998
	Joint MAE/World Bank mission on bank restructuring	February 2–12, 1999
	Bank restructuring	October 4–14, 1999
	Bank restructuring, accounting	January 2000
	Banking reform, reserve management, accounting	March 28–April 12, 2000
	Internal audit, reserve management, accounting	May 24–June 13, 2000
	Bank restructuring	June 20–29, 2000
	Accounting and internal audit	October 30–November 10, 2000
	Accounting and internal audit	May 3–18, 2001
	Internal audit	October 8–19, 2001
	Accounting	October 22–November 2, 2001
STA	Producer price index	October 26–30, 1998
	National accounts	October 5–23, 1998
	National accounts	May 17–28, 1999
	Monetary and banking statistics	February 23–March 7, 2000
	Consumer price index	March 12–22, 2001
	Monetary and banking statistics	May 16–30, 2001
	Consumer price index	November 5–16, 2001
LEG	Article VIII	November 1–5, 1998

XII. Fund Resident Representatives and Advisors, 1998–2002

Purpose	Representatives/Advisors	Assignment
Resident Representatives		
	Mr. Lenain	January 1997–February 1999
Senior Resident Representative	Mr. Ghesquiere	March 1999–August 2001
	Mr. Figliuoli	Since August 2001
Resident Representative	Mr. Kwon	July 1997–July 1998
	Mr. Orsmond	July 1999–July 2001
	Mr. Lissovolik	Since July 2001
Advisors		
Macroeconomic Policy Advisor to the Ministry of Finance	Mr. Marion	October 1998–April 2001
	Mr. Robertson	Since May 2001
Tax Enforcement Adviser	Mr. McDonald	November 1999–April 2001
General advisor at National Bank of Ukraine	Mr. Ehlers	April 1996–April 1998
Banking Supervision Advisor at National Bank of Ukraine	Mr. Herron	July 1998–July 2000
	Mr. Lopes	Since March 2001
Treasury Advisor	Mr. Platais	July 1998–June 2001
	Mr. Lepage	Since July 2001
Multisector Statistics Advisor	Mr. Piche	March 2000–March 2002

UKRAINE: RELATIONS WITH THE WORLD BANK

(As of March 1, 2002)

General

1. Since Ukraine joined the World Bank in September 1992, the Bank has assisted Ukraine with its transition to a market-based economy through lending, policy dialogue, and assistance in resource mobilization and aid coordination. As of February 28, 2002, World Bank commitments to Ukraine totaled \$3,192.8 million and net disbursements amounted to \$2,393.3 million.

Country assistance strategy

2. The World Bank Board of Executive Directors approved a new Country Assistance Strategy (CAS) for Ukraine on September 12, 2000. Its main objective is to assist the Government and civil society in obtaining sustained growth and poverty reduction in Ukraine. To do so, the strategy addresses the institution-building challenges faced by Ukraine both from the demand side (civil society) and supply side (government). It proposes a \$1.8 billion Base Case lending program to support structural reforms and a \$461 million Low Case lending program for investment support in environment, private sector development, health, education, agriculture title distribution, and social mitigation of coal sector restructuring.

3. A distinct feature of the new Ukraine CAS is its intensified focus on social issues as well as areas that address globally important issues (tuberculosis, HIV/AIDS, environment). The two-legged CAS strategy also relies on a stronger civil society as a key component for progress in institutional reform and poverty reduction:

- the first (under the *Low Case*) aims to support civil society in its demand for better governance, and addresses globally sensitive areas; and
- the second (which would be added under the *Base Case*) aims to support opportunities to strengthen institutions that foster sustainable development, when these opportunities present themselves.

4. The Base Case lending scenario requires, in addition to a sustainable macroeconomic framework (e.g., full resumption and timely subsequent implementation of the IMF's Extended Fund Facility (EFF) program), achievement of agreed-upon benchmarks under the first Programmatic Adjustment Loan (PAL) in the five cross-sectoral areas mentioned below. Ukraine has already met these benchmarks and moved into the base case with the PAL approval on September 20, 2001.

World Bank program

5. The current project portfolio consists of approximately 22 operations. The **public sector reform** program includes the Treasury System Project ($16.4 million) currently under implementation, designed to help the government in creating an efficient budget management system. The PAL is conceived as a sequence of three separate operations, totaling up to $750 million, with disbursements depending entirely on performance, covering five cross-sectoral issues: (i) financial accountability, (ii) regulatory framework, (iii) property rights, (iv) public sector accountability and (v) social sustainability. PAL I ($250 million) was approved by the World Bank Board of Executive Directors on September 20, 2001 and fully disbursed in two tranches of $150 and $100 million respectively. Another operation under preparation is the Tax Administration Modernization Project ($100 million) for which the Bank approved a $2 million PPF. Two new projects are planned for the fiscal year 2003—Public Administration Incentives Reform ($60 million) and Statistics Modernization ($30 million).

6. The **agriculture sector** program includes a Rural Land Titling Project ($100 million), which will support the distribution of land titles to new land owners and a Title Registration Project that would support the development of a modern title registration system. A Rural Finance Project ($100 million) is envisaged in fiscal year 2003.

7. Good progress has been made in **energy efficiency and district heating**. Two District Heating Projects (a $200 million Kyiv District Heating Project and an $18.3 million Kyiv Energy Efficiency Project) are under implementation. In **the coal sector**, the preparation of the Coal Sector Social Mitigation Project ($100 million) was dropped due to disagreements on the coal sector reform strategy. Instead, the Bank is presently conducting a Coal Sector Study to determine the fiscal impact of the sector on the economy.

8. In **infrastructure**, the Lviv Water and Wastewater Project ($24.2 million) was approved in June 2001.

9. **Privatization and financial sector reform** received strong attention in the Bank's program. To promote a stronger private sector, an Adaptable Program Lending (APL) for Private Sector Development ($30 million) will be discussed by the Bank's Board on March 28, 2002. The World Bank has been helping the Ukrainian government with the restructuring of Bank Ukraina (10 percent of the banking system) and with the development of a restructuring plan for the Savings Bank. In order to attract private investment, the Commercial Sea Launch guarantee operation ($100 million) was approved by the Bank in 1997. The Government requested a technical assistance operation ($5 million) for E-development, which is currently under preparation.

10. In the **social sector**, the Bank's Board has recently approved a Social Investment Fund ($30 million), which will provide support to poor communities. In addition, the Bank is developing a TB/AIDS Control Project ($40 million) aimed at fighting these epidemics and

improving prevention systems. A Social Sector Adjustment Loan is planned for fiscal year 2004, and further operations will be developed in the areas of health and education.

11. **Environmental** work is proceeding well. A Global Environmental Fund (GEF) project that is addressing the problem of Ozone-Depleting Substances is nearing completion. A new GEF grant on preserving the Azov-Black Sea wetlands ($8 million) has been approved recently. An Environmental Public Expenditure Review is currently underway and will serve as a basis for a future operation on environmental pollution.

12. The Bank is also providing significant **nonlending support**. Specific economic and sector work (ESW) to date include: a Country Economic Memorandum (CEM) (FY99), an Expenditure Review in Health and Education (FY99), and a Farm Restructuring Note (FY00), a Financial Sector Note (FY01) and a Poverty Update (FY01). More recently, two reports, the draft Country Procurement Assessment Report (CPAR) and the Country Financial Accountability Assessment (CFAA), have been discussed with the Government and action plans for their implementation have been agreed. The Bank has also recently finished a study on Regional Development and Regional Policy in Ukraine and a Public Expenditure/Institutional Review, which was discussed with the Government in February. Two policy sector notes in Health and Education are nearing completion.

UKRAINE: RELATIONS WITH THE EBRD
(As of end-February 2002)

1. Ukraine joined the EBRD in 1992 and EBRD has since then been active in supporting Ukraine's transformation toward a market economy, promoting the business environment and improving the investment climate for all investors. This has been primarily through its contribution to the funding of projects in both the public and private sectors, some equity investments, a range of technical cooperation activities and by engaging in policy dialogue with the government, especially through its membership of the Foreign Investment Advisory Council.

2. The EBRD's first country strategy for Ukraine was approved in October 1992 and was revised in November 1993. These two documents underlined the need for financing private sector projects, developing the financial sector and rehabilitating existing infrastructure. In June 1997, the Board of Directors approved a new strategy for EBRD's activities in Ukraine which included the development of the private sector, restructuring the energy sector, strengthening the financial sector, reform of key infrastructure sectors and continued efforts to improve nuclear safety in the context of the EBRD's Energy Operations Policy.

3. This period saw a considerable expansion of the EBRD's activities in Ukraine. However, it was apparent that the investment climate remained difficult, which deterred foreign direct investment and led to part of the growing private sector operating in the informal economy. In proposing its latest strategy for Ukraine, which was discussed by the Board in July 2000 and formally approved a month later, the EBRD proposed a more coordinated approach. There would be greater emphasis on policy dialogue with the Ukraine authorities, other IFIs and donor agencies to advance the country's immediate transition objectives and support the EBRD's operational strategy. Thus since the summer of 2000 the EBRD's strategy has been to focus on the following key areas:

- Strengthening of the financial sector and supporting the needs of SMEs;
- Promoting the commercialization and structural reform of public utilities, services and improving energy efficiency; and
- Supporting the transition of the enterprise sector, especially in agribusiness, consumer products, and intermediate goods.

4. In addition, the EBRD has sought to improve nuclear safety through the Nuclear Safety Account and the Chernobyl Shelter Fund initiatives, and ensure a clear understanding of the outstanding conditions to be fulfilled in respect of the K2R4 project financing to cover the completion of two nuclear power plants. This project was approved by the EBRD Board on December 7, 2000 subject to fulfillment of four conditions, namely the permanent closure of the Chernobyl nuclear power plant; a number of important safety assurances; resumption

by the IMF of the Extended Fund Facility to Ukraine; and commitments by the other institutions expected to provide funds for the project. A meeting of the Board on November 29, 2001 was due to confirm approval of the loan on the EBRD President's recommendation that the conditions had been met. The loan could then have been signed by December 6, 2001. However, at the Board meeting, the Director for Ukraine stated that, in view of issues raised by the Prime Minister of Ukraine in a letter to the EBRD President the day before, the project was not yet ready for final approval by the Board. Since then, discussions between the EBRD and the Ukraine authorities on the project have continued.

5. The EBRD's ability to implement the strategy and explore new business opportunities in the private sector has been enhanced by the decision, put into effect in 2000, to strengthen the EBRD's local office in Ukraine, including the appointment of the Director for Banking Operations in Ukraine, based in Kyiv.

6. The staff will review the progress made under the current strategy in the coming months with a view to preparing a new Country Strategy for submission to the Board of the EBRD later this year.

7. The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 51 by the end of February 2002. These amount to a historical net business volume of EUR 1,466.3 million. Of this amount EUR 1,000.6 million represented the Portfolio (operating assets plus undrawn commitments), of which 64 percent were assigned to the private sector (EUR 643.5 million) and 36 percent to the state sector (EUR 357.1 million). Operating assets amounted to EUR 418.1 million at the end of February 2002.

8. The outstanding commitments to Ukraine represent almost 5 percent of the total of the EBRD's commitments to all its countries of operation. There are in addition Technical Cooperation activities in Ukraine and these currently include 286 projects with a total value of commitments of almost EUR 47.9 million. These are mainly related to project preparation and implementation.

9. Projects in the financial sector account for slightly over 25 percent of the EBRD's commitment to Ukraine, with much of this represented by the loans provided under sovereign guarantee to support the development of small and medium size companies in Ukraine through lending via participating banks. The first of these loans (for EUR 143 million) was signed at the end of 1994, and is now almost fully disbursed. A second credit line (for EUR 52 million) was signed at the time of the EBRD's Annual Meeting in Kyiv in May 1998, but was only approved by the Rada in early 2000. The energy sector accounts for a further 25 percent of all commitments. The largest single project in this category is in the power sector; other projects include the development of oil and gas resources, gas transit and energy efficiency. Projects in manufacturing, including agribusiness, account for 26 percent, transport 13 percent, telecommunications 6 percent, municipal infrastructure 2 percent, with tourism, property and shipping accounting for most of the remaining 3 percent of all commitments.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2002 Article IV Consultation
Supplementary Information

Prepared by the European II Department

(In consultation with the Policy Development and Review Department)

Approved by Gérard Bélanger and Michael T. Hadjimichael

April 18, 2002

1. This supplement provides information on developments since the staff report was issued. The update does not affect the thrust of the staff appraisal.

2. **Parliamentary elections were held on March 31**. The pro-government coalition of parties led by the head of the presidential administration was third in party-list voting, but emerged with the largest plurality of seats in the new parliament due to strong results in the single-member constituencies. The six parties or blocs voted into parliament are currently discussing the make-up of a majority coalition, prospects for which remain uncertain. It is not clear yet whether there will be consequential changes in the government or in economic policy.

3. Preliminary data for the first part of 2002 indicate that **macroeconomic performance has continued to be encouraging.** Real GDP increased by about 4 percent in the first quarter compared to the same period last year, signaling some slowing of GDP growth in 2002 relative to 2001, in line with projections. Inflation has continued to decline, with the 12-month inflation rate falling to 2.2 percent in March from 6.1 percent in December 2001, and the consumer price index (CPI) actually fell in February and March by a cumulative 2 percent. This drop in the CPI was driven by reductions in prices for staple foods, including bread, milk, and eggs, following a significant boost in agriculture output in recent months. Other components of the CPI have largely remained unchanged. In addition, there are some indications that administrative pressures may have contributed to the fall in inflation, including a drop in the price of some staples, decreases in gas, water, and heating tariffs in several regions, and the absence of a customary increase in communal tariffs at the beginning of the year. In this context, and in the presence of continued inflationary pressures outlined in the staff report, the staff considers that it would be premature to lower the inflation target of 9.8 percent for the year 2002.

4. **Developments in the fiscal area are mixed**. Although preliminary data through end-March suggest that a small seasonal surplus was achieved (as was the case last year), information on revenue performance indicates that recent administrative measures to boost tax collections have not yet had a significant impact, with the result that central government nonearmarked revenue fell short of the official target by 0.3 percent of GDP. There are also signs that tax compliance may have deteriorated as the stock of tax arrears increased by 0.7 percent of GDP in the first two months of 2002. The authorities have reported that VAT refund arrears were reduced by Hrv 113 million through end-February. Continued delays in the privatization area may render it more difficult to achieve the revised privatization target for this year.

5. The authorities appear to have maintained prudent spending policies in the first quarter. In addition, to minimize the build-up of arrears, the government introduced a reporting and financing scheme for housing and communal services privileges. However, the government raised pensions by 10–12 percent in early April, which comes on top of earlier increases in pensions (10 percent) and wages of civil servants working in health, social protection, education and sciences (15 percent), effective from January 1, 2002. As a result, the pension fund balance is projected to turn into a deficit of 0.4 percent of GDP (from a projected surplus of 0.2 percent of GDP), heightening the need for prompt corrective action to secure the consolidated deficit target of 1.8 percent of GDP.

6. The exchange rate remains at about Hrv 5.3 per U.S. dollar, and **Ukraine's gross international reserves stand at $3 billion**, slightly below their level at end-December, but higher than projected. Monetary aggregates continued to rise in the first quarter, although not at the rapid pace of 2001. In light of the low inflation outturn, in early April the authorities further lowered the discount rate to 10 percent, and reduced the reserve requirements ratios, with the weighted average ratio falling from 11.5 percent to 10.8 percent. Given the rapid monetary expansion in 2001, and the further wage and pension increases, the authorities will need to be especially vigilant against any upturn in inflation.

7. **In the structural area**, the cash collection rate for electricity increased to 68 percent in the first quarter of 2002, from 65 percent in 2001. For gas, the cash collection rate fell to 71 percent in the first quarter from an annual rate of 87 in 2001, partly due to seasonal factors. The authorities have not yet adopted the medium-term strategy for the Savings Bank, while preparations for the third-stage audit of Naftogaz have not begun.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 02/52
FOR IMMEDIATE RELEASE

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

IMF Concludes 2002 Article IV Consultation with Ukraine

On 04/24/02, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.[1]

Background

The economic situation has continued to improve in 2001. Real GDP growth is estimated to have increased from almost 6 percent in 2000 to 9 percent in 2001, mainly on account of double-digit growth of industrial output and a good grain harvest, resulting from favorable weather conditions and a lessening of government controls in agriculture. The continued economic recovery in 2001 has been made possible by: (i) considerable idle capacity; (ii) improved competitiveness of the Ukrainian economy in the wake of the real exchange rate depreciation in 1998–99 and, through the first half of the year, further expansion of Ukraine's main export markets, in particular Russia; and (iii) the strengthening of domestic demand as a result of wage and pension increases granted in 2000–01; and (iv) the clearance of wage and pension arrears. Annual consumer price inflation declined sharply from almost 26 percent in 2000 to a rate of about 6 percent in 2001, significantly below target. This outcome reflected the downward impact of the good harvest on food prices, some delays in increasing administered prices, including for electricity, and the stable exchange rate.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the 04/24/02 Executive Board discussion based on the staff report.

Ukraine's external current account surplus narrowed from 4¾ percent of GDP in 2000 to 3½ percent in 2001, mainly because of strong import growth driven by the expansion of domestic demand. Export growth remained vigorous, but slowed in the course of the year. The competitiveness of the Ukrainian economy was preserved, as the real effective exchange rate has remained broadly stable since mid-2000. As a result of the debt-rescheduling agreement with Paris Club creditors concluded in July 2001, the debt-service burden was moderated. Ukraine has also started to benefit from transfers, including in the form of World War II compensation payments, and from increasing inflows of foreign direct investment, albeit from a comparatively low base.

The nominal exchange rate of the hryvnia remained stable in 2001. With the National Bank of Ukraine (NBU) continuing its extensive purchases of foreign exchange on the interbank market, Ukraine's official gross international reserves increased to $3.1 billion at end-December, equivalent to almost eight weeks of imports, and net international reserves turned positive, reaching $1.1 billion. Spreads for Ukrainian eurobonds are now at about 650 basis points, some 800 basis points below their levels in the first half of 2001.

Fiscal policy through end-September 2001 was broadly on track, although indicators of revenue were affected by the accumulation of arrears on VAT refunds, and privatization proceeds fell short of the budgeted amounts. While spending policies were kept under control, tax collection has been undermined by the broad tax amnesty granted in early 2001, and by the rapid accumulation of new tax arrears. The overall cash deficit of the general government is estimated at 1½ percent of GDP in 2001, compared to 1⅓ percent in 2000. The reduction of social payments arrears by end-September exceeded the target for the year as a whole, and the stock of payments arrears on energy consumption and other utilities remained at 1 percent of GDP.

Monetary policy in 2001 was dominated by largely-unsterilized foreign exchange market intervention by the NBU, and monetary aggregates continued to expand rapidly. Base and broad money grew by 37 percent and 42 percent, respectively. The strong money growth accommodated a further increase in real money demand, in line with the economic growth, the continuing remonetization of the economy, and the return of confidence in the hryvnia. During the period January–October, the NBU bought some $2.1 billion in the foreign exchange market, reflecting the strong balance of payments situation. The commercial banks boosted their lending to the economy, although real interest rates remain high.

Some progress has been made on structural reforms. Despite the successful sale of six electricity distribution companies earlier in the year and satisfactory compliance with transparency criteria, the implementation of the 2001 privatization program met with delays. In the energy sector, payments discipline has continued to improve, as a result of adequate budget allocations for energy consumption and stricter implementation of cut-off policies, but the completion of the audit of Naftogaz was delayed. The overall health of the financial system has improved in 2001, but weaknesses remain with regard to a number of banks. A new Land Code was adopted, which allows for private ownership of land in the medium term.

Executive Board Assessment

Executive Directors commended the authorities for Ukraine's strong economic performance in 2001, marked by high growth, low inflation, and an improved external position. While acknowledging that temporary factors had facilitated the positive outcome, Directors commended the authorities' contribution in protecting the macroeconomic stabilization gains. They regretted, however, that the seventh and eighth reviews under the Extended Arrangement have not been completed, owing mainly to delays in reaching understandings on appropriate fiscal measures and the requisite parliamentary approval to close the fiscal gap and on the timing and pace of clearing the outstanding value-added tax (VAT) arrears.

Directors urged the authorities to continue adhering to a prudent macroeconomic policy stance and press ahead with comprehensive and well-implemented structural reforms in order to bring about the strong and sustained economic growth that Ukraine needs to raise living standards and alleviate poverty. Firm steps to close the fiscal gap and a clear resolution of the problems associated with the VAT will be crucial initial measures for keeping macroeconomic policy on course in 2002. The prospects for economic growth in 2002 remain good, although somewhat less favorable than earlier envisaged. The authorities should, however, remain alert to potential downside risks arising from weaker external demand.

Directors noted that although the authorities met most of their fiscal program targets for 2001, they accumulated arrears of VAT refunds and privatization proceeds fell short of projections. While expressing concern about the adverse impact of the tax amnesty passed in April 2001 and the continued granting of tax exemptions and privileges, Directors welcomed the introduction of several key structural reforms in the fiscal area, including the Budget Code and improvements in tax administration.

For 2002, Directors welcomed the adoption of a budget with a deficit of 1¾ percent of GDP, but expressed concern that corrective measures remain to be put in place to compensate for possible shortfalls in revenue and privatization receipts, as well as to cover unfunded social expenditure mandates. They called on the authorities to refrain from granting wage increases not incorporated in the budget. Directors expressed concern about the deteriorating revenue performance in recent years. They urged the authorities to broaden the tax base and reduce tax distortions and tax privileges, and called on them to ensure that any Tax Code adopted in 2002 addresses these concerns. Directors also stressed the urgency of repayment of VAT refund arrears in order to safeguard the integrity of the tax system. They added that more progress is needed in developing a single treasury account that will support other reforms at the treasury including spending controls.

Directors noted that high growth in combination with an expansion of the cash economy has allowed greater room for remonetization of the economy. They called on the authorities to monitor price developments closely, and to be prepared to tighten monetary policy as necessary if inflationary pressures emerge. Directors also encouraged the authorities to manage the exchange rate flexibly.

Directors urged the authorities to pay particular attention to the financial sector in light of the recent rapid credit growth, poor capitalization of many banks, and incomplete application of prudential regulations. In this context, they suggested that the authorities should enforce supervisory regulations, improve loan evaluation procedures, and formulate and implement reform plans for the two state-owned banks. Directors welcomed the authorities' plan to participate in the forthcoming Financial Sector Assessment Program (FSAP). They urged the authorities to move ahead rapidly and ambitiously on efforts to combat money laundering and the financing of terrorism.

Directors called on the authorities to press ahead vigorously with their structural policy agenda. Measures to improve the privatization climate and to level the playing field for all investors will be crucial to overcome weaknesses in the business environment and promote private investment, including foreign direct investment, which remains quite low in Ukraine. In the energy sector, measures to resolve the debts of the companies should be developed, and efforts are needed to strengthen payments discipline further in the electricity and gas sectors. Directors urged the authorities to speed up preparations for a comprehensive and independent third stage Naftogaz audit, in line with international standards, as a crucial step toward better governance in the energy sector. They also urged the authorities to implement the actions required for World Trade Organization accession. Directors regretted that Ukrainian exporters face significant trade barriers in certain foreign markets.

Directors commended the authorities' efforts to enhance Ukraine's macroeconomic statistics and welcomed their decision to proceed with subscription to the Special Data Dissemination Standard (SDDS) by July 2002.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Ukraine: Selected Economic Indicators

	1999 Est.	2000 Prel.	2001 Prel.	2002 Proj.
	(Percent change, unless indicated otherwise)			
Production and prices				
Nominal GDP (in millions of hryvnia)	130,442	170,070	201,927	235,982
Real GDP growth	-0.2	5.9	9.1	5.0
Consumer price index (period average)	22.7	28.2	12.0	7.6
Consumer price index (end of period)	19.2	25.8	6.1	9.8
	(In percent of GDP)			
Public finance				
Consolidated government budget balance, cash basis	-2.4	-1.3	-1.6	-1.8
Of which: Primary balance	0.0	1.8	0.5	-0.1
Revenue	33.8	35.1	35.0	34.2
Expenditure	36.1	36.4	36.6	36.0
	(Annual change in percent, unless indicated otherwise)			
Money and credit				
Base money	39.2	40.1	37.4	21.0
Broad money	40.4	45.4	42.0	25.0
Net domestic assets of the banking system	34.8	13.1	20.6	19.2
Velocity (annual GDP divided by period-average broad money)	6.9	6.3	5.2	4.6
External sector				
Current account balance (in percent of GDP)	2.6	4.7	3.5	1.5
External public debt (in percent of GDP)	39.4	33.1	27.5	24.9
Debt service ratio, after rescheduling (in percent of exports of goods and nonfactor services)	16.6	10.0	6.4	6.5
Terms of trade (annual change in percent)	9.2	-8.2	1.4	-0.4
Gross reserves (end of period; in weeks of current year imports of goods and nonfactor services)	3.7	4.2	7.8	10.7

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

Statement by Yuriy G. Yakusha, Alternate Executive Director for Ukraine
April 24, 2002

My Ukrainian authorities regret that the 2001 Article IV consultation is being considered separately from the program review by the Executive Board. The authorities acknowledge the problems mentioned by staff as obstacles for the program review, and they have been addressing these problems to the extent feasible under the circumstances of a very intensive election period. The authorities hope that a reasonable compromise with staff will eventually be reached and that a proposed solution could also be supported by the newly elected Parliament, thus strengthening the country's ownership of the reform program.

Given the overall positive results achieved in the course of the program implementation, it is difficult to imagine the program expiring (this coming September) without an agreement on program reviews. The past two years, being the most successful in implementing reforms that finally reached a critical mass to produce visible positive results, have also been marked by the least frequent program reviews (one review each year instead of four under the program). There have been various reasons for every delay. The authorities have not always been able to deliver all specified structural measures exactly on time, while they have been implementing some other structural reforms outside the scope of their commitments under the program. In addition, out of the 50 structural measures of the authorities' own program (attached to their draft letter of intent) most have been implemented, or are currently being implemented. Quantitative performance criteria or even jointly (with staff) established targets (when program reviews were delayed for long enough) have consistently been met to a reasonable extent. The occasional overshooting of indicative targets of base money growth has been accompanied by disinflation and recently even by overall price deflation.

The performance of the economy in 2001 was the most successful since Ukraine's independence in 1991. Good macroeconomic indicators of GDP growth (9 percent), and consumer and wholesale price inflation (6.1 and 0.9 percent correspondingly) were achieved, alongside with the continued current account surplus, exchange rate stability and doubling of gross foreign exchange reserves (albeit from a very modest level). Real wages and pensions have also increased substantially, so far without jeopardizing budgetary targets.

Structural reforms were implemented in energy and agricultural sectors, as well as in the fiscal and other important areas (the description of some of these reforms is provided in SM/02/109 Ukraine—Selected Issues Statistical Appendix). In addition, there have been some important successes in the open and transparent privatization of large enterprises (first of all, in the energy sector), and in overall enterprise reform. The share of barter transactions in the economy further decreased (to only about 4 percent now), payment discipline was maintained and even improved on many fronts, despite several pre-election populist legislative initiatives adopted by Parliament (some of them were subsequently vetoed by the President).

Budget constraints have been hardened throughout the economy and labor productivity is estimated to have increased by at least 18 percent in 2001. The structure of both industrial production and exports improved in favor of finished goods with the higher value added component, while the performance of some sectors of the economy, notably of the agriculture, as well as of the trade and services has exceeded even the most optimistic forecasts made a year ago by domestic think tanks. It is, therefore, not entirely surprising that projections made at the time of last Article IV Consultation have proved to be rather conservative in some important aspects.

Alongside the improvement in the investment climate (overall increase in investment in 2001 was 2.6 times higher than in 2000), the authorities have undertaken additional efforts in fighting tax evasion and money laundering and the share of the so called shadow economy decreased further, which incidentally also increased demand for money.

The picture was not positive on all fronts. The authorities agree with the staff assessment on tax amnesty as having produced prolonged negative results in terms of decreased tax compliance. That was quite a high price to pay for the parliamentary adoption of a modern system of tax compliance enforcement. To this end, the authorities are strongly committed to widening a tax base and to reducing the number of tax exemptions and privileges in the context of the envisaged second stage of the tax reform and the adoption of the Tax Code.

This commitment is not expressed only in intentions. The budget revenue targets for this year are indeed ambitious. It was not possible to entirely meet those targets in the first quarter, but nevertheless the overall budget revenues increased by almost 9 percent in nominal terms and about 5 percent in real terms in January-March, the period preceding the parliamentary elections that were held on March 31. The indicative revenue target for the first quarter of this year, which was established jointly with staff, was met with some margin. Tax exemptions for joint ventures were eliminated in the process of approval of the 2002 budget. Thus, the trend of decreasing revenue to GDP ratios has already been broken in the most inopportune of times. Revenue performance improved further in April. In order to sustain this new trend it will be very important to achieve much more consistent support from Parliament for the fiscal efforts by the government. The decreased representation in the newly elected Parliament of political parties that used to vote against some of the reforms probably opens such a window of opportunity.

The staff attaches great importance to the need to eliminate arrears on VAT refunds, and so do the authorities. As soon as the problem was discovered by the authorities and preliminary identified last November in discussions with staff, they have undertaken efforts in firstly determining the possible sources of the still not fully explained rapid growth of claims for VAT refunds, and only then, after receiving much appreciated urgent technical assistance from the Fund, worked on a set of short term and longer term measures to address not only the problem itself, but also the likely sources of the problem. There has been an extensive exchange of letters with management and staff on this issue, and several rounds of discussions—the latest one today. In the process of these discussions the differences in the positions of the authorities and the staff about the feasible schedule of clearing these arrears have not been fully resolved as of yet. The bottom line of this problem lies probably in the fact that Ukraine found itself not entirely ready for all hidden pitfalls and many sophisticated tax evasion (and money laundering) opportunities offered by inconsistent implementation of probably too complex VAT legislation. Parliament made numerous changes to the tax legislation, which made it even more complicated. Just one example: many claims for refunds are coming from the industries, which currently do not pay any VAT to the budget. There have been also many instances of faulty VAT refunds claims.

The authorities also acknowledge other fiscal risks and are working with staff in order to close likely fiscal gaps. They have established some track record since 1999 in maintaining the fiscal discipline, while consistently clearing accumulated (over the previous years) budget social arrears and doing away with the quasi-fiscal operations of the energy and other sectors. Given such an established track record and the expected continuation of the flow of helpful advice from the staff, it is almost certain that this year's fiscal performance will not jeopardize the achievement of the authorities' goals of maintaining high economic growth under low inflation.

Data ROSC mission, currently in Ukraine, and the coming FSAP mission as well as a comprehensive PAL program with the World Bank are expected to help the authorities to address other problem areas, identified in the staff report.

The Ukrainian authorities appreciate the attention devoted in the staff report to the issue of trade restrictions against some of the Ukrainian exports. Traditional exports (metals first of all) indeed almost stagnated in 2001, while the exports of machinery and food staples increased more rapidly. Exports of metals likely fell sharply in the first quarter of this year. The most recent round of trade protectionism in the area of steel products can potentially create additional problems for some of the Ukrainian traditional exports. It remains to be seen whether market diversification and diversification of export products will be able to sustain the so far positive trends in the current account.

Ukraine achieved quite modest results in attracting FDIs so far. The continuation of cooperation with the Fund, and successful implementation of far-reaching reforms should make the country more attractive for domestic and foreign investors.

The authorities are discussing the issue of publication of staff reports; their final decision will depend on how the suggested factual corrections and issues of market-sensitive information are handled.