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Ukraine: Request for Stand-By Arrangement—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **December 20, 2003,** 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 11, 2004**. 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 **March 25, 2004** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its March 29, 2004 discussion** of the staff report that completed the request.

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

Letter of Intent sent to the IMF by the authorities of Ukraine*
Memorandum of Economic and Financial Policies by the authorities of Ukraine*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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INTERNATIONAL MONETARY FUND

UKRAINE

Request for Stand-By Arrangement

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

Approved by Carlo Cottarelli and Michael T. Hadjimichael

March 11, 2004

Following the 2003 Article IV consultations, discussions were held in Kyiv during June 18-30, 2003; October 1-9, 2003, December 16-20, 2003, and in Washington D.C., during July 28-August 1, 2003. The staff met with President Kuchma; Prime Minister Yanukovich; First Deputy Prime Minister and Finance Minister Azarov; the then Minister of Economy and European Integration Khoroshkovsky; Minister of Fuel and Energy Yermilov; Governor of the National Bank of Ukraine (NBU) Tihipko; Speaker of Parliament Lytvyn; other senior officials, as well as representatives of parliament; academia, business, and the diplomatic communities.

The staff participating in the discussions were E. van der Mensbrugghe (head), C. Mumssen, S. Bassett, P. Lohmus, A. Schaechter, R. Tchaidze, A. Tiffin (EUR/EU2), M. Flanagan, V. Moissinac (FAD), and L. Nielsen (PDR). The discussions were joined by A. Krueger (First Deputy Managing Director) during June 24-25, 2003; J. Odling-Smee (Director, EU2) during February 17-18 and June 23-25, 2003; and M. Deppler (Director, EUR) during December 16-17, 2003. J. Berengaut headed the mission during June 25-30, 2003. L. Figliuoli and B. Lissovolik of the Resident Representative's Office in Kyiv took part in the discussions. J. Kremers, Executive Director, and Y. Yakusha, Alternate Executive Director, attended some policy meetings.

The Ukrainian authorities have requested a 12-month stand-by arrangement, which they intend to treat as precautionary. Total access would be SDR 411.6 million (30 percent of quota). Disbursements would be on a quarterly basis and there would be one review. The details of the program are described in the attached Letter of Intent (LOI), Memorandum of Economic and Financial Policies (MEFP), and the Technical Memorandum of Understanding (TMU). The arrangement under the Extended Fund Facility (EFF) expired on September 3, 2002. At end-December 2003, Ukraine's total outstanding debt to the Fund was SDR 1,235 million (90 percent of quota).

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EXECUTIVE SUMMARY

The Ukrainian authorities have requested a 12-month stand-by arrangement, which they intend to treat as precautionary. Their economic program for 2004 aims to sustain recent stabilization gains and advance some important structural reforms. Key objectives are to support economic growth; keep inflation under control; bolster debt sustainability; maintain an adequate level of international reserves; reduce credit risk in the banking sector; and improve the investment climate, including through wide-ranging tax reforms.

The macroeconomic outlook for 2004 is favorable. Ukraine's strong economic expansion is now in its fifth year. Consumer price inflation should remain in single digits. The large current account surplus is expected to unwind, but gross international reserves should remain adequate to cover near-term external debt service.

The government aims to maintain its prudent fiscal stance. The 2004 budget law implies a consolidated deficit of 1¾ percent of GDP, allowing for the continued decline in public debt ratios. Cuts in the personal and corporate income tax rates are partly offset by the elimination of tax exemptions. The authorities aim to resolve the problem of VAT refund arrears.

Continued rapid credit growth is a risk to banking sector stability. Unsterilized foreign exchange interventions by the NBU have fuelled very rapid money and credit growth in recent years. Given a tight fiscal policy and a sharp increase in money demand, this has not translated into high inflation, but it has raised concerns about loan quality in the banking sector. These concerns are aggravated by extensive foreign-currency denominated lending coupled with a *de facto* fixed exchange rate regime. The credit boom is expected to subside somewhat this year, and the NBU is taking steps to strengthen banking supervision and prudential regulation.

Improvements in the investment climate are critical to sustain economic growth over the medium term. Several key structural reforms are being implemented in 2004, including overhauls of the tax and pension systems. Other structural reforms are monitored under the World Bank's PAL program, including steps to improve the social safety net, rehabilitate a commercial bank, reform the energy sector, and join the WTO.

Notwithstanding the positive near-term economic outlook, vulnerabilities remain. Macroeconomic stability could be undermined by potential banking sector problems, external shocks, and/or political instability (especially in the context of constitutional reform efforts and this year's presidential elections). While medium-term debt dynamics appear sustainable based on current policies, a loosening of fiscal policy combined with a large-scale assumption of non-government debt could reverse recent stabilization gains.

I. Background

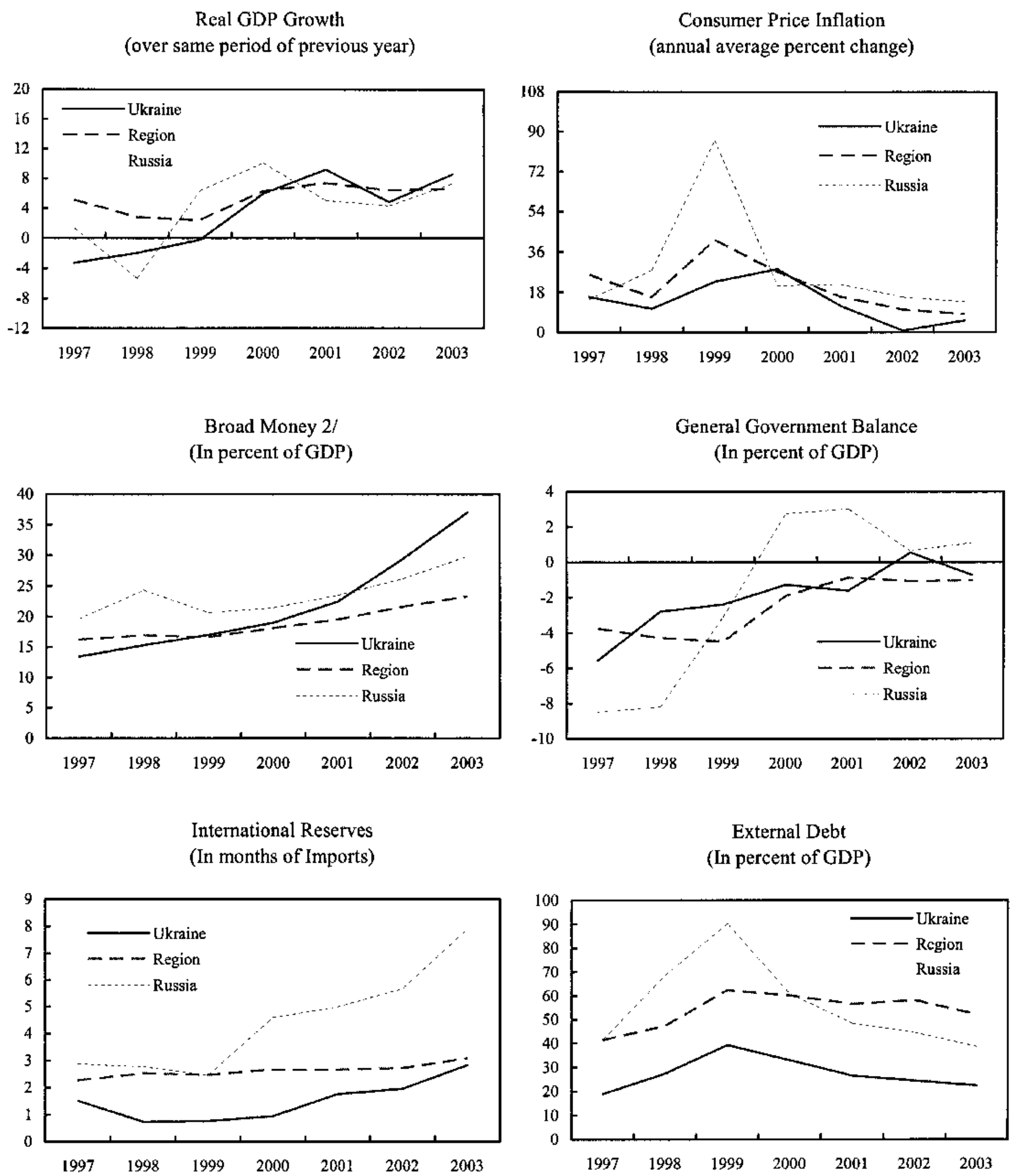
1. **The Ukrainian authorities have requested a 12-month stand-by arrangement, which they intend to treat as precautionary, with total access of SDR 411.6 million.** Their economic program is aimed at sustaining recent stabilization gains and momentum on structural reform. Discussions were initiated in late 2002, on the basis of a country strategy paper prepared by Fund staff, summarized in Box 1 of the 2003 Article IV staff report (SM/03/133). Given past difficulties in implementing key structural reforms under the EFF-supported arrangement, time was allowed to build ownership and make progress on key structural reforms prior to the arrangement. The authorities implemented several prior actions relatively quickly, but it took until late 2003 to make sufficient progress on VAT exemptions, partly reflecting resistance in parliament, and on VAT refund arrears, partly reflecting governance weaknesses. At the same time, two envisaged structural benchmarks were implemented ahead of schedule.

2. **Macroeconomic performance has improved substantially since the 1998-99 financial crisis, but vulnerabilities remain.** The sustained economic recovery that followed the deep output slump in the 1990s was supported by the sharp real exchange rate depreciation in 1998-99 and by the establishment of macroeconomic stability, in particular the maintenance of a prudent fiscal stance. This allowed a sharp reduction in public debt ratios, rapid remonetization, and the rebuilding of international reserves. These favorable trends have also been seen in other countries in the region (Figure 1). Ukraine has regained access to international capital markets and there is no immediate balance of payments need. However, international reserves adequacy could be jeopardized in case of a loss in confidence resulting from potential political instability, banking sector problems, or external shocks. Moreover, to sustain strong economic growth over the medium term, the investment climate would need to be improved, including by strengthening governance and pushing ahead with market-oriented reforms.

3. **The government's economic reform agenda has found support in parliament.** In 2003, parliament approved the government's comprehensive economic reform strategy; wide-ranging tax reforms; anti-money laundering legislation; pension reform; new civil and commercial codes; and laws that strengthen the legal framework for financial intermediation.

4. **Presidential elections are scheduled for October 2004, implying likely changes to the cabinet.** Ukraine's constitutional court recently ruled that president Kuchma could run for another term, but he has repeatedly stated that does not intend to do so. Parliament has cast a vote in favor of a constitutional reform that would shift some powers from the president to parliament. Changing the constitution would require a two-thirds majority in parliament. At this stage, it is uncertain whether the reform will pass.

Figure 1. Ukraine and the Region: Economic Indicators, 1997–2003 1/

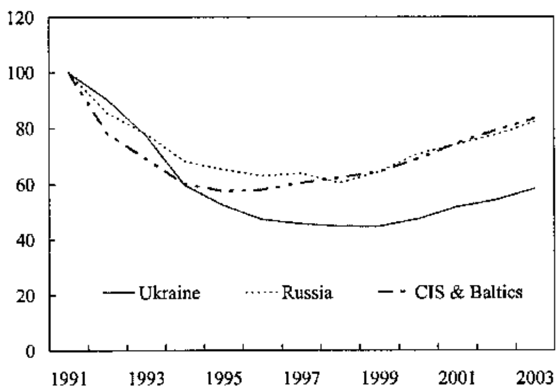


Sources: Ukrainian authorities; and Fund staff estimates.

1/ Regional data are the simple average of the CIS (excluding Turkmenistan) and Baltic countries.
2/ Includes foreign currency deposits.

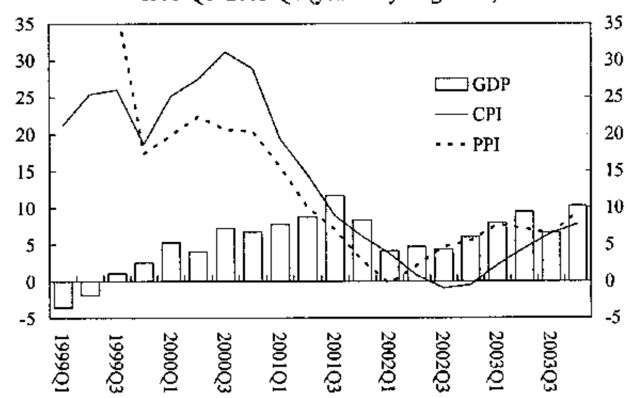
5. **Real GDP grew by an estimated 8½ percent in 2003, despite the poor grain harvest, completing the fourth year of Ukraine's strong economic recovery** (Figure 2). The expansion was driven by an 18 percent increase in manufacturing (especially metals, machinery, vehicles, and food processing), double-digit growth of transport services and domestic trade, as well as a sharp rebound in construction. Aggregate demand was supported by buoyant consumer spending, reflecting continuing strong wage growth (Table 1), and by a rebound in private investment, supported by an improved economic outlook.

Figure 2. Ukraine: Real GDP Level, 1991–2003 (1991=100)



Source: Fund staff estimates.
1/ Simple average of the CIS (excl. Turkmenistan) and Baltic countries.

Figure 3. Ukraine: GDP Growth and Inflation, 1999 Q1–2003 Q4 (year-on-year growth)

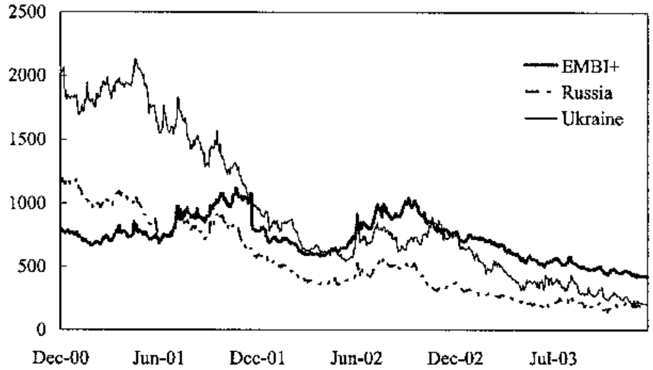


Sources: Ukrainian authorities; and Fund staff estimates.

6. **Inflation rose considerably in 2003 (Figure 3), largely due to supply-side factors.** Consumer price inflation, on a 12-month basis, rose from near zero at end-2002 to about 8 percent at end-2003, as poor weather conditions in agriculture led to a sharp increase in food prices, which account for almost two-thirds of the CPI. Excluding the most volatile food items, the 12-month inflation rate was 4½ percent at end-2003, up by less than 2 percentage points from end-2002. Producer price inflation increased to 11 percent at end-2003, partly as a result of higher food, oil, and metals prices. Continued strong growth in money demand and a tight fiscal policy helped keep inflation in the single digits, despite the very high rates of money growth.

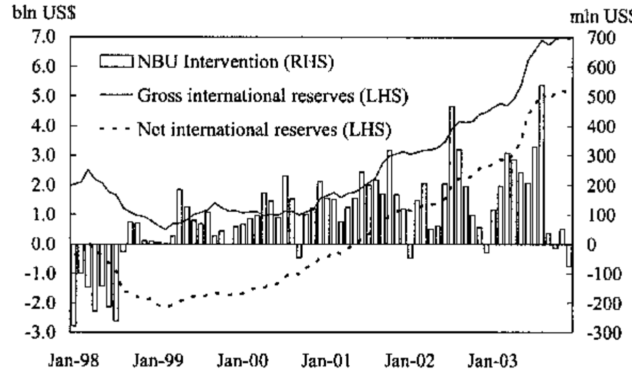
7. **The balance of payments recorded a large surplus in 2003.** The current account surplus remained high, at an estimated 6 percent of GDP. Both exports (especially energy products and chemicals) and imports (especially food) increased significantly. The capital account was boosted by US$1¼ billion in foreign direct investment and US$1 billion in sovereign 10-year Eurobond issues in June and October 2003. The issues, which contained a collective action clause, sold for a yield of 7.65 percent, benefiting from low spreads over U.S. treasury bonds (Figure 4). Two rating agencies upgraded their sovereign risk ratings for Ukraine in 2003. Gross international reserves increased to almost US$7 billion, about 3 months of imports and 3½ times one-year official external debt service, driven by over US$2 billion in net foreign exchange purchases by the NBU (Figure 5). Gross external debt of the government and central bank increased modestly in U.S. dollar terms as a result of the depreciation of the U.S. dollar against other currencies.

Figure 4. Ukraine: Eurobond Spreads for Ukraine, Russia and Emerging Markets, Dec. 2000–Dec. 2003 (Basis points)



Source: Datastream.

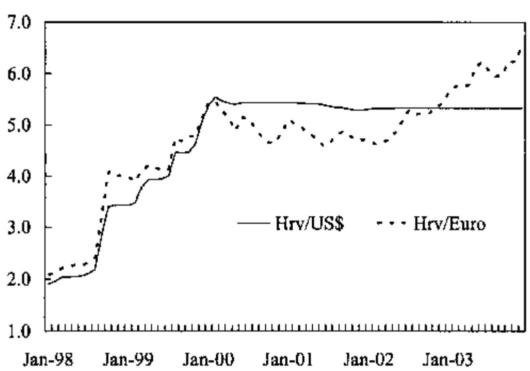
Figure 5. Ukraine: International Reserves and NBU Intervention, January 1998–December 2003



Sources: Ukrainian authorities; and Fund staff estimates.

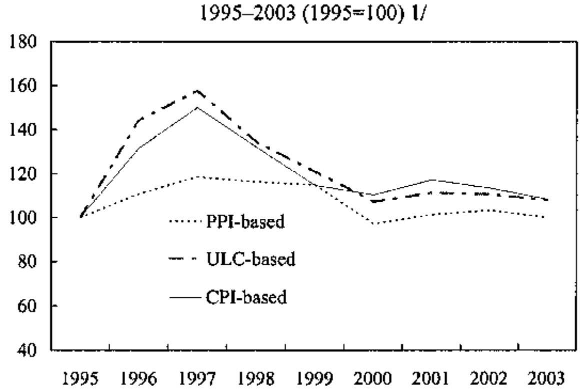
8. **NBU interventions have kept the hryvnia constant against the U.S. dollar** (Figure 6). The exchange rate has remained competitive, as reflected in relatively low wage levels and the continued large surplus on the trade and services balance. Ukraine's real effective exchange rate has remained broadly stable since the 1998-99 financial crisis (Figure 7). The annual average of the CPI-based real effective rate depreciated by almost 7 percent in 2003, partly reflecting the depreciation of the U.S. dollar against the euro and the real appreciation of the Russian ruble against the hryvnia.

Figure 6. Ukraine: Nominal Exchange Rate, January 1998–December 2003 (period average)



Source: National Bank of Ukraine.

Figure 7. Ukraine: Real Effective Exchange Rates, 1995–2003 (1995=100) 1/

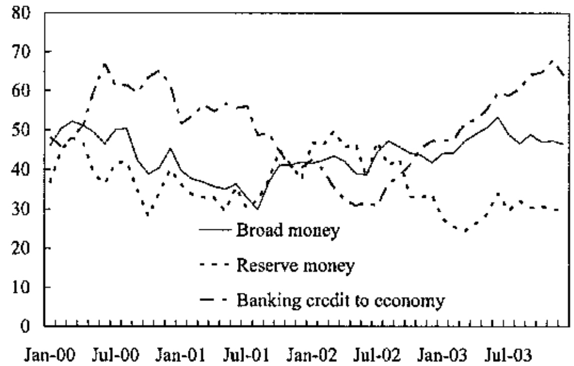


Sources: Ukrainian authorities; WEO; and Fund staff estimates.
1/ Estimates for 2003.

9. **Large unsterilized foreign exchange purchases continued to fuel rapid money and credit growth** (Figure 8). Base and broad money grew by 30 and 47 percent respectively in 2003. Deposits in commercial banks increased by 63 percent. Banking credit to the economy grew by 64 percent in 2003, raising the credit-to-GDP ratio to 28 percent at end-2003, from just under 20 percent a year earlier. The share of foreign currency loans declined only modestly, to 39 percent at end-2003. Interest rates on hryvnia loans continued to decline, but still remained high, at about 18 percent on average in December 2003 (Figure 9).

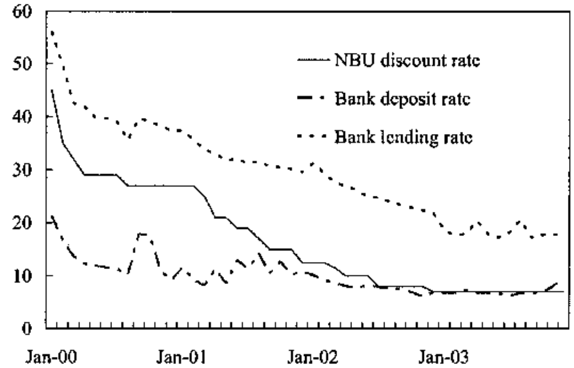
Responding to rising inflation, the NBU raised its overnight rate from 8 to 8½ percent in January 2004.

Figure 8: Ukraine: Money and Credit Developments, January 2000–December 2003 (year-on-year growth)



Sources: Ukrainian authorities; and Fund staff estimates.

Figure 9. Ukraine: Interest Rates, January 2000–December 2003 (in percent)



Source: National Bank of Ukraine.

10. **The 2003 FSSA found that the rapid rate of credit growth had weakened banking sector capitalization and contributed to high credit risk (SM/03/148).** To enhance banking sector capitalization, the NBU has strengthened loan classification rules and decreed to increase the minimum capital adequacy ratio from 8 to 10 percent, effective from March 2004.

11. **Budget execution improved significantly in 2003, resulting in a consolidated deficit of ¾ percent of GDP.** Revenues were boosted by stronger-than-expected economic growth and central government expenditures reached the overall budgeted level, a major break with Ukraine's long history of expenditure sequestration. The public sector wage bill continued to rise faster than nominal GDP, partly due to the need to restore relative wage scales, following the January 2003 minimum wage increase. The government contained future wage growth by obtaining parliamentary approval of postponing the 28 percent minimum wage increase planned for July 2003 to December 2003, and reducing it to 11 percent. Pension increases were broadly in line with inflation.

12. **Progress has been made in addressing VAT refund arrears.** For the first time in years, the stock of refund arrears was reduced in 2003, to about ¾ percent of GDP. The size of the reduction (almost ½ percent of GDP) was well above the floor specified as a prior action under the program. The government has embarked on a one-off securitization of the remaining arrears, offering taxpayers 5-year interest-bearing bonds as payment. Arrears on wages and social assistance for families, which had increased in 2002, were almost fully cleared.

13. **Ukraine's tax and pension systems are being overhauled.** Effective January 2004, the corporate income tax rate was reduced from 30 percent to 25 percent, and the progressive personal income tax schedule was replaced with a single 13 percent rate. The tax base has

been broadened significantly with the elimination of many tax preferences[1] (Box 1). Parliament also approved laws on mandatory state pensions and voluntary private pensions, after more than four years of preparation. The laws reform the current pay-as-you-go pension system, improving its equity and rationalizing privileges, and establish a framework to allow for a gradual transition to a three-pillar pension system.

14. **Progress on energy sector reform has been modest.** Quasi-fiscal operations in the energy sector remain significant, although the cash collection ratio increased in the electricity sector in 2003 (91 percent compared to 83 percent in 2002) and in the gas sector (91 percent compared to 89 percent in 2002). The state-owned gas company *Naftogaz* paid its obligations to the budget in full for the first time in years, largely reflecting the introduction of a zero VAT rate for imports of natural gas. Efforts to privatize electricity distribution companies and address the large stock of debts in the energy sector have been delayed.

15. **Ukraine's legal system has been strengthened.** Creditor rights and the legal framework for financial intermediation were improved by the adoption of new civil and commercial codes, as well as a law on mortgages. The recently adopted telecommunications law sets up an independent regulator and provides a legal basis for future privatization and regulation of the sector. Privatization receipts in 2003 were boosted by the sale of a mobile phone company.

II. Policy Discussions on the 2004 Program

A. Program Objectives and Risks

16. **The authorities' economic program for 2004 aims to sustain Ukraine's recent macroeconomic stabilization gains and maintain the momentum on growth-oriented structural reforms.** No immediate balance of payments need is expected, although potential domestic or external shocks (discussed below) could undermine international reserve adequacy. Moreover, the authorities believe that a Fund-

Ukraine: Key Economic Indicators, 2001–2004

	2001	2002	2003 Est.	2004 Prog.
	(Percent change)			
Real GDP	9.2	4.8	8.5	6.0
Consumer prices, eop	6.1	-0.6	8.2	6.0
Broad money, eop	41.9	41.8	46.5	24.1
	(In percent of GDP)			
Budget balance, cash basis	-1.6	0.5	-0.7	-1.8
Current account balance	3.7	7.7	6.1	3.7
	(In months of imports)			
Gross Reserves	1.7	1.9	2.8	3.0

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

[1] The term "tax preferences" is used throughout the report and the attached MEFP to refer to all non-standard tax exemptions and other tax privileges (such as reduced rates), which are also sometimes called "tax expenditures" to highlight their budgetary cost.

supported program would facilitate the coordination of macroeconomic policies and help signal a strong commitment to achieving their economic goals.

17. The main program objectives are to:

- **Support sustained economic growth.** The 2004 budget is based on a conservative projection of about 5 percent real GDP growth. Higher growth is quite possible, given the improved business outlook. To sustain economic growth over the medium term, the authorities aim to improve the investment climate by strengthening governance, reforming the tax system, strengthening the financial sector, and achieving WTO membership.

- **Keep inflation under control.** The objective for 2004 is to reduce consumer price inflation to the mid-single digits. This is likely to require a tighter monetary policy and the maintenance of prudent fiscal policies, although the high volatility of food prices implies significant uncertainty about the CPI outlook.

- **Reduce vulnerabilities.** Executing the 2004 budget and maintaining a low deficit thereafter will support the continued reduction in public debt ratios, providing a safety net for potential fiscal costs of future structural reforms or economic shocks. Addressing the financial problems of the energy sector will help reduce quasi-fiscal deficits and contingent liabilities. The authorities' international reserves target of 3 months of import coverage is equivalent to about 4 times external official debt service and to about two times foreign currency deposits in the banking sector. To reduce credit risk in the banking sector, the NBU is strengthening prudential regulations and banking supervision with a view to discourage imprudent lending practices.

18. **Achieving these objectives will enhance prospects for medium-term growth and stability.** Under the baseline scenario, real GDP growth would average about 4 percent per year during 2005-2008 (Table 2), almost 5 percent on a per capita basis. The current account surplus would gradually unwind, as investment and foreign capital inflows increase over time (Table 3). International reserves are targeted at 3 months of imports, which should ensure adequate coverage of official debt service. Public debt ratios would continue to decline, from 32 percent of GDP in 2003 to below 20 percent of GDP in 2008.

19. **Most vulnerability indicators have improved (Table 4), but stabilization gains could be reversed in case of banking sector problems, political instability, and/or external shocks.**

- A key area of risk is Ukraine's banking sector. A sustained lending boom, a limited role played by international banks, inadequate regulation of connected lending, extensive foreign-currency denominated lending in the context of a *de facto* fixed exchange rate – these are features that have eventually led to banking crises in a number of other countries. While the program addresses this problem in part by raising minimum capital adequacy requirements and tightening insider lending rules, the rapidly expanding banking sector will remain a significant source of risk.

- Political risk remains substantial, especially in the context of the proposed constitutional reform and the run-up to the October 2004 presidential elections. A politicized environment could undermine macroeconomic management and is likely to slow down the structural reform process. In the short term, this could weaken domestic confidence and put pressure on international reserves and/or the exchange rate. Over the medium term, if combined with fiscal loosening and/or a large-scale assumption of non-government debt (such as energy sector debt), it could jeopardize economic growth and debt sustainability (Appendix IV).

- External shocks, such as lower demand for Ukrainian exports or a deterioration in international capital market sentiment, could lead to a sharp reversal in the balance of payments position, jeopardizing reserve adequacy.

B. Fiscal Policy and Reform

20. **The government intends to maintain a prudent fiscal policy stance.** The 2004 budget law provides for a central government deficit of 1½ percent of GDP, and the program aims to keep the consolidated cash deficit of the general government at about 1¾ percent of GDP.[2] The deterioration in the consolidated balance of about 1 percent of GDP is broadly explained by the acceleration in arrears clearance, the projected increase in foreign project financing, and an increase in interest expenditure (Table 5). Taking into account arrears clearance, the consolidated deficit would be about ¾ percent of GDP, implying a primary surplus on a commitments basis. Under baseline assumptions, this would reduce total debt of the government and central bank from about 32 percent of GDP at end-2003

Ukraine: Consolidated Government Finances, 2001–2004
(In percent of GDP)

	2001	2002	2003 Est.	2004 Prog.
Revenue and grants	33.5	36.8	37.7	37.3
Expenditure	35.1	36.3	38.5	39.0
o/w: Interest payments	2.0	1.3	1.0	1.4
Overall cash balance	-1.6	0.5	-0.7	-1.8
Commitments balance 1/	-1.5	0.2	0.1	-0.8
Financing	1.6	-0.5	0.7	1.8
Net external	0.4	-0.7	0.8	0.4
Net domestic	-0.1	-0.3	-1.2	0.5
Privatization	1.3	0.5	1.1	0.8

1/ Cash balance adjusted for net change in arrears and non-cash property income.

[2] Owing to data limitations, estimates of a consolidated public sector deficit, including public enterprises, are not available. Fund staff estimated the quasi-fiscal deficit of the energy sector at about 3½ percent of GDP in 2002. As the deficit was partly financed through tax arrears and budgetary subsidies, the combined public sector balance for 2002 (including energy enterprises) was 1½ percent of GDP below the consolidated budget balance (IMF Country Report No. 03/172), the bulk of which was financed through arrears to suppliers.

to about 28 percent by end-2004.[3] The reduction in public debt ratios during the current economic expansion will create room to finance future structural reforms and to cope with the fiscal consequences of a potential economic downturn. The authorities intend to submit a 2005 budget that would allow for a further consolidation of debt sustainability. The size of the deficit, to be discussed at the time of the review, will depend on the outlook for aggregate demand, the speed and cost of structural reforms, and the revenue outlook based on recent and planned tax reforms.

21. **The sweeping tax reforms (Box 1) imply greater than usual uncertainty about the fiscal revenue outlook for 2004.** Aiming for revenue neutrality, the government delayed the envisaged reduction in the VAT rate, while suspending some key sectoral VAT exemptions already this year. On this basis, the steep reductions in corporate and personal income tax rates, effective since January 2004, are projected to be broadly offset by the reduction in tax exemptions (Box 1) and additional revenue measures, including a heating surcharge and higher customs fees.

22. **Non-interest expenditure of the consolidated budget is projected to grow in line with GDP.** The budget provides for a reallocation of spending, with additional spending on capital spending (including road construction) and social spending. Direct subsidies for coal and agriculture have also been increased, to about ¼ percent and 1 percent of GDP respectively, while spending on goods and services has been curtailed. Despite the reduction in public debt, interest expenditure is set to rise this year, due to the inflation indexation of restructured treasury bills held by the NBU and the securitization of VAT refund arrears.

23. **The government intends to clear the entire stock of VAT refund arrears in 2004.** Staff welcomed this intention and stressed the importance of remaining current on refund claims, in order to address governance concerns, strengthen tax compliance, and remove distortions in international trade. In early 2004, the government initiated a one-off securitization of VAT refund arrears, offering taxpayers interest-bearing five-year government bonds with equal annual amortization payments for all valid refund arrears outstanding prior to November 1, 2003. The interest rate is currently about 8½ percent, based on a markup over the NBU discount rate (currently 7 percent). The secondary market value of the bonds is expected to be below face value, given a relatively illiquid domestic securities markets and an average yield on 18-month treasury bills of 11½ percent in 2003. To remain current on refund claims, the authorities will employ more risk-based audits of tax payers and allow greater automaticity in making refunds. The staff welcomed some of the proposals, while cautioning against the introduction of individual taxpayer VAT accounts, given the additional administrative burden. The staff also questioned whether the authorities' action plan would suffice to resolve the arrears problem, stressing the need to strengthen governance in the tax administration, including by holding it more accountable for processing valid claims on time and improving the coordination between the relevant government agencies.

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[3] This excludes contingent liabilities (energy debts alone were estimated at 12 percent of GDP at end-2002), and assumes that no new IMF purchases are effected.

Box 1: Tax Reforms

Effective January 2004, the corporate income tax rate has been reduced to 25 percent, from 30 percent. The rate schedule of the personal income tax, with a top marginal rate of 40 percent and an effective tax rate of about 17 percent, has been replaced by a single rate of 13 percent and a tax credit equivalent to 30 percent of the minimum wage. The VAT rate is scheduled to be reduced from the current 20 percent to 17 percent in 2005, and 15 percent in 2006.

At the same time, tax preferences have been cut significantly in 2003 and 2004, reducing their fiscal costs to 2¾ percent of GDP in 2004, compared to 4½ percent of GDP in 2002. The main profit tax exemptions were eliminated or suspended by the 2003 and 2004 budget laws. The personal income tax base has been broadened to include interest income and a wider definition of capital gains, while occupation-based tax exemptions have been replaced by equivalent budgetary payments to beneficiaries. Many sectoral VAT exemptions have been suspended, including for aircraft production, housing construction, shipbuilding, and some pharmaceutical goods.

Tax Preferences (in percent of GDP) 1/

	2001 est.	2002 est.	2003 est.	2004 proj.
Total revenue forgone	4.3	4.5	3.2	2.7
Enterprise profit tax	1.3	0.8	0.4	0.3
Personal income tax	0.3	0.3	0.3	0.0
VAT	2.1	2.5	1.9	1.6
Import duties	0.2	0.3	0.2	0.3
Land tax	0.5	0.6	0.4	0.4
Excises	0.0	0.0	0.1	0.1

Sources: Finance Ministry, State Tax Administration, and staff estimates
1/ Excludes exemptions for social security contributions; uses new tax rates in 2004.

The reforms of the corporate and personal income tax regimes are estimated to result in a net revenue loss of about 1 percent of GDP, reflecting a loss of about 2 percent of GDP due to rate reductions and about 1 percent of GDP gained through base broadening. The planned VAT rate reduction in 2005 would reduce revenue by about 1 percent of GDP, which is projected to be largely offset by the elimination of VAT preferences, while the additional rate reduction in 2006 would reduce the revenue base by another ½ percent of GDP.

24. **The authorities intend to continue reforming the tax system.** The revenue impact of the reduction in the VAT rate scheduled for January 2005 would be partly offset by a reform of the highly preferential VAT regime for agriculture and the elimination of other sectoral VAT exemptions. To make the cost of the remaining tax preferences transparent, the authorities will continue to include a tax expenditure budget for information in the annual budget submission. As one option to reduce the shadow economy, the authorities have considered the possible legalization and taxation of previously undeclared assets and income, but have not decided whether to pursue such a scheme. Staff cautioned about the risks to future tax compliance, and the authorities stressed that they will not write off existing tax obligations (tax arrears were equivalent to about 5 percent of GDP at end-2003).

25. **Expenditure controls are to be strengthened further.** As of January 2004, the treasury system covers all local governments. A system of monitoring social entitlements is also being introduced. The government intends to address the problem of unfunded social entitlements and rationalize eligibility for social benefits by defining the principles for replacing in-kind benefits with cash subsidies.

26. **Wide-ranging pension reforms have been initiated.** Based on the recently approved law on mandatory pensions, pensions in the existing pay-as-you-go system are recalculated based on a new framework that uses lower accrual rates, lengthens the period for determining pensionable income, introduces below-wage indexation of pensions, and tightens eligibility for disability pensions and early retirement. Combined with measures to widen the contribution base, this would allow for a sustainable pension system, even though the reform does not address the low retirement age (60 for men and 55 for women). The recalculation of pensions should result in a one-off increase in expenditure in 2004, due to the abolition of pension ceilings. The envisaged transition to a three-pillar system will be phased in gradually at a later stage, in line with progress on strengthening the institutional environment.

C. Monetary Policy and Financial Sector Reform

27. **The authorities are aiming to preserve single-digit inflation.** The NBU remains confident that the rapid expansion of monetary aggregates in recent years has been consistent with money demand growth (Box 2). In the authorities' view, the increase in inflation in 2003 resulted from one-off supply-side factors, in particular the effect of a poor grain harvest on food prices, and should be partly reversed in 2004. However, if inflation pressures mount, the NBU is prepared to tighten monetary policy, including by issuing certificates of deposits and/or scaling down the pace of foreign exchange purchases, which may require exchange rate flexibility. The NBU also intends to keep its overnight refinancing rate above inflation. These policies should ensure that inflation returns to the mid-single digits by end-2004.

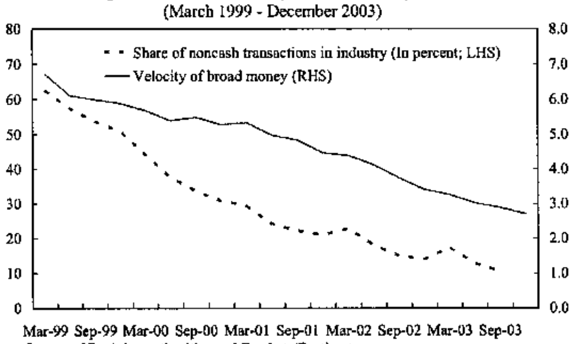
28. **The NBU does not foresee a change in its exchange rate policy in the near term.** The staff recommended to introduce greater exchange rate flexibility, especially in the context of a relatively strong balance of payments position. Exchange rate flexibility would help discourage imprudent lending practices, and may become necessary if inflation pressures rise, credit risk in the banking sector worsens, or in case of a negative balance of payments shock. The authorities felt that the current exchange rate regime was adequate for the time being and that the introduction of alternative monetary policy regimes, such as money or inflation targeting, would be premature, given uncertainties about money demand and the absence of a stable transmission mechanism. They agreed, however, that exchange rate flexibility may become necessary in case of economic shocks.

29. **The monetary program for 2004 entails a slowdown in money and credit growth** (Table 6). Given the difficulty in projecting money demand in Ukraine, the timing and speed of the slowdown are subject to significant uncertainty. The program ensures that base money growth will continue to reflect primarily the build up in net international reserves of the NBU, while net domestic assets are kept broadly constant.

Box 2: How Problematic is the High Pace of Money and Credit Growth?

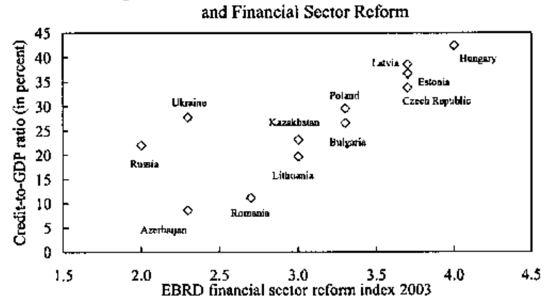
In the three years to end-2003, broad money grew by an average of 43 percent per year, while inflation remained in single digits, as velocity declined from 5.3 to 2.7. The increase in demand for hryvnia was evidenced by the large balance of payments surplus, which was the main driver of base money growth. Key factors underlying the remonetization process were: (a) renewed confidence in the hryvnia, due to the restoration of macroeconomic stability following the 1998-99 crisis; (b) the rapid decline in noncash payments (Figure 10); (c) the public's greater confidence in the banking sector; and (d) repatriation of capital, supported by the improved macroeconomic outlook. Looking ahead, money demand growth is likely to slow down, as the scope for further sizeable reductions in velocity without significant deepening of the financial sector appears limited. Combined with a modest relaxation of the fiscal stance, this would imply the need for a deceleration in monetary growth to keep inflation low.

Figure 10. Ukraine: Velocity and Noncash Payments
(March 1999 - December 2003)



Sources: Ukrainian authorities and Fund staff estimates.

Figure 11. Transition Economies: Credit-GDP Ratio 1/
and Financial Sector Reform



Sources: International Financial Statistics; EBRD Transition Report 2003; and Fund staff estimates.
1/ Nongovernment credit, excluding credit to nonbank financial institutions.

Whereas inflation has remained broadly under control, years of rapid monetary and credit growth have raised serious concerns about credit risk in the banking sector, as highlighted in the 2003 FSSA. The authorities see the recent credit boom primarily as a result of a "catch-up" process, following the 1998-99 crisis. However, Ukraine's credit-to-GDP ratio is now well within the average range of the more advanced transition countries and above average for transition countries with similar institutional quality in the financial sector (Figure 11). This observation remains broadly true even when GDP is corrected for the underestimation of the shadow economy. Going forward, it implies that continued high credit growth cannot easily be justified on the basis of any catch-up mechanism.

More importantly, the *speed* of the recent credit expansion entails significant risks, irrespective of the overall level of credit. The increase in Ukraine's credit-to-GDP ratio over the last three years, at an annual average of about 5 percentage points, was among the highest of the transition countries. While the increase in credit was primarily funded through rapid deposit growth, there was also an increase in short-term foreign borrowing by Ukrainian banks. Lending booms of similar scale have preceded some of the financial sector crises in other emerging markets, partly because risk assessments of individual loans tend to suffer in times of very rapid loan growth. Imprudent lending practices are of particular concern in Ukraine because of insider lending practices (to be addressed under program conditionality) and extensive foreign currency-denominated lending in the context of a *de facto* fixed exchange rate, including to borrowers without significant foreign exchange income. The continuously high share of nonperforming loans (defined as substandard, doubtful, and loss) in Ukraine, at about 26 percent of total loans at end-August 2003, suggests that new loans have continued to be extended to risky borrowers. Banking supervision is still in need of strengthening and the share of foreign ownership in the banking sector is low (at about 11 percent of statutory capital) compared to other transition economies.

30. **The NBU plans to implement key recommendations of the FSSA to mitigate credit risk in the banking sector.** Staff stressed that banking sector problems could have significant macroeconomic implications, with banking assets now equivalent to about 40 percent of GDP, although balance sheet problems may only become apparent once the lending boom subsides and/or in case of a major change in the exchange rate. The authorities were not convinced that the credit expansion in recent years has been excessive (Box 2), but they acknowledged the need to reduce credit risk and ensure an adequate capitalization of banks. In addition to raising the minimum capital adequacy ratio from 8 to 10 percent, effective March 1, 2004, the NBU is planning to tighten the rules for capital formation, further restrict related-party lending, and strengthen banking supervision, supported by IMF technical assistance. In addition, steps to develop the domestic securities market should promote the diversification of banking assets and enhance monetary policy instruments. The authorities are also implementing anti-money laundering initiatives, in line with FATF recommendations, and are seeking to be removed soon from the list of noncooperative jurisdictions. The NBU has decided to cancel its long-term lending facility, effective April 2004.

31. **The authorities are working with the World Bank on the financial rehabilitation of a commercial bank.** In July 2003, the NBU signed a Memorandum of Understanding with a commercial bank and the World Bank that calls for a due diligence report and a business plan, while imposing interim operational constraints, including on loan growth and operating costs.

D. Other Structural Reforms

32. **The World Bank is supporting a range of reforms in the energy sector.** The authorities are targeting a further increase in cash collection ratios for 2004, 92 percent for gas and 95 percent for electricity, which should help reduce quasi-fiscal operations in these sectors. The government is planning to introduce procedures to monitor the size of these deficits more precisely. The results are to be presented in the context of the 2005 budget and should provide insights into the appropriateness of current tariff levels. The government is working with the World Bank to improve the quality and scope of audits of *Naftogaz*, although the first fully consolidated audit of the entire holding company is not expected before 2005. In consultation with the World Bank, the authorities are aiming to improve the effectiveness of the energy sector regulator and are preparing legislation on the resolution of energy sector debt, which should facilitate sector restructuring and help attract private investors.

33. **Ukraine aims to join the WTO this year.** The resulting progressive trade liberalization coupled with ongoing efforts at implementing EU standardization will help to strengthen Ukraine's trade regime. Specific reforms needed for WTO accession are monitored under the World Bank's PAL program.

34. **The authorities are planning to accelerate the privatization process.** Their draft medium-term privatization program would further reduce state ownership in the economy, by reducing the number of companies currently excluded from privatization; by restructuring

some strategic enterprises to enhance their attractiveness to strategic investors; and by accelerating the sale of minority stakes. Land reforms are continuing, with improvement in registration and titling, preparing the institutional framework for a functioning land market.

35. **Broad-based efforts to strengthen governance will be critical for sustaining economic growth over the medium term.** The perception of widespread corruption—Ukraine ranked 106th out of 132 countries in *Transparency International's* Corruption Perception Index in 2003—and the lack of transparency in areas such as the gas sector and tax administration have continued to undermine the business environment.

III. Financing Needs, Access, and Capacity to Repay the Fund

36. **Ukraine's balance of payments position is expected to remain strong in 2004.** External program financing of about US$1 billion is projected to be provided through World Bank and EU disbursements, and the issuance of new Eurobonds (Table 7). Under baseline assumptions, this would be sufficient to maintain an adequate level of international reserves. However, potential external and domestic shocks (discussed in Section II.A) could lead to recourse to exceptional balance of payments financing.

37. **The authorities intend to treat the proposed stand-by arrangement as precautionary.** Access under the proposed 12-month arrangement would be SDR 411.6 million (30 percent of quota), evenly phased (Table 8). The proposed level of access is broadly in line with other recently approved precautionary stand-by arrangements. Should the need arise to draw on the resources made available under the proposed stand-by arrangement, the staff is confident that Ukraine could meet its obligations to the Fund. Under the proposed purchase schedule, Ukraine's liabilities to the Fund would peak at 99 percent of quota (Table 9) at end-2004. Annual debt service to the Fund would peak in 2007, equivalent to 2 percent of exports or 7 percent of gross official reserves in the baseline scenario.

IV. Program Monitoring

A. Fund Conditionality

38. **Macroeconomic performance under the proposed arrangement will be evaluated on the basis of quarterly quantitative performance criteria.** These include (a) ceilings on the cash deficit of the general government; (b) ceilings on the stock of budgetary arrears on wages, pensions and benefits; (c) ceilings on the stock of VAT refund arrears; (d) ceilings on the net domestic assets of the NBU; (e) floors on the net international reserves of the NBU; and (f) ceilings on external debt contracted or guaranteed by the government or NBU. The proposed performance criteria for end-March and end-June 2004 and indicative targets for end-September and end-December 2004 are shown in Table 2 of the MEFP (Attachment I), alongside indicative targets for base money, nonearmarked revenue of the central government, and cash collection ratios for electricity and gas. A continuous performance criterion applies to the non-accumulation of external arrears. Definitions, adjustment mechanisms, program exchange rates, and reporting requirements are specified in the TMU (Attachment II).

39. **One review is scheduled under the arrangement** (Table 8). A particular focus of the review—scheduled for completion by September 2004—will be the implementation of measures to further strengthen the banking system. The review will also focus on fiscal and monetary developments, the implementation of recent tax reforms, measures to develop the domestic securities market, and on quasi-fiscal deficits in the energy sector. Quantitative performance criteria for end-September 2004 and end-December 2004 will be established at the time of the review.

40. **Structural conditionality (Table 1 of the MEFP) focuses on a few areas that are critical for achieving the program's objectives**:

- **Tax reform** is intended to help improve the investment climate, shrink the shadow economy, and boost long-term economic growth. Following major reforms of the personal and corporate income tax systems, the authorities have suspended sectoral VAT exemptions (prior action) and have put forward a major reform of the VAT law, eliminating key sectoral tax preferences (structural performance criterion). The transparency of tax preferences has been enhanced through submitting a tax expenditure budget for information (prior action). The stock of VAT refund arrears was reduced in 2003, and the 2004 budget provides for the clearance of the remainder of the stock (prior actions).

- **Public expenditure reform** is covered extensively under the World Bank's PAL program, including on pensions and social privileges. In addition, to contain the public sector wage growth, parliament postponed a planned minimum wage increase (prior action). The expansion of the treasury system (an envisaged structural benchmark that has already been implemented) should help to improve expenditure control at the local government level.

- **Credit risk in the banking sector** has been highlighted as a key challenge in the 2003 FSSA. To strengthen banks' capitalization, the NBU has raised the minimum capital adequacy ratio from 8 to 10 percent (prior action). The NBU also intends to tighten insider lending regulations (structural performance criteria). The elimination of the NBU's long-term refinancing facility (an envisaged structural benchmark that has already been implemented) should reduce distortions in the credit market.

- **Vulnerabilities related to public debt** have been reduced in recent years, as debt ratios have has fallen substantially. In addition, the authorities are planning to develop the domestic government securities market (structural benchmark), partly to reduce the reliance on external borrowing. To mitigate risks arising from contingent liabilities, the government plans to strengthen the monitoring of financial problems in the energy sector (structural benchmark) and achieve a further increase in cash collections (indicative target), with a view to controlling quasi-fiscal operations.

41. **A full safeguards assessment of the NBU is underway.** The authorities have already submitted most of the required documentation and the assessment should be concluded by the time of the review.

42. **As of February 2004, Ukraine was under upper-credit tranche stand-by or extended arrangements 81 months out of the last 120 months.** Under the proposed arrangement, Ukraine would be classified as a prolonged user of Fund resources in June 2004. Program design for the proposed arrangement reflects the conclusions of a country strategy paper, discussed with the authorities, which evaluated the EFF that expired in September 2002.

B. Collaboration with the World Bank

43. **The World Bank's PAL program covers a broad range of structural reforms that are relevant to the success of the government's macroeconomic objectives.** This includes steps to improve the targeting of social assistance; strengthen the social and financial viability of the pension system; enhance the effectiveness and accountability of the state tax administration; strengthen the financial position of the state-owned commercial bank; improve the quality and coverage of *Naftogaz* audits; implement an energy debt restructuring plan and privatize the remaining state-owned *oblenergos*; improve the transparency of the privatization process; improve the legal system to strengthen creditor and shareholder rights; establish a unified registration for land and real estate ownership; and prepare for WTO membership. The World Bank disbursed the first tranche (US$75 million) of its US$250 million PAL II loan in December 2003.

V. Staff Appraisal

44. **The macroeconomic outlook remains favorable.** The broad-based economic recovery following the 1998-99 financial crisis has been very strong and sustained. Inflation has been reduced to single digits. Fiscal discipline has helped restore public debt sustainability. Renewed confidence in macroeconomic stability has contributed to a strong balance of payments, the remonetization of the economy, and the rebuilding of international reserves. These basic trends are expected to persist in the near term.

45. **The authorities' program is designed to sustain macroeconomic stabilization gains and advance growth-oriented structural reforms.** The program supports continued economic growth and should also help to counter inflation pressures. Maintaining a low budget deficit will bolster debt sustainability and public confidence in macroeconomic stability. The structural reform agenda should help alleviate credit risk in the banking sector and improve the investment climate, enhancing long-term growth prospects.

46. **Program ownership has been strengthened with the approval of key structural reforms.** Parliament has approved the government's economic reform strategy, as well as wide-ranging tax and pension reforms. The staff welcomes the improved collaboration between various executive and legislative bodies, which enabled the implementation of prior actions on reducing VAT exemptions and refund arrears, restraining public sector wage growth, strengthening banking sector capitalization, and adopting an appropriate budget for 2004, as well as the early implementation of envisaged structural benchmarks related to the expansion of the treasury system and the termination of the NBU long-term financing facility.

Building on these achievements, the authorities should strive to consolidate program ownership further, with a view to implementing their remaining structural reform agenda.

47. **The 2004 budget is consistent with the preservation of macroeconomic stability.** The relatively low budget deficit will bolster debt sustainability at a time of strong macroeconomic performance, creating room for the potential fiscal costs of future structural reforms or economic shocks. In light of the potential revenue impact of the proposed reduction in the VAT rate, it will be important to keep spending under control, in particular with respect to wages, pensions, and sectoral subsidies.

48. **The staff welcomes the recent tax and pension reforms.** The reduction in corporate and personal income tax rates, coupled with a significant reduction in tax exemptions, should help level the playing field for taxpayers and improve the investment climate. The postponement of the envisaged VAT rate cut was prudent, given greater-than-usual uncertainty about fiscal revenues this year, and the authorities are commended for their efforts to curtail sectoral VAT preferences. The staff welcomes the recent reduction in VAT refund arrears and the authorities' intention to resolve the issue, and believes that sustained efforts are necessary to remain current on refund claims. The government's aim to shrink the shadow economy is welcome, but tax amnesties should be avoided in light of the inherent risks to future tax compliance. Following recent progress on pension reform, the authorities should work with the World Bank on additional measures to strengthen the social safety net.

49. **The NBU needs to be vigilant with respect to inflation and credit risks.** Money and credit growth will need to slow down to mitigate these risks. The recent increase in the overnight refinancing rate was a step in the right direction. The staff has advised the authorities to introduce greater exchange rate flexibility, which would also help discourage imprudent lending practices. Strengthening prudential regulations and banking supervision, including through increasing the minimum capital adequacy ratio and tightening insider lending rules, will be critical to alleviate credit risk in the banking sector. The staff welcomes the elimination of the NBU's long-term lending facility.

50. **Sustained economic growth will require further structural reforms aimed at improving the investment climate.** Apart from the implementation of tax reforms, this should include efforts to strengthen governance; improve the social safety net; enhance transparency and reduce quasi-fiscal operations in the energy sector; intensify efforts to combat money laundering; join the WTO; and make the privatization process competitive and transparent. Collaboration with the World Bank under the PAL program should help support many of these reforms.

51. **There are a number of risks to the program.** Political risk remains substantial, especially in the run-up to the presidential elections, which could adversely affect program implementation. Fiscal loosening and/or a spillover of quasi-fiscal liabilities could reverse recent debt sustainability gains. A relapse into higher inflation could undermine public confidence in macroeconomic stability, possibly triggering a shift back into foreign currency. The rapid expansion of bank lending in a weak institutional context is a significant risk to financial sector stability. External vulnerabilities remain, especially with respect to a potential

decline in demand from key trading partners. Failure to strengthen governance and establish a more stable tax environment could undermine Ukraine's medium-term economic prospects.

52. **On balance, the authorities' economic program for 2004 deserves support from the Fund.** Ukraine's strong macroeconomic performance over the last three years and recent progress on structural reform lend credibility to the authorities' economic program. While there are clear risks, the program should help maintain macroeconomic stability and make a contribution to Ukraine's long-term growth prospects. The staff therefore recommends approval of the authorities' request for a stand-by arrangement.

Table 1. Ukraine: Selected Economic Indicators, 1999–2004

	1999	2000	2001	2002	2003 Est.	2004 Prog. 1/
Output and employment						
Real GDP (annual change in percent)	-0.2	5.9	9.2	4.8	8.5	6.0
Nominal GDP (in billions of hryvnia)	130.4	170.1	204.2	220.9	257.0	292.0
Nominal GDP (in billions of U.S. dollars)	31.6	31.3	38.0	41.5	48.2	54.8
Unemployment rate (ILO definition)	11.9	11.7	11.1	10.1	8.7	...
Prices and wages (percent change)						
Consumer prices, period average	22.7	28.2	12.0	0.8	5.2	7.1
Consumer prices, end of period	19.2	25.8	6.1	-0.6	8.2	6.0
Producer prices, end of period	15.7	20.6	0.9	5.7	11.1	5.5
Average monthly wages, annual average	16.1	30.2	34.9	20.7	23.0	...
Consolidated budget (in percent of GDP)						
Revenue 2/	31.9	33.4	33.5	36.8	37.7	37.3
Expenditure (cash basis)	34.2	34.7	35.1	36.3	38.5	39.0
Cash balance 2/	-2.4	-1.3	-1.6	0.5	-0.7	-1.8
Primary balance (cash basis)	0.0	1.8	0.4	1.9	0.3	-0.4
Commitments balance 3/	-1.4	2.1	-1.5	0.2	0.1	-0.8
Privatization proceeds	0.6	1.3	1.3	0.5	1.1	0.8
Net domestic financing	1.5	0.3	-0.1	-0.3	-1.2	0.5
Net external financing 2/	0.2	-0.3	0.4	-0.7	0.8	0.4
Public debt and arrears (in percent of GDP) 4/	61.3	47.7	39.4	36.9	32.1	27.7
o.w. external debt	39.5	33.1	26.6	24.6	22.5	19.5
Money and credit (end of period, percent change)						
Base money	39.2	40.1	37.4	33.6	30.1	16.3
Broad money	40.4	45.5	41.9	41.8	46.5	24.1
Credit to nongovernment	43.5	61.3	40.5	47.3	63.4	25.1
Velocity 5/	5.9	5.3	4.5	3.4	2.7	2.5
Average hryvnia lending rate (in percent, period average)	55.0	41.5	32.3	25.5	18.3	...
Average hryvnia deposit rate (in percent, period average)	20.7	13.7	11.0	7.9	7.0	...
Balance of payments						
Current account balance (in percent of GDP)	5.2	4.7	3.7	7.7	6.1	3.7
Gross reserves (end of period, in billions of U.S. dollars)	1.1	1.5	3.1	4.4	6.9	7.8
In months of next year's imports of goods and services	0.7	0.9	1.7	1.9	2.8	3.0
Debt service (in percent of exports of goods and services) 4/	15.8	10.4	6.7	5.4	6.3	6.4
Exports (annual change in percent)	-3.7	19.2	8.7	9.2	27.1	6.3
Imports (annual change in percent)	-20.5	15.4	13.0	6.3	33.7	8.4
Exchange rate						
Hryvnia per U.S. dollar, end of period	5.22	5.43	5.30	5.33	5.33	...
Hryvnia per U.S. dollar, period average	4.13	5.44	5.37	5.33	5.33	...
Real effective exchange rate, (percent change) 6/	-15.9	-4.5	7.0	-4.2	-6.8	...

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

1/ Assumes an exchange rate of 5.33 Hrv/US$.

2/ From 2003 onwards, based on an accounting treatment that excludes offset-based amortization to Russia, which decreases revenues and increases net external financing (and the budget deficit) by 0.2 percent of GDP relative to previous years.

3/ Cash balance adjusted for the net accumulation of expenditure and VAT refund arrears, as well as for non-cash property income.

4/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.

5/ Annual GDP divided by end-period broad money (M3).

6/ Period averages; (+) represents real appreciation; based on CPI and average trade weights for 1996-2002.

Table 2. Ukraine: Medium-term Scenarios, 2003–2008

		Baseline scenario					High-case scenario 1/					Low-case scenario 2/				
	2003 Est.	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
									(percent change)							
Output																
Real GDP growth	8.5	6.0	4.0	4.0	4.0	4.0	9.0	6.0	5.0	5.0	5.0	4.0	2.0	2.0	2.0	2.0
									(percent of GDP)							
Consolidated budget																
Revenue and grants	37.7	37.3	37.3	36.8	36.8	36.8	37.3	37.3	36.8	36.8	36.8	36.6	36.6	36.1	36.1	36.1
Expenditure and net lending (cash basis)	38.5	39.0	38.2	37.7	37.6	37.6	39.0	38.2	37.7	37.6	37.6	41.0	40.0	39.8	40.1	40.1
of which: interest	1.0	1.4	1.5	1.4	1.4	1.3	1.3	1.4	1.4	1.3	1.2	2.3	2.2	2.5	2.8	3.1
Cash balance	-0.7	-1.8	-1.0	-0.9	-0.9	-0.8	-1.8	-1.0	-0.9	-0.9	-0.8	-4.4	-3.4	-3.7	-4.0	-4.0
Public debt (end of period) 3/	32.1	27.7	25.3	23.0	20.9	19.1	27.0	24.2	21.8	19.7	17.8	28.2	29.2	30.3	31.6	33.1
External	22.5	19.5	17.4	15.5	13.7	12.3	19.0	16.7	14.6	12.8	11.4	19.9	18.1	16.4	14.8	13.5
									(percent of GDP, unless otherwise indicated)							
External sector																
Current account balance, % of GDP	6.1	3.7	2.7	1.7	1.0	0.3	3.7	2.3	1.2	0.5	-0.2	3.6	2.1	0.8	-0.2	-1.0
Merchandise exports, value (percentage change)	27.1	6.3	5.9	6.1	6.5	6.5	7.3	6.9	7.1	7.5	7.5	4.3	3.9	4.1	4.5	4.5
Merchandise imports, value (percentage change)	33.7	8.4	6.8	6.8	6.8	6.8	9.4	7.8	7.8	7.8	7.8	6.4	4.8	4.8	4.8	4.8
Gross official reserves (end of period)																
in months of imports of goods and services	2.8	3.0	3.0	3.0	3.0	3.0	2.9	3.0	3.1	3.1	3.1	2.3	2.1	1.9	1.7	1.5
External debt service (percent of XGS) 3/	6.3	6.4	6.3	6.1	4.9	3.8	6.3	6.1	5.9	4.6	3.5	6.5	6.4	6.4	5.2	4.1
									(percent of GDP)							
Savings-Investment Balance																
Foreign savings	-6.1	-3.7	-2.7	-1.7	-1.0	-0.3	-3.7	-2.3	-1.2	-0.5	0.2	-3.6	-2.1	-0.8	0.2	1.0
Domestic savings	27.4	26.3	24.8	24.3	23.5	22.8	27.2	25.4	24.8	24.0	23.3	23.1	21.2	20.4	19.4	18.5
Private	25.6	25.5	23.2	22.6	21.8	21.1	26.4	23.8	23.1	22.3	21.6	25.0	22.0	21.5	20.8	20.0
Public	1.8	0.7	1.6	1.7	1.7	1.7	0.7	1.6	1.7	1.7	1.7	-1.9	-0.9	-1.1	-1.5	-1.5
Investment	21.3	22.5	22.1	22.6	22.5	22.5	23.5	23.1	23.6	23.5	23.5	19.5	19.1	19.6	19.5	19.5
Private	18.8	20.0	19.5	20.0	20.0	20.0	21.0	20.5	21.0	21.0	21.0	17.0	16.5	17.0	17.0	17.0
Public	2.5	2.5	2.6	2.6	2.5	2.5	2.5	2.6	2.6	2.5	2.5	2.5	2.6	2.6	2.5	2.5

Sources: Ukrainian authorities and Fund staff estimates.

1/ Compared to the baseline, the high-case scenario assumes more rapid progress on structural reforms, an improved investment climate, and a more favorable external environment.
2/ Compared to the baseline, the low-case scenario assumes slower pace of structural reform, a looser fiscal policy, lower privatization receipts, higher interest rates, and more capital flight.
3/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

Table 3. Ukraine: Medium-term Balance of Payments, 2000-2008

(In millions of U.S. dollars; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
			Prel.	Est.	Prog.	Projections			
Current account balance	1,481	1,402	3,173	2,940	2,052	1,577	1,110	684	201
Merchandise trade balance	779	198	710	-289	-816	-1,087	-1,336	-1,499	-1,678
Exports	15,722	17,091	18,669	23,725	25,212	26,711	28,352	30,208	32,185
Imports	-14,943	-16,893	-17,959	-24,014	-26,028	-27,798	-29,688	-31,707	-33,863
Of which: Energy	-5,947	-6,182	-6,539	-7,696	-7,960	-8,181	-8,410	-8,648	-8,893
Services (net)	796	415	1,147	1,665	1,597	1,508	1,315	1,108	867
Receipts 1/	3,800	3,995	4,682	5,222	5,276	5,445	5,646	5,872	6,107
Payments	-3,004	-3,580	-3,535	-3,557	-3,679	-3,937	-4,331	-4,764	-5,240
Income (net)	-942	-667	-606	-540	-629	-644	-669	-725	-788
Of which: Interest on public debt 2/	-655	-529	-475	-496	-540	-529	-511	-503	-522
Current transfers (net)	848	1,456	1,922	2,104	1,900	1,800	1,800	1,800	1,800
Financial and capital account	-690	100	-1,137	188	--	407	831	1,248	1,529
Direct investment and capital transfers (net)	586	772	713	1,315	1,200	850	930	965	994
Portfolio equity	-195	-735	-1,957	-1,601	-1,266	-684	-328	12	197
Bonds and medium and long-term loans (net)	-87	-120	375	1,101	575	240	220	230	240
Of which: Bonds and loans (official)	-358	-361	-235	204	135	--	--	--	--
Disbursements	179	475	444	1,313	1,258	1,192	1,164	846	618
Repayments 1/ 2/	-537	-836	-679	-1,109	-1,123	-1,192	-1,164	-846	-618
Other capital (net)	-994	183	-268	-627	-509	1	8	41	99
Of which: Natural gas arrears (net) 3/	161	137	166	...	...	...	...	...	...
Errors and omissions	-150	-231	-885	-885	-885	-885	-885	-885	-885
Overall balance	641	1,271	1,151	2,243	1,167	1,099	1,056	1,047	845
Gross official reserves (- is increase)	-398	-1,606	-1,045	-2,034	-867	-798	-641	-632	-525
Net use of IMF resources	-604	-79	-191	-209	-300	-301	-415	-415	-320
Purchases	245	375	--	--	--	--	--	--	--
Repurchases	-849	-454	-191	-209	-300	-301	-415	-415	-320
Official arrears to bilateral creditors (+ is increase)	361	-361	...						
Rescheduling 4/	...	775	85						
Memorandum items:									
Total public external debt 2/	10,349	10,118	10,194	10,841	10,677	10,376	9,961	9,546	9,225
Public external debt (in percent of GDP) 2/	33.1	26.6	24.6	22.5	19.5	17.4	15.5	13.7	12.3
Stock of external gas arrears 3/	1,577	1,714	1,880	...	...	...	...	...	...
Current account (in percent of GDP)	4.7	3.7	7.7	6.1	3.7	2.7	1.7	1.0	0.3
Excluding transfers	2.0	-0.1	3.0	1.7	0.3	-0.4	-1.1	-1.6	-2.1
Debt service ratio (in percent of exports of goods and services) 2/ 4/									
Before rescheduling	10.4	8.7	5.7	...	...	...	...	...	...
After rescheduling	10.4	6.7	5.4	6.3	6.4	6.3	6.1	4.9	3.8
Of which: Interest payments	3.4	2.5	2.0	1.7	1.8	1.6	1.5	1.4	1.4
Gross international reserves (end of period)	1,505	3,089	4,417	6,939	7,806	8,604	9,245	9,877	10,402
In months of next year's imports of goods and services	0.9	1.7	1.9	2.8	3.0	3.0	3.0	3.0	3.0
Over next year's official debt service	0.8	2.3	2.4	3.5	3.9	4.1	5.2	6.8	9.5
Merchandise export values (percent change) 5/	19.2	8.7	9.2	27.1	6.3	5.9	6.1	6.5	6.5
Merchandise import values (percent change)	15.4	13.0	6.3	33.7	8.4	6.8	6.8	6.8	6.8
Merchandise export volume (percent change) 5/	16.5	6.1	7.2	24.8	4.8	4.2	4.3	4.7	4.7
Merchandise import volume (percent change)	3.5	11.6	6.1	30.4	7.7	5.4	5.3	5.2	5.2
Terms of trade (percent change)	-8.2	1.3	1.6	8.6	0.0	0.8	-0.2	-0.2	-0.3
Program financing 6/	70	310	353	1,075	1,013	950	900	600	400

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

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

2/ Public and publicly-guaranteed debt. Historic debt data are preliminary.

3/ Arrears stemming from natural gas imports as reported by Naftogaz.

4/ Rescheduling by the Paris Club and other bilateral creditors (on comparable terms).

5/ Estimates in 2000 and 2001 include goods-arrears swap transactions with Russia in 1999 and 2000.

6/ World Bank, European Union, and central government commercial borrowing.

Table 4. Ukraine: Indicators of Vulnerability, 1998-2003
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Est.	Date
Financial indicators							
Public debt 1/	40.5	61.3	47.7	39.4	36.9	32.1	12/02
Broad money (percent change, 12-month basis)	25.3	40.4	45.5	41.9	41.8	46.5	12/03
Private sector credit (percent change, 12-month basis)	16.7	43.5	61.3	40.5	47.3	63.4	12/03
Share of non-performing loans in total loans (percent)	35.6	35.8	29.6	25.1	21.9	26.3 2/	08/03
Share of foreign currency loans in total lending (percent)	40.5	45.4	41.4	41.3	39.5	38.5	12/03
Share of foreign currency deposits in total deposits (percent)	39.0	44.6	38.5	32.9	32.6	32.2	12/03
Ratio of the stock of treasury bills to reserves	2.5	1.9	1.3	0.7	0.5	0.3	12/03
Ratio of broad money to reserves	5.9	3.9	3.9	2.8	2.8	2.6	12/03
Ratio of foreign currency deposits to reserves	1.2	1.0	0.9	0.5	0.5	0.5	12/03
3 month T-bill yield (percent)	50.5	33.0	21.8	15.3	13.5	5.5	12/03
External Indicators							
Exports of merchandise (percent change in US$)	-11.1	-3.7	19.2	8.7	9.2	27.1	12/03
Imports of merchandise (percent change in US$)	-17.0	-20.5	15.4	13.0	6.3	33.7	12/03
Terms of trade (percent change, 12 month basis)	4.7	9.2	-8.2	1.3	1.6	8.6	12/03
Current account balance	-3.1	5.2	4.7	3.7	7.7	6.1	12/03
Capital and financial account balance	1.2	-1.6	-2.2	0.3	-2.7	0.4	12/03
Public medium and long-term external debt	26.5	39.5	33.1	26.6	24.6	22.5	12/03
Public medium and long-term external debt service	4.7	8.5	6.5	4.8	3.2	3.8	12/03
Short term external debt 3/	4.4	4.6	5.9	5.1	4.0	6.3	12/03
Ratio of short-term external debt to reserves	2.3	1.3	1.2	0.6	0.4	0.4	12/03
Gross reserves in months of imports	0.6	0.7	0.9	1.7	1.9	2.8	12/03
Exchange rate (Hrv/US$, period average)	2.4	4.1	5.4	5.4	5.3	5.3	12/03
Real effective exchange rate (percent change) 4/	-8.8	-15.9	-4.5	7.0	-4.2	-6.8	12/03
Financial Market Indicators							
Stock market index (PFTS) 5/	21.6	39.1	55.5	42.7	57.3	85.4	12/03
Foreign currency debt rating 6/	B3	B3	Caa1	Caa1	B2	B1	12/03
Spread on benchmark Eurobonds (basis points, end of period) 7/	...	...	1430	780	750	204	12/03

Sources: Ukrainian authorities; Moody's Investors Service; DataStream; and Fund staff estimates.

1/ Domestic and external debt contracted by the general government and the NBU; includes budgetary arrears;
VAT refund arrears data only begin in 2001.
2/ Series break due to new classification rules in 2003.
3/ Data include amortization of public debt falling due within the year, central bank short-term liabilities, short-term financial liabilities of commercial banks, and treasury bill holdings of non-residents. There are no reliable data on private capital flows and some capital inflows may be misclassified as current account transactions.
4/ An appreciation is indicated by a positive growth rate; period average; CPI-based and average trade weights (1996-2002).
5/ Based on the average weighted price (in U.S. dollars) of common shares of issuers meeting Ukraine's First Stock Trading System (PFTS) listing requirements with the highest liquidity. The index base is 100 as of October 1, 1997.
6/ Moody's Investors Service. Note that on June 25, 2003 Fitch upgraded Ukraine's long term sovereign rating from B to B+.
7/ Relative to yield on U.S. treasury bonds.

Table 5. Ukraine: Consolidated Government Finances, 2000-2004

	2000	2001	2002	2003	2004	2004			
				Est.	Prog.	Prog. Jan-Mar.	Prog. Apr-Jun	Prog. Jul-Sept.	Prog. Oct-Dec.
				(in millions of Hrv)					
Revenue and grants	56,774	68,435	81,280	96,999	108,828	22,438	25,836	29,286	31,269
Tax revenue	47,633	56,929	68,572	81,407	92,124	19,083	21,669	25,525	25,846
Taxes on income, profit	14,812	18,168	21,385	28,053	27,934	6,062	6,316	7,114	8,442
o/w: Personal Income Tax	6,378	8,775	10,824	13,521	12,959	2,665	3,120	3,361	3,814
o/w: Enterprise Profit Tax	7,698	8,280	9,398	13,237	13,099	2,893	2,747	3,309	4,149
Taxes on payroll 1/	12,282	16,085	19,806	23,082	27,620	5,755	6,319	7,773	7,773
Property taxes	1,376	1,619	1,806	2,032	2,503	562	573	679	690
Domestic taxes on goods and services	16,847	18,258	22,277	23,481	28,710	5,654	7,230	8,436	7,390
o/w: VAT	9,441	10,348	13,471	12,598	14,533	2,543	3,783	5,020	3,187
Taxes on international trade	1,561	1,945	2,366	3,795	4,261	801	980	1,221	1,258
Other taxes	754	853	932	964	1,095	249	252	302	292
Nontax, capital revenue, and grants	9,141	11,506	12,708	15,593	16,704	3,355	4,166	3,760	5,423
Expenditure 2/	58,949	71,711	80,120	98,906	113,979	23,976	27,731	30,235	32,038
General public services	4,229	4,420	4,324	6,006	...	...	...	...	...
Defense	2,504	3,337	3,230	5,130	...	...	...	...	...
Public order and safety affairs	2,637	3,717	4,577	5,304	...	...	...	...	...
Education affairs and services	5,843	7,798	10,848	13,468	...	...	...	...	...
Health affairs and services	4,251	5,403	7,172	9,289	...	...	...	...	...
Social security and welfare affairs	24,581	30,293	37,133	40,297	...	...	...	...	...
o/w: Pension Fund	12,678	15,547	20,061	21,984	27,286	...	...	...	...
Housing and community services	1,381	1,746	1,407	1,820	...	...	...	...	...
Recreational, cultural, religious affairs	1,038	1,319	1,351	1,992	...	...	...	...	...
Energy, agriculture, industry, and transports	4,100	4,839	5,030	9,041	...	...	...	...	...
Interest payments	5,292	4,060	2,954	2,638	4,046	884	1,123	921	1,118
Domestic interest payments	2,385	1,651	714	325	1,189	297	297	297	297
Foreign interest payments	2,907	2,409	2,240	2,313	2,857	586	826	624	821
Other and statistical discrepancy	3,093	4,779	2,094	3,922	...	...	...	...	...
Overall cash balance	-2,175	-3,276	1,161	-1,907	-5,151	-1,538	-1,895	-949	-769
Net accumulation of VAT refund arrears	...	1,172	847	-1,114	-1,828	-1,000	-500	-328	0
Net accumulation of energy and utility arrears	-2,766	-158	-379	-300	-300	-75	-75	-75	-75
Net social arrears accumulation	-1,745	-724	257	-300	-300	-75	-75	-75	-75
Other arrears (interest)	-724	0	0	0	0	0	0	0	0
Noncash property income	532	0	0	521	521	521	0	0	0
Commitment balance 3/	3,591	-3,040	435	329	-2,202	133	-1,245	-471	-619
Financing	2,175	3,276	-1,161	1,907	5,151	1,538	1,895	949	769
Net external	-584	866	-1,550	2,097	1,235	288	1,286	129	-468
Disbursements	381	2,252	2,020	7,106	6,321	2,096	1,808	2,187	231
o/w: project loans	...	610	189	201	922	231	231	231	231
Amortization 4/	-965	-1,386	-3,570	-5,009	-5,086	-1,808	-522	-2,057	-698
Net domestic	469	-152	-693	-3,091	1,479	641	0	211	628
Privatization	2,290	2,562	1,082	2,901	2,437	609	609	609	609
Memorandum items:									
End-period stock of VAT refund arrears	...	2,095	2,942	1,828	0	828	328	0	0
End-period stock of social arrears	1,344	621	878	578	178	403	328	253	178
Primary balance	3,117	784	4,115	731	-1,105	-654	-772	-29	349
Earmarked revenue	20,517	29,893	33,247	38,706	45,873	9,269	10,747	12,264	13,383
Nonearmarked cash revenue	35,988	38,545	48,033	58,293	62,955	13,169	15,088	17,022	17,886
Government wage bill	10,340	13,562	16,274	20,400	23,500	...	...	...	...
Nominal GDP	170,070	204,190	220,932	257,000	292,000	...	...	...	...
				(in percent of GDP)					
Revenue and grants	33.4	33.5	36.8	37.7	37.3	7.7	8.8	10.0	10.7
o/w: Tax revenue	28.0	27.9	31.0	31.7	31.5	6.5	7.4	8.7	8.9
Expenditure 2/	34.7	35.1	36.3	38.5	39.0	8.2	9.5	10.4	11.0
o/w: Pension Fund	7.5	7.6	9.1	8.6	9.3	0.0	0.0	0.0	0.0
o/w: Interest payments	3.1	2.0	1.3	1.0	1.4	0.3	0.4	0.3	0.4
Overall cash balance	-1.3	-1.6	0.5	-0.7	-1.8	-0.5	-0.6	-0.3	-0.3
Net accumulation of VAT refund arrears	...	0.6	0.4	-0.4	-0.6	-0.3	-0.2	-0.1	0.0
Net accumulation of energy and utility arrears	-1.6	-0.1	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0
Net social arrears accumulation	-1.0	-0.4	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Other arrears (interest)	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Noncash property income	0.3	0.3	0.0	0.2	0.2	0.2	0.0	0.0	0.0
Commitment balance 3/	2.1	-1.5	0.2	0.1	-0.8	0.0	-0.4	-0.2	-0.2
Financing	1.3	1.6	-0.5	0.7	1.8	0.5	0.6	0.3	0.3
Net external	-0.3	0.4	-0.7	0.8	0.4	0.1	0.4	0.0	-0.2
Disbursements	0.2	1.1	0.9	2.8	2.2	0.7	0.6	0.7	0.1
Amortization 4/	-0.6	-0.7	-1.6	-1.9	-1.7	-0.6	-0.2	-0.7	-0.2
Net domestic	0.3	-0.1	-0.3	-1.2	0.5	0.2	0.0	0.1	0.2
Privatization	1.3	1.3	0.5	1.1	0.8	0.2	0.2	0.2	0.2
Memorandum items:									
Primary balance	1.8	0.4	1.9	0.3	-0.4	-0.2	-0.3	0.0	0.1
Earmarked revenue	12.1	14.6	15.0	15.1	15.7	3.2	3.7	4.2	4.6
Nonearmarked cash revenue	21.2	18.9	21.7	22.7	21.6	3.2	5.2	5.8	6.1
Government wage bill	6.1	6.6	7.4	7.9	8.0	...	...	...	...

Sources: Ministry of Finance; NBU; and Fund staff estimates and projections.

1/ Starting from 2001, includes the newly-created Accident Fund.
2/ Reported on a cash basis. Due to a new budget classification, expenditure data beginning in 2002 are not comparable to earlier years.
3/ Cash balance adjusted for the net accumulation of overdue VAT refunds, energy and utility payment arrears, social payment arrears, and noncash property income (i.e. netting of debt owed to Russia with Russia's payment for use of black sea port facilities).
4/ Excludes offset with Russia involving US$ 98 million amortization for 2003-2004 (for both budget and program data).

Table 6. Ukraine: Monetary Accounts, 2000-2004

	2000	2001	2002	2003				2004			
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
	Act.	Act.	Act.	Prel	Prel	Prel.	Est.	Prog.	Prog.	Prog.	Prog.
				(In millions of hryvnia)							
Monetary Survey											
Net foreign assets	-511	6,875	13,942	17,118	24,150	25,897	25,511	26,108	28,277	30,442	31,732
(In millions of US dollars)	-94	1,297	2,615	3,209	4,529	4,857	4,785	4,897	5,304	5,710	5,952
Net domestic assets	32,763	38,881	50,927	52,996	54,884	60,598	69,533	72,642	76,102	80,095	86,221
Domestic credit	40,511	48,074	61,986	65,516	68,599	75,838	86,505	89,863	93,525	97,763	104,192
Net credit to government	19,385	18,390	18,273	17,509	13,068	12,141	15,080	14,751	14,283	14,197	14,856
Credit to nongovernment	21,126	29,684	43,712	48,007	55,531	63,697	71,425	75,112	79,243	83,566	89,336
Other items, net	-7,748	-9,193	-11,058	-12,519	-13,715	-15,240	-16,973	-17,221	-17,424	-17,668	-17,971
Broad money	32,253	45,755	64,870	70,114	79,034	86,495	95,043	98,750	104,379	110,537	117,953
Hryvnia broad money	24,760	37,097	52,324	55,136	62,893	68,578	75,074	79,197	83,920	89,093	95,070
Foreign currency deposits	7,493	8,658	12,546	14,978	16,141	17,917	19,969	19,552	20,458	21,444	22,883
Accounts of the National Bank of Ukraine											
Net international reserves 1/	-3,089	6,249	13,526	14,622	23,064	25,768	27,204	27,802	30,020	32,189	33,425
(In millions of U.S. dollars)	-568	1,179	2,537	2,741	4,325	4,833	5,103	5,215	5,631	6,038	6,269
Net domestic assets 2/	19,870	16,806	17,282	16,569	12,113	12,252	12,885	13,126	12,374	12,414	13,190
Net domestic credit	21,100	18,289	19,182	18,476	14,518	14,501	16,185	16,426	15,674	15,714	16,490
Net credit to government	19,939	18,518	17,449	16,687	12,278	12,417	13,575	13,591	12,702	12,516	13,325
Net credit to nongovernment	122	69	-19	120	89	111	113	113	113	113	113
Claims on banks	1,039	-298	1,752	1,669	2,151	1,973	2,497	2,721	2,859	3,084	3,052
Other items, net	-1,230	-1,483	-1,899	-1,908	-2,404	-2,249	-3,300	-3,300	-3,300	-3,300	-3,300
Base money	16,781	23,055	30,808	31,191	35,178	38,021	40,089	40,928	42,393	44,603	46,616
Currency in circulation	12,799	19,465	26,434	26,002	29,375	30,862	33,119	34,009	35,572	37,450	39,514
Banks' reserves	3,982	3,590	4,374	5,189	5,803	7,158	6,970	6,919	6,821	7,153	7,102
Deposit Money Banks											
Net foreign assets	2,494	656	233	2,243	915	-81	-1,924	-1,924	-1,924	-1,924	-1,924
Net domestic assets	17,999	25,337	39,955	43,539	50,895	57,687	66,346	69,386	73,590	78,096	83,415
Domestic credit	20,394	29,377	44,350	48,642	56,133	63,232	72,740	76,082	80,633	85,057	90,677
Net credit to government	-554	-128	825	822	790	-276	1,505	1,160	1,581	1,681	1,531
Credit to the economy	20,948	29,505	43,526	47,820	55,343	63,508	71,235	74,922	79,053	83,376	89,146
Banks' reserves	3,982	3,590	4,374	5,189	5,803	7,158	6,970	6,919	6,821	7,153	7,102
Other Items Net	-6,376	-7,630	-8,770	-10,292	-11,041	-12,703	-13,365	-13,615	-13,865	-14,115	-14,365
Banks' Liabilities	20,493	25,992	40,188	45,781	51,810	57,606	64,421	67,462	71,666	76,171	81,491
Credit to banks from NBU	1,039	-298	1,752	1,669	2,151	1,973	2,497	2,721	2,859	3,084	3,052
Deposits	19,454	26,290	38,436	44,112	49,659	55,633	61,924	64,740	68,806	73,087	78,439
				(Percentage change from end of previous year)							
Memorandum items:											
Broad money	45.5	41.9	41.8	8.1	21.8	33.3	46.5	3.9	9.8	16.3	24.1
Credit to nongovernment	61.3	40.5	47.3	9.8	27.0	45.7	63.4	5.2	10.9	17.0	25.1
Real broad money 3/	15.6	33.7	42.6	4.2	16.5	29.1	35.4	1.9	6.5	13.3	17.1
Real credit to nongovernment 3/	28.2	32.4	48.1	5.9	21.5	41.0	51.0	3.2	7.6	14.0	18.0
Base money	40.1	37.4	33.6	1.2	14.2	23.4	30.1	2.1	5.7	11.3	16.3
				(Ratio)							
Velocity of broad money 4/	5.3	4.5	3.4	3.3	3.0	2.9	2.7	2.7	2.6	2.6	2.5
Money multiplier	1.9	2.0	2.1	2.2	2.2	2.3	2.4	2.4	2.5	2.5	2.5
				(In percent)							
Share of foreign currency loans 5/	41.4	41.3	39.5	38.1	37.0	37.6	38.5	...	...	...	...
Share of foreign currency deposits 6/	38.5	32.9	32.6	34.0	32.5	32.2	32.2	...	...	...	...

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

1/ Historical data for NIR are at actual exchange rates. From end-March 2004 onwards, NIR is based on end-Dec. 2003 exchange rates.

2/ NDA are calculated as the difference between base money and NIR.

3/ Deflated by the CPI.

4/ Based on nominal GDP over the last four quarters.

5/ In percent of total bank loans to the economy.

6/ In percent of total bank deposits.

Table 7. Ukraine: Medium-term External Financing Requirements, 2000-2008
(In millions of U.S. dollars)

	2000	2001	2002 Prel.	2003 Est.	2004 Prog.	2005	2006	2007	2008
						Projections			
Net income (excluding public sector interest due)	-287	-138	-131	-44	-89	-115	-158	-222	-266
Public sector's long-term debt service (including IMF)	-2,041	-1,819	-1,345	-1,814	-1,963	-2,022	-2,089	-1,764	-1,461
Other capital account net flows (incl. errors and omissions)	-1,068	-542	-2,500	-2,216	-2,220	-1,328	-984	-602	-350
Increase in official reserves (- is increase)	-398	-1,606	-1,045	-2,034	-867	-798	-641	-632	-525
Gross financing needs (-)	-3,794	-4,105	-5,021	-6,108	-5,139	-4,263	-3,873	-3,220	-2,601
Trade balance (goods and services)	1,575	613	1,857	1,376	781	421	-21	-391	-811
Transfers (net)	840	1,459	1,937	2,104	1,900	1,800	1,800	1,800	1,800
Foreign direct investment (net)	594	769	698	1,315	1,200	850	930	965	994
Public sector's long-term borrowing before program financing	109	165	91	238	245	242	264	246	218
Gross financing gap (-)	-676	-1,099	-438	-1,075	-1,013	-950	-900	-600	-400
Program financing	70	310	353	1,075	1,013	950	900	600	400
Central government Eurobond issues	--	--	353	1,000	700	...	...	...	...
World Bank	70	310	--	75	175	...	...	...	...
European Union	--	--	--	--	138	...	...	...	...
IMF purchases	245	375	0	0	0	0	0	0	0
Arrears (build-up and clearance) and rescheduling	361	414	85	0	0	0	0	0	0
Residual gap	0	0	0	0	0	0	0	0	0

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

Table 8. Ukraine: Access and Phasing Under a Proposed Precautionary Stand-By Arrangement

Date available	Purchases		Conditions include
	In millions of SDRs	In percent of quota	
March 2004	82.32	6.0	Board approval of arrangement
May 15, 2004	82.32	6.0	Observance of end-March performance criteria
September 1, 2004	82.32	6.0	Completion of review and observance of end-June performance criteria
November 15, 2004	82.32	6.0	Observance of end-September performance criteria
February 15, 2005	82.32	6.0	Observance of end-December performance criteria
Total	411.60	30.0	

Table 9. Ukraine: Indicators of Fund Credit, 2003-2008
(In units indicated)

	2003	2004	2005	2006	2007	2008
	Prel.	Projections				
Existing and prospective Fund credit 1/ 2/						
In millions of SDRs	1,235	1,363	1,242	902	427	68
In percent of exports of goods and services	6	7	6	4	2	0
In percent of public sector external debt	17	19	18	13	7	1
In percent of gross reserves	26	26	21	14	6	1
In percent of quota	90	99	91	66	31	5
Existing Fund credit 1/ 2/						
In millions of SDRs	1,235	1,034	831	552	273	57
In percent of exports of goods and services	6	5	4	2	1	0
In percent of public sector external debt	17	14	12	8	4	1
In percent of gross reserves	26	20	14	9	4	1
In percent of quota	90	75	61	40	20	4
Prospective Fund credit 1/ 2/						
In millions of SDRs	...	329	412	350	154	10
In percent of exports of goods and services	...	2	2	2	1	0
In percent of public sector external debt	...	5	6	5	2	0
In percent of gross reserves	...	6	7	6	2	0
In percent of quota	...	24	30	26	11	1
Repurchases and charges due from existing and prospective drawings 2/						
In millions of SDRs	178	234	236	368	493	367
In percent of exports of goods and services	1	1	1	2	2	1
In percent of public sector external debt service 3/	13	18	17	25	35	32
In percent of gross reserves	4	4	4	6	7	5
In percent of quota	13	17	17	27	36	27
Repurchases and charges due from existing drawings 2/						
In millions of SDRs	178	230	226	297	290	220
In percent of exports of goods and services	1	1	1	1	1	1
In percent of public sector external debt service 3/	13	17	16	20	21	20
In percent of gross reserves	4	4	4	5	4	3
In percent of quota	13	17	16	22	21	16
Repurchases and charges due from prospective drawings 2/						
In millions of SDRs	...	4	10	71	203	146
In percent of exports of goods and services	...	0	0	0	1	1
In percent of public sector external debt service 3/	...	0	1	5	15	13
In percent of gross reserves	...	0	0	1	3	2
In percent of quota	...	0	1	5	15	11

Sources: Data provided by the Ukrainian authorities; and staff estimates.

1/ End of period.
2/ Under the expectations schedule, which does not affect debt service in 2004.
3/ Public sector debt service including debt service from prospective drawings.

UKRAINE: FUND RELATIONS
(As of December 31, 2003)

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

II. **General Resources Account:**	**SDR Million**	**Quota**
Quota	1,372.00	100.0
Fund holdings of currency	2607.48	190.05
Reserve position in Fund	0.00	0.0

III. **SDR Department:**	**SDR Million**	**% Allocation**
Holdings	14.27	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**%Quota**
Extended arrangements	1,131.59	82.48
Systemic transformation	103.89	7.57

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 Payments to Fund (Expectations Basis):** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	201.80	202.83	278.97	278.98	215.62
Charges/interest	24.57	20.82	16.20	10.15	4.32
Total	226.37	223.64	295.18	289.12	219.94

VII. **Safeguards Assessments**:

Under the Fund's safeguards assessment policy, the National Bank of Ukraine (NBU) is now subject to a full assessment with respect to the expected arrangement. A full safeguards assessment of the NBU is underway. The NBU was subject to the transitional procedures with respect to the EFF arrangement, which expired on September 3, 2002. The transitional procedures required a review of only the NBU's external audit mechanism. The external audit assessment of the NBU was completed on February 3, 2001, and concluded that the NBU's external audit mechanism met internationally accepted standards, as reported in Country Report. No. 01/216 (09/04/01).

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–Hrv 1.9 per U.S. dollar. The limits of the band were moved on several occasions, most recently on February 9, 1999, to Hrv 3.4–4.6 per U.S. dollar. Since March 19, 1999, the exchange rate for the hryvnia has been allowed to be determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention of allowing the free float of the hryvnia. On December 31, 2003 the hryvnia stood at Hrv 5.33 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 (IMF Country Report No. 03/172, 04/12/03), and the Selected Issues and Statistical Appendix (IMF Country Report Nos. 03/173 and 03/174, 04/29/03) were considered by the Executive Board on May 14, 2003.

X. **FSAP Participation and ROSCs**

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

XI. Fund Technical Assistance Missions, 1999–2003

(As of December 31, 2003)

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
	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
MFD	Joint MFD/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
	Review of TA needs and inspection	June 10–12, 2002
STA	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
	SDDS: Assessment	June 12–19, 2002
	ROSC data module mission	April 3–17, 2002
	Money and Banking Statistics	October 17–23, 2002
	Money and Banking Statistics	October 17–23, 2002

XII. Fund Resident Representatives and Advisors, 1998–2003

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	July 2001-January 2004
Advisors		
Macroeconomic Policy Advisor to the Ministry of Finance	Mr. Marion	October 1998–April 2001
	Mr. Robertson	May 2001–May 2002
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	March 2001–June 2002
Treasury Advisor	Mr. Platais	July 1998–June 2001
	Mr. Lepage	July 2001–January 2002
Multisector Statistics Advisor	Mr. Piché	March 2000–March 2002

UKRAINE: RELATIONS WITH THE WORLD BANK

(January 2004)

Country Assistance Strategy

53. The World Bank Country Assistance Strategy (CAS) for Ukraine was approved on October 23, 2003. It covers fiscal years 2004–2007, and its major focus is to support the "European choice" agenda of Ukraine, including further institutional developments that would lead to a business-friendly environment and a more inclusive and responsive government. It emphasizes the need to build Ukraine's European aspiration both from the top, through reform of institutions and policies, and from the bottom, through strengthening of civil society which will help to increase public sector accountability. The strategy proposes a US$2.4 billion Base Case lending program. Allowance is also made for a more ambitious High Case (up to a maximum of US$3 billion).

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

55. Taking into account political realities in Ukraine, before the elections the strategy will concentrate on implementation of the reforms underway, as well as on activities aimed at increasing the voice of civil society. But following the presidential elections, the strategy will provide for the possibility of a High-Case lending scenario, based on Ukraine's ability to seize the reform momentum and accomplish substantial advances in the energy sector, agriculture, financial sector, public sector accountability, and social sector reform. A CAS Update will review this possibility in early FY06.

World Bank program

56. There are 12 operations under implementation in the current project portfolio, and another 9 projects are under preparation.

57. A series of Programmatic Adjustment Loans (PALs) form the backbone of CAS. PAL is conceived as a sequence of loans, totaling up to US$1.45 billion, with disbursements depending entirely on performance. The PAL covers five cross-sectoral issues: (i) financial accountability; (ii) regulatory framework; (iii) property rights; (iv) public sector accountability; and (v) social and environmental risk management. PAL I (US$250 million) was approved by the World Bank Board of Executive Directors on September 20, 2001, and fully disbursed in two tranches of US$150 million and US$100 million, respectively. PAL II (US$250 million) was approved by the Board on December 9, 2003, upon which a first tranche of US$ 75 million was disbursed. Implementation of the program is ongoing and a

second tranche of US$ 175 million will be disbursed as soon as all of the agreed benchmarks have been accomplished. Indicative benchmarks have already been defined and agreed for the proposed PAL III. Among other projects in the **public sector** are the Treasury System Project (US$16.4 million), which is designed to assist the government in creating an efficient budget management system, and which is in the final stage of implementation; the State Tax Service Modernization Project (US$40 million), which is currently under implementation; and a Statistical System Modernization Project (US$30 million), which has been negotiated and will be shortly presented to the Board for approval.

58. Two loans have been approved in **agriculture**: the Seeds Development Project (US$32 million) - designed to improve agricultural productivity and boost agricultural exports through private production of high quality commercial seeds; and the Agricultural Sector Adjustment Loan (US$300 million), which supported trade liberalization, privatization of land and agricultural enterprises, and farm restructuring. In June 2003, the Rural Land Titling and Cadastre Development Project (US$195 million) was approved. A new Rural Finance project (US$200 million) is currently in late stages of preparation. This proposed project aims at developing economically competitive and sustainable rural areas with less incidence of poverty through increased access by all segments of the rural population to financial services.

59. The Bank's program also includes support for the **energy** sector. The Bank provided two loans—US$15.8 million for the Coal Pilot Project and US$300 million for the Coal Sector Adjustment Loan—which contributed significantly to efficiency improvements in Ukraine's coal sector. The Hydropower Rehabilitation and System Control Project (US$114 million) led to the increased production of environmentally clean energy. Two District Heating Projects (US$200 million Kyiv District Heating Improvement Project and US$18.29 million Kyiv Public Building Energy Efficiency Project) are under implementation. They are helping to rehabilitate the existing district heating systems in Kyiv and to increase heat production capacity as well as to improve energy efficiency in public buildings (schools, hospitals, kindergartens and public administration buildings).

60. In **infrastructure**, the Lviv Water and Wastewater Project (US$24.25 million) became effective in February 2003. A Municipal Development Loan Fund (US$150 million) is under preparation, which is designed to provide loans to local governments for priority infrastructure and other investments.

61. **Private sector development and financial sector reform** have been receiving strong attention in the Bank's program. Enterprise Development Adjustment Loans I and II (US$310 million and US$300 million) assisted the government in acceleration and completion of the mass-privatization program and strengthening the capital markets. To promote a stronger private sector, the World Bank approved a Private Sector Development Loan (US$30 million) in March, 2002. In addition, the World Bank has been helping the Ukrainian

government with a restructuring plan for a commercial bank. An Export Development Project (US$70 million) is being implemented to promote the Ukrainian economy's export capacity and to strengthen institutional capacity of state-owned Ukreximbank. Also, in May 2003, the E-development project was approved which is aimed at enhancing efficiency of the Government's decision-making process for public procurement and documentation flow, fostering private sector development, and strengthening civil society in Ukraine through the introduction of innovative models of Information and Communication Technology (ICT) solutions.

62. The Bank has devoted considerable resources to the **social sector**. The US$50 million Social Investment Fund Project, which supports the development of community-based social services for the most vulnerable groups, was approved in late 2001. The US$60 million Tuberculosis and AIDS Epidemic Control Project was approved in December 2002. A Social Protection Reform Administration Project, and an Education Reform Project are in preparation stage.

63. **Environmental** work is proceeding well. Two Global Environmental Fund projects—on formulation and adoption of strategies necessary for the protection and sustainable use of the country's biodiversity, and on assessment of capacity building needs in biodiversity conservation—have been completed satisfactorily. The third GEF project that is addressing the problem of Ozone-Depleting Substances is nearing completion and a new GEF grant on preserving the Azov-Black Sea wetlands (US$6.9 million) has been approved.

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

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

66. The Bank also carries out **economic research**, including recent studies on tax policy and tax administration, regional policy, intergovernmental reform, pension policy, public expenditures and the budget process, poverty, financial sector and corporate governance, procurement system, financial accountability, and health and education. Reports under preparation include a new CEM, a Trade Study, an Energy Study, and an agriculture policy review.

World Bank Contact: Luca Barbone, Country Director (Tel.: 473-2556).

UKRAINE: RELATIONS WITH THE EBRD

(January 2004)

67. 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, partly through its membership of the Foreign Investment Advisory Council, but more especially, and in a sector-focused manner, through its co-chairmanship of the Task Force on Energy Sector reform.

68. 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.

69. 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. As a consequence, in the strategy 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.

70. Thus since the summer of 2000 the EBRD's strategy has been to focus on strengthening the financial sector and supporting the needs of SMEs; promoting the commercialization and structural reform of public utilities, services and improving energy efficiency; supporting the transition of the enterprise sector, especially in agribusiness, consumer products, and intermediate goods. 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.

71. During the period of this strategy, the size of the EBRD's portfolio remained at little under EUR 1 billion. However, the EBRD was successful in attracting more non-EBRD financing so that the total value of projects in which the EBRD was involved rose quite sharply. This period was also one of rapid economic growth, progress in reform in some sectors, for example energy and agriculture, and also saw the government's re-confirmation of its European aspirations. In its latest Country Strategy, which was approved by the EBRD Board at the beginning of September 2002, the EBRD resolved to build on the experience of the previous two years and further expand its involvement in Ukraine. There would be particular focus on promoting new private sector business and on using the leverage afforded by priority public sector projects and policy dialogue, to improve the investment climate. It was also recognized that maintaining co-ordination with other IFIs and with other sources of TC funding remained essential.

72. The EBRD's latest operational strategy has six main elements which are listed below (not necessarily in order of priority), and where the EBRD intends to be active during the next two years:

- encouraging sustained momentum in privatization and commercialization of major utilities;
- encouraging energy efficiency in both the state and private sectors;
- providing funding through the banks to develop the small business sector and at the same time continue to strengthen the banking sector to enable banks to meet the demand for a growing range of banking services from other parts of the economy;
- providing direct financing to the private corporate sector;
- commence funding for the agricultural sector through the provision of working capital;
- continuing to implement the EBRD's nuclear safety mandate, both in the administrative role for donor funds on the Chernobyl project initiatives and the negotiations leading towards potential financing of the K2R4 project.

73. With respect to the K2R4 project, 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.

74. 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.

75. The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 58 by the end of December 2003. These amount to a historical net business volume of EUR 1,278.7 million. Of this amount EUR 858.6 million represented the Portfolio (operating assets plus undrawn commitments), of which 72 percent were assigned to the private sector (EUR 614.7 million) and 28 percent to the state sector (EUR 243.9 million). Operating assets amounted to EUR 524.1 million at the end of December 2003.

76. The outstanding commitments to Ukraine represent almost 5.8 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 207 projects with a total value of commitments of almost EUR 46.6 million. These are mainly related to project preparation and implementation.

77. Projects in the financial sector account for slightly over 27 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 96.2 million) was signed at the end of 1994, and is now fully disbursed. A second credit line (for EUR 70.1 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 18.7 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 32 percent, transport and shipping 14 percent, telecommunications 4.8 percent, municipal infrastructure 2 percent, with tourism and property accounting for the remaining 1.5 percent of all commitments.

STATISTICAL APPENDIX

78. The authorities continued to make improvements in a number of areas over the past year. A Report on the Observance of Standards and Codes (ROSC) Data Module was prepared in 2002, and disseminated on IMF's website on August 19, 2003, assessing Ukraine's data dissemination practices against the IMF's Special Data Dissemination Standards (SDDS). On January 10, 2003, Ukraine become the first CIS country to subscribe to the SDDS. Ukraine's first international investment position was compiled by the NBU in 2002. The country's *IFS* page has been published since July 1996.

79. While the Fund's technical assistance has been significantly reduced in recent years, various multilateral and bilateral sources continued to play an important role. The ROSC recommended to strengthen the independence of the State Committee on Statistics (SCS). The problem areas include national accounts, which suffer from a variety of methodological problems, and balance of payments data, including timely publishing of external debt data.

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

Real Sector

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

82. Despite the success achieved in recent years, the national accounts still suffer from several weaknesses: (i) lack of published time series of real GDP showing its level relative to given reference year; (ii) the quarterly data are not seasonally adjusted; (iii) the fourth quarter national accounts are not compiled from the source data that are consistent with the source data of the first three quarters; and (iv) there are no proper quarterly price indices for exports and imports, although the development of these indices has started. The authorities agreed that the methodology covering the informal economy needs to be revised and improved. A further revamp of the data collection and production environment is needed; in particular, in terms of greater use of sample surveys and improving data flow management and processing. To address the shortcomings, it is important to revive the Statistical Council to provide guidance on the quality of the statistical series and on strategies for improving data production.

Government Finance Statistics

83. The Ministry of Finance (MoF) and the State Treasury (STU) have made considerable progress in the compilation of fiscal data. The MoF publishes monthly data on operations of the central and regional government within 25 days of the reference period. The economic classification of transactions and the classification of outstanding debt are consistent with the

methodology outlined in the 1986 Fund publication *A Manual on Government Finance Statistics (GFSM 1986.)* From 2002, the functional classification is consistent with the *GFSM 2001*. All central government transactions and local government revenue transactions are recorded in the Treasury Single Account (TSA). Starting in 2004, local government expenditures will also be covered.

84. The data ROSC report highlighted that Government Finance Statistics (GFS) are available monthly but do not provide the coverage recommended in the *GFSM 1986*. The data formats are more suited to the short-term needs of monitoring the execution of the budget in the current year, rather than for statistical analysis. The ROSC report also encouraged the authorities to report annual general government data for 1999–2001, in the *GFSM 2001* format, for publication in the *GFS Yearbook*. The authorities were also encouraged to publish more extensive information on the definitions, sources, and methods used in the compilation of fiscal data. In addition, the non-budget social security funds need to be included in the coverage of data on central government operations, and further work is needed to improve the timeliness of these data.

85. The staff also noted that reporting on arrears, both for receipts and payments, should be improved in terms of coverage and quality. There are still significant delays in reporting on the operations of social special funds.

Money and banking statistics

86. Ukraine has received extensive technical assistance in money and banking statistics, and substantial improvements have already been made. The data ROSC report suggested that the timeliness of the analytical accounts of the central bank be improved using the daily accounting records excluding internal organizations The staff urged the authorities to meet the prescribed SDDS timeliness for these accounts rather than exercise the flexibility option on this matter.

87. The authorities are working on disseminating information on the compilation of monetary data, including on major aggregates and differences from internationally accepted standards; as well as on establishing a migration plan to adopt the recommendations included in the *Monetary and Financial Statistics Manual (MFSM)*.

Other recommendations highlighted in the ROSC report are: (i) expand the coverage of the monetary data, including on nonbank financial institutions issuing deposit substitutes; (ii) enhance the consistency of monetary data; (iii) separately identify information on financial derivatives; and (iv) verify consistency of monetary statistics and government finance statistics on a regular basis.

Balance of Payments Statistics

88. Ukraine reports balance of payments statistics to STA on a quarterly basis with a lag of about ten weeks, that are compiled in broad conformity with the conceptual framework of the *BPM5*. The principal data sources are a closed ITRS, administrative data sources, and a survey

of enterprises. Following the recommendations of the data ROSC report, the authorities have expanded the survey on inter-enterprise arrears to include information relevant for balance of payments purposes, and are going to implement lower reporting thresholds for banks. Due to lack of financing, the authorities have not implemented travelers' surveys in order to improve the quality of shuttle trade, compensation of employees, and travel estimates. Some methodological weaknesses exist in private portfolio and FDI surveys. The authorities have made progress in disseminating international reserves data. The release of monthly data, in line with the Fund's reserve template, started in mid-2002. Though the cooperation between different government agencies has improved in recent years, problems still exist in coordinating the work of the National Bank of Ukraine, the SCS, and the MoF, particularly regarding short-term external debt.

Ukraine: Core Statistical Indicators

(as of January 28, 2004)

	Exchange Rates	International Reserves[1/]	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt	Debt Service
Date of latest observation	Jan. 26, 2004	Jan. 26, 2004	Dec. 31, 2004	Jan. 22 , 2004	Jan. 22, 2004	Jan. 22, 2003	December 2003	Q4 2003	Q3 2003	November, 2003	Novembe r 2003	December 2003	December 2003
Date received	Jan. 28, 2004	Jan. 28 , 2004	Jan. 28, 2004	Jan. 28, 2004	Jan. 28, 2004	Jan. 28, 2004	January 9, 2004	January 2004	December 2003	Dec. 29, 2003	Decembe r 24, 2003	January 2004	January 2004
Frequency of data	D	D	M	D	D	D	M	M	Q	M	M	M	M
Frequency of reporting	D	D	M	D	D	D	M	M	Q	M	M	M	M
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	V	C	C	C	C	C
Confidentiality	C	B	B	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	D	M	M	M	M	M	Q	Q	M	M	Q	Q

1/ Gross Official Reserves and Net International Reserves

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 e-mailed to Headquarters.

Confidentiality: B-for use by the staff and the Executive Board, C-unrestricted use.

VULNERABILITIES AND DEBT SUSTAINABILITY

A. Potential Sources of Vulnerability

89. Favorable economic performance in recent years has brought about an improvement in several key vulnerability indicators. Medium- and long-term debt of the government and the central bank declined from about 61 percent at end-1999 to 32 percent at end-2003. The stock of treasury bills held by nonresidents, which had contributed to Ukraine's liquidity problems in 1998-99, is now insignificant. Economic growth has resumed, and there has been a current account surplus since 1999. Gross international reserves have recovered from very low levels in 1998 and reached almost three months of imports by end-2003.

90. Ukraine's most immediate vulnerabilities are not related to public debt levels, but rather to potential imbalances in the financial sector and domestic confidence reversals:

- **Credit and exchange rate risk in the banking sector**: Very rapid money and credit growth has exposed the banking sector to significant credit risk, especially given banks' limited risk management capacities and relatively weak financial conditions. Real growth of banking credit to the economy has averaged 40 percent per year since 2000, and accelerated to 51 percent in 2003. About a quarter of loans are nonperforming (defined as substandard, doubtful, and loss). Lending rates and spreads over deposit rates have fallen, but remain high. Assets of the banking sector now amount to about 40 percent of GDP, suggesting that systemic banking distress could have a significant impact on the economy and the budget. The stable exchange rate has induced a large increase in lending denominated in foreign currency. While the share of foreign currency loans in total loans has slightly fallen to 38½ percent, it has risen substantially relative to GDP (from 5 percent at end-2000 to 11 percent at end-2003). To fund this increase banks have increasingly resorted to short-term funds from abroad. Given this exposure, a large exchange rate depreciation could result in many borrowers defaulting on their loans; withdrawal of foreign currency deposits; and reversal of foreign funds. The *de facto* fixed exchange rate regime is contributing to the exchange rate-related credit risks and is likely to instill even more "fear of floating."[4]

- **A loss of domestic confidence**: Renewed domestic confidence in macroeconomic stability has been instrumental in driving the remonetization process and the economic recovery as a whole. Confidence could suffer under various circumstances. First, rapid money growth would fuel inflation if money demand slows down. Second, with the upcoming presidential elections later in the year, economic policies may become more

[4] The more financially dollarized an economy is, the less disposed the monetary authorities will be to let the exchange rate float. In addition, highly dollarized countries tend to have a high pass-through coefficient of the exchange rate to prices.

"politicized," which could affect the fiscal stance, banking sector policies, and the investment climate. Third, banking sector weaknesses could become more immediate, especially if money demand slows down. Fourth, external shocks could weaken optimism about future economic growth. These factors could induce residents to switch into foreign currency as a store of value, and put downward pressure on reserves and/or the exchange rate. They could also put additional stress on the banking system and lead to increased capital outflows. This in turn would lead to a sharp slowdown in economic growth and could create debt problems in the medium term.

91. A number of other risks remain over the medium term:

- **Reversal of private transfers and large capital outflows**: Adverse external developments could lead to a reversal of private transfers, and loss of confidence in macroeconomic stability (see above) could trigger capital flight.

- **Liquidity risks**: Gross reserves, at US$6.9 billion at the end of 2003, are projected to cover public sector external debt service falling due over the next three years. This suggests that foreign currency liquidity risks for the government are relatively minor, even in case of a temporary disruption of access to international capital markets. There are a number of caveats, however. First, reserves could fall if the NBU intervenes to prop up the hryvnia. Second, there are a number of contingent liabilities, notably in the energy and banking sectors, that could lead to unforeseen debt service obligations. Third, if new external borrowing becomes a lot more expensive, interest payments could rise substantially. Fourth, if new Eurobond issuance becomes prohibitively expensive, recourse to domestic financing may not be available, given underdeveloped financial markets, implying risks to budget implementation.

- **Downturn in Russia**: The Ukrainian economy is relatively open and dependent on international trade. While exports are diversified and Ukrainian companies have been successful in finding new markets, Russia remains the largest market for Ukrainian goods, accounting for close to 20 percent of all exports. Taking into account the other CIS countries, which are also dependent on the Russian economy, a downturn in Russia would affect about one fourth of Ukraine's exports, equivalent to about 12 percent of GDP. A decline in net service demand, foreign investment, and worker's remittances from Russia may also have a noticeable adverse impact on Ukraine's economy.

- **Contingent liabilities**: The quasi-fiscal deficit in the electricity, gas, and coal sectors was estimated by Fund staff at 3½ percent of GDP in 2002, but since the deficit was partly financed through tax arrears and budgetary subsidies, the combined public sector deficit was about 1½ percent above the consolidated budget deficit. Electricity and gas debts were estimated at 12 percent of GDP. The state-owned commercial bank remains highly undercapitalized and a failure to rehabilitate the bank may have some budgetary implications over the medium run.

- **Stalled structural reforms:** Lack of reform progress would reduce growth prospects and increase vulnerabilities (see below). Fiscal loosening could exacerbate problems over the medium term and lead to high and unsustainable debt ratios.

B. Debt Sustainability

Medium-term scenarios

92. The baseline scenario (see Table 2 of the staff report) assumes prudent macroeconomic policies and significant progress on structural reform aimed at improving the investment climate. New external borrowing is assumed to be limited to external amortization. Taking into account population decline and weaknesses in the rule of law, real GDP growth is projected at about 4 percent per year. The current account surplus is expected to unwind gradually, as investment and import demand increase. The capital account is projected to strengthen as portfolio outflows subside. The NBU is projected to maintain gross international reserves equivalent to three months of imports.

93. In the low case (Table 2 of the staff report), it is assumed that no significant progress on structural reform is made and there is a looser fiscal stance, with non-interest spending one percentage point of GDP higher than in the base case. This would crowd out some private investment, and real GDP growth is assumed to be about 2 percent per year on average. Lack of structural reform would depress export growth, while low investment demand would lead to slower import growth than in the baseline. Reduced domestic confidence would imply higher interest rates, by an assumed 2 percentage points on domestic and external borrowing, and would lead to higher capital outflows relative to the baseline. As a result, public debt would rise and international reserves would fall.

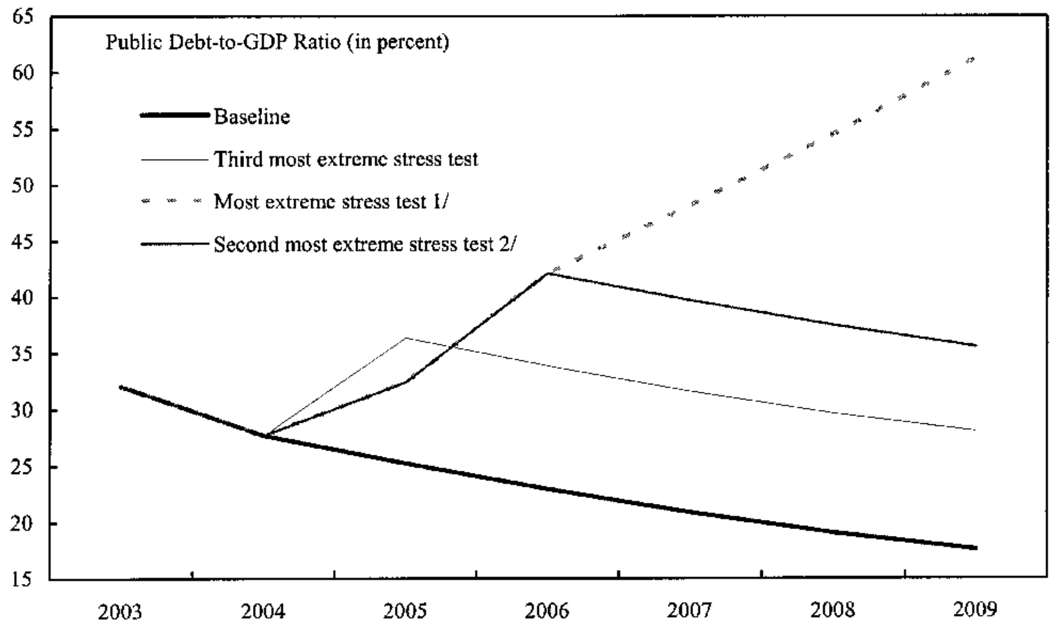
Fiscal and external sustainability

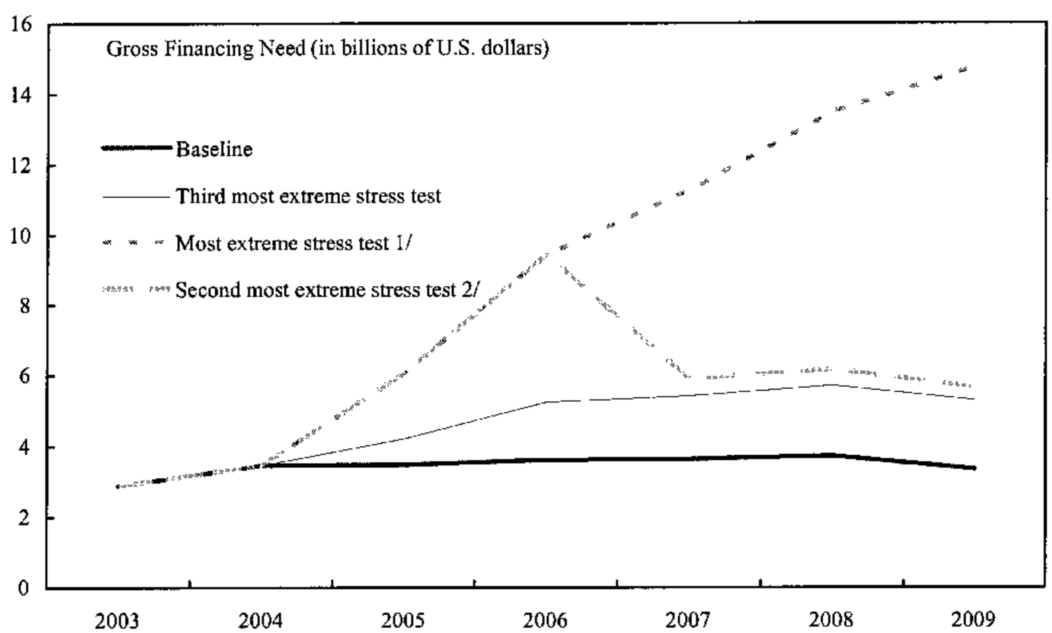
94. Figures 1, 2 and Tables 1, 2 show the results of the sensitivity analysis performed to test the sustainability of public and external debt to various types of one-time shocks. The shocks reflect historical volatilities of key economic indicators during the period 1997-2003. In the baseline scenario, the sensitivity analysis suggests that a large output shock—negative real growth rates of 6.7 percent for two consecutive years—could push the public debt to GDP ratio over 40 percent. As long as fiscal policy responds by curbing expenditure, such a development would be short-lived and the debt to GDP ratio would reverse to below the 40 percent threshold from 2007. However, if fiscal policy lacked such prudence, public debt dynamics would become unsustainable and debt ratios would rise to over 60 percent by 2009. A one-time 30 percent depreciation in 2005 could raise the public debt-to-GDP ratio by 9 percentage points above the baseline. An even more pronounced depreciation over two consecutive years could increase external debt to 40 percent of GDP in 2006. However, under all other baseline scenarios the debt ratios would converge to below or close to 30 percent of GDP by the 2009 unless a quasi-fiscal deficit in the magnitude of 1½ percent per year would persist which could push debt ratios above 40 percent for some time in case of large output

shocks. Thus, as long as macroeconomic policies remain prudent and structural reforms continue even when there are large shocks, the debt ratios are sustainable over the longer run.

95. In the low case scenario (Figures 3, 4 and Tables 3, 4), the same shocks would result in high and unsustainable public debt-to-GDP ratios. A temporary growth decline and depreciation would lead to continuously rising public debt ratios to over 50 percent of GDP by 2009, well above the 40 percent benchmark that is considered to be a useful indicator for vulnerability in emerging market economies.

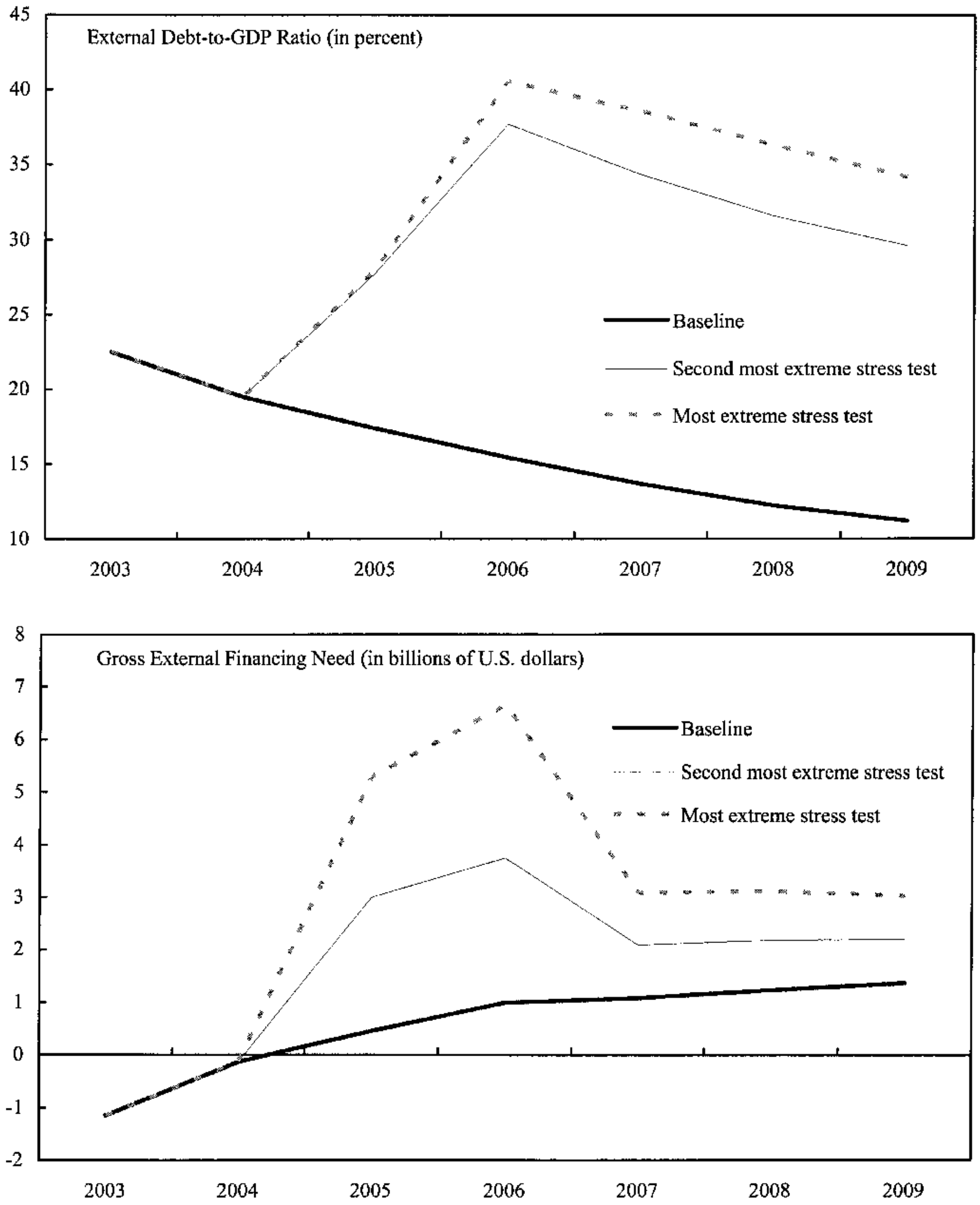
Figure 1. Ukraine: Baseline Scenario: Public Debt Sustainability: Debt Ratio and Gross Financing Need, 2003-09





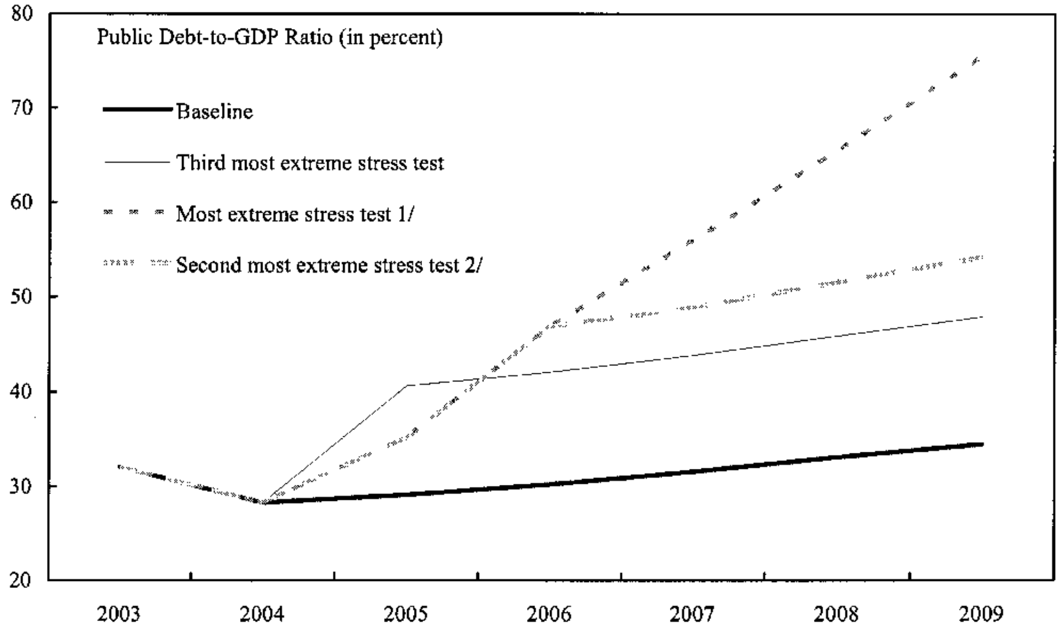
Source: IMF staff calculations.
1/ Based on GDP growth stress test which assumes no adjustment of fiscal expenditure.
2/ Based on GDP growth stress test which assumes a return of the expenditure ratio to baseline average after the two shock years.

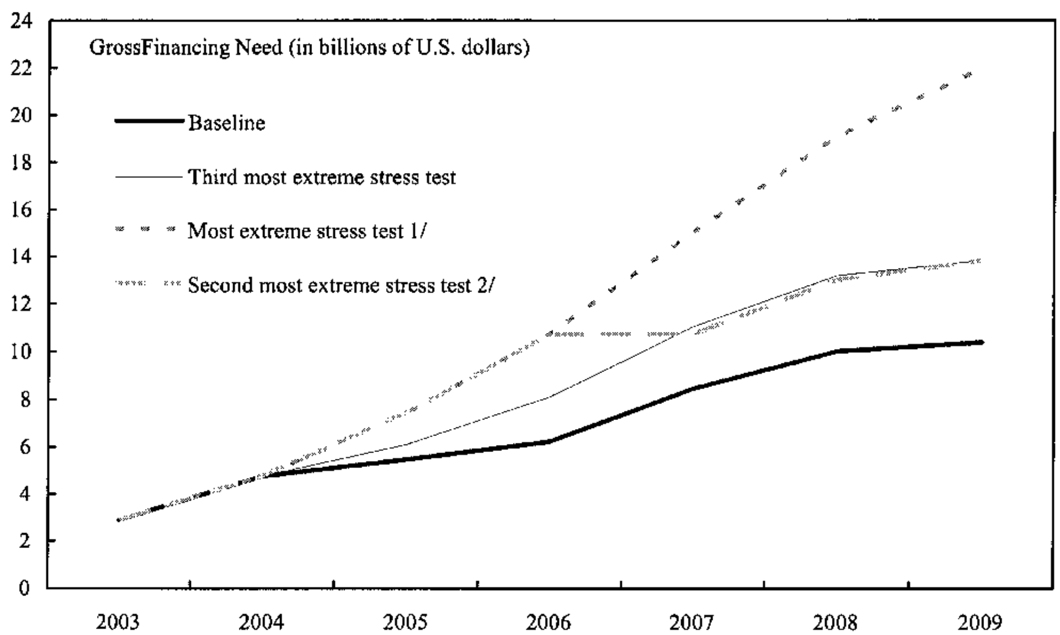
Figure 2. Ukraine: External Debt Sustainability, Baseline Scenario, External Debt Ratio, and Gross External Financing Need, 2003-09



Source: IMF staff calculations.

Figure 3. Ukraine: Public Debt Sustainability, Low Case Scenario, Debt Ratio, and Gross Financing Need, 2003-09



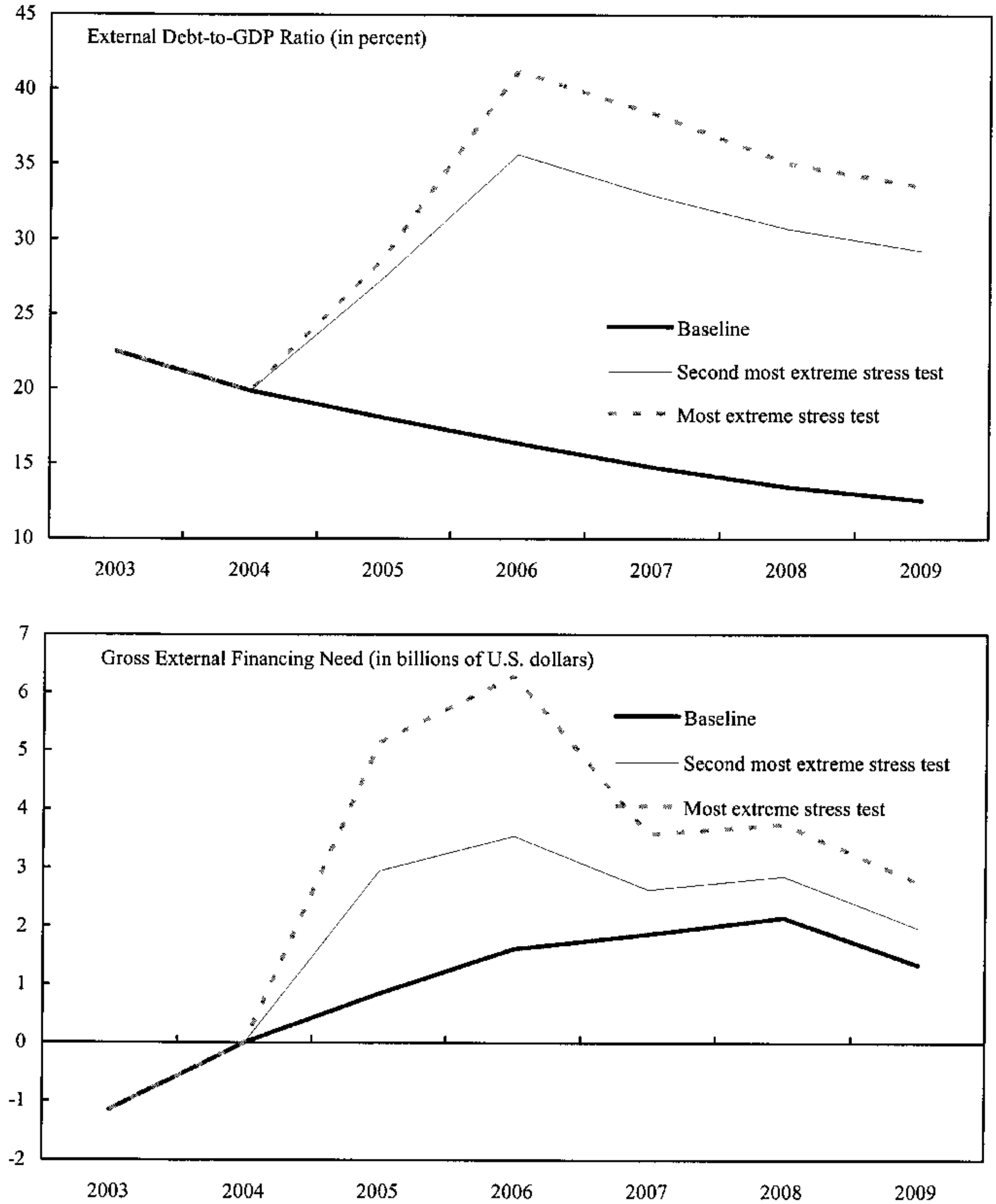


Source: IMF staff calculations.

1/ Based on GDP growth stress test which assumes no adjustment of fiscal expenditure.

2/ Based on GDP growth stress test which assumes a return of the expenditure ratio to baseline average after the two shock years.

Figure 4. Ukraine: External Debt Sustainability, Low Case Scenario, Debt Ratio, and Gross External Financing Need, 2003-09



Source: IMF staff calculations.

Table 1. Ukraine: Baseline Scenario: Public Sector Debt Sustainability Framework, 2002-2009

(In percent of GDP, unless otherwise indicated)

	2002	Est. 2003	7-Year Historical Average	7-Year Standard Deviation	Projections 2004	2005	2006	2007	2008	2009	
					I. Baseline Projections						**Debt-stabilizing primary balance 11/**
1 **Public sector debt 1/**	36.9	32.1			**27.7**	**25.3**	**23.0**	**20.9**	**19.1**	**17.6**	**-0.7**
o/w foreign-currency denominated	27.8	25.2			21.9	19.7	17.5	15.6	14.0	12.8	
2 Change in public sector debt	-2.5	-4.9			-4.3	-2.4	-2.3	-2.1	-1.8	-1.5	
3 Identified debt-creating flows (4+7+12)	-3.8	-5.6			-2.9	-1.7	-1.5	-1.4	-1.3	-1.2	
4 Primary deficit	-1.9	-0.3			0.4	-0.5	-0.5	-0.5	-0.5	-0.5	
5 Revenue and grants	36.8	37.7			37.3	37.3	36.8	36.8	36.8	36.8	
6 Primary (noninterest) expenditure	34.9	37.5			37.6	36.8	36.3	36.3	36.3	36.3	
7 Automatic debt dynamics 2/	-1.5	-4.1			-2.5	-0.7	-0.5	-0.4	-0.3	-0.2	
8 Contribution from interest rate/growth differential 3/	-1.6	-4.2			-2.5	-0.7	-0.5	-0.4	-0.3	-0.2	
9 Of which contribution from real interest rate	0.1	-1.5			-0.8	0.3	0.5	0.5	0.5	0.5	
10 Of which contribution from real GDP growth	-1.7	-2.7			-1.7	-1.0	-0.9	-0.9	-0.8	-0.7	
11 Contribution from exchange rate depreciation 4/	0.2	0.0			...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.5	-1.1			-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	
13 Privatization receipts (negative)	-0.5	-1.1			-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	
14 Recognition of implicit or contingent liabilities	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.3	0.7			-1.4	-0.7	-0.8	-0.7	-0.6	-0.3	
Public sector debt-to-revenue ratio 1/	100.3	84.9			74.3	67.9	62.7	56.9	51.9	48.0	
Gross financing need 6/	4.4	6.0			6.3	5.9	5.6	5.2	5.0	4.1	
in billions of U.S. dollars	1.8	2.9			3.5	3.5	3.6	3.6	3.7	3.4	
Key Macroeconomic and Fiscal Assumptions			7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.8	8.5	3.3	5.0	6.0	4.0	4.0	4.0	4.0	4.0	4.3
Average nominal interest rate on public debt (in percent) 7/	3.7	3.2	5.5	1.6	4.9	5.7	6.1	6.4	6.8	7.1	6.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.4	-4.0	-9.0	7.6	-2.3	1.4	2.1	2.4	2.8	3.1	1.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.6	0.0	-11.6	19.3	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.3	7.2	14.5	8.8	7.2	4.4	4.0	4.0	4.0	4.0	4.6
Growth of real primary spending (deflated by GDP deflator, in percent)	10.4	16.4	3.6	12.9	6.5	1.6	2.6	4.0	4.0	4.0	3.8
Primary deficit	-1.9	-0.3	-0.1	1.8	0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4
					II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 8/					**27.7**	**23.3**	**19.2**	**15.7**	**12.7**	**10.4**	**-1.7**
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006					**27.7**	**26.6**	**25.3**	**23.1**	**21.2**	**19.8**	**-0.7**
B2 a. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 (unchanged nominal expenditure)					**27.7**	**32.5**	**42.2**	**48.2**	**54.6**	**61.3**	**-1.2**
B2 b: Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 (expenditure ratio adjusts to baseline average after two shock years)					**27.7**	**32.5**	**42.2**	**39.8**	**37.5**	**35.6**	
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006					**27.7**	**29.4**	**31.1**	**28.8**	**26.9**	**25.4**	**-0.8**
B4. Combination of 2-4 using one standard deviation shocks					**27.7**	**28.3**	**28.7**	**26.4**	**24.3**	**22.7**	**-0.8**
B5. One time 30 percent real depreciation in 2005 10/					**27.7**	**36.3**	**33.9**	**31.6**	**29.6**	**28.0**	**-0.8**
B6. 10 percent of GDP increase in other debt-creating flows in 2005					**27.7**	**35.3**	**32.9**	**30.6**	**28.6**	**27.1**	**-0.8**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - p (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ The implied change in other key variables under this scenario is discussed in the text.

10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 2. Ukraine: Baseline Scenario: External Debt Sustainability Framework, 2002-2009
(In percent of GDP, unless otherwise indicated)

	2002	Est. 2003			Projections 2004	2005	2006	2007	2008	2009	
					I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
1 **External debt**	24.6	22.5			19.5	17.4	15.5	13.7	12.3	11.2	-1.7
2 Change in external debt	-2.0	-2.1			-3.0	-2.0	-2.0	-1.8	-1.5	-1.0	
3 Identified external debt-creating flows (4+8+9)	-7.1	-9.0			-4.8	-3.6	-3.3	-3.0	-2.4	-1.5	
4 Current account deficit, excluding interest payments	-8.9	-7.1			-4.7	-3.5	-2.5	-1.7	-1.0	-0.3	
5 Deficit in balance of goods and services	-4.5	-2.9			-1.4	-0.7	0.0	0.6	1.1	1.6	
6 Exports	56.3	60.1			55.7	54.1	52.9	51.9	50.9	49.9	
7 Imports	51.8	57.2			54.2	53.4	52.9	52.4	52.0	51.5	
8 Net non-debt creating capital inflows (negative)	2.7	0.6			0.1	-0.3	-0.9	-1.4	-1.6	-1.4	
9 Automatic debt dynamics 1/	-1.0	-2.4			-0.2	0.2	0.1	0.2	0.2	0.2	
10 Contribution from nominal interest rate	1.2	1.0			1.0	0.9	0.8	0.7	0.7	0.7	
11 Contribution from real GDP growth	-1.2	-1.8			-1.2	-0.7	-0.6	-0.6	-0.5	-0.5	
12 Contribution from price and exchange rate changes 2/	-1.1	-1.6			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	5.1	6.9			1.8	1.6	1.3	1.2	0.9	0.5	
External debt-to-exports ratio (in percent)	43.7	37.5			35.0	32.3	29.3	26.5	24.1	22.5	
Gross external financing need (in billions of US dollars) 4/	-1.8	-1.1			-0.1	0.5	1.0	1.1	1.2	1.4	
in percent of GDP	-4.3	-2.4			-0.2	0.8	1.6	1.6	1.6	1.7	
Key Macroeconomic Assumptions			7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.8	8.5	3.3	5.0	6.0	4.0	4.0	4.0	4.0	4.0	4.3
GDP deflator in US dollars (change in percent)	4.2	7.1	-1.0	14.7	7.2	4.4	4.0	4.0	4.0	4.0	4.6
Nominal external interest rate (in percent)	4.9	4.9	6.6	2.2	5.0	5.0	4.9	5.0	5.5	5.8	5.2
Growth of exports (US dollar terms, in percent)	10.7	24.0	5.8	12.4	5.3	5.5	5.7	6.1	6.1	6.1	5.8
Growth of imports (US dollar terms, in percent)	5.0	28.3	4.9	17.0	7.7	6.8	7.2	7.2	7.2	7.2	7.2
Current account balance, excluding interest payments	8.9	7.1	4.9	4.2	4.7	3.5	2.5	1.7	1.0	0.3	2.3
Net non-debt creating capital inflows	-2.7	-0.6	0.5	1.8	-0.1	0.3	0.9	1.4	1.6	1.4	0.9
					II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 5/					19.5	17.5	15.1	12.5	9.5	5.8	-1.2
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006					19.5	18.5	17.6	15.8	14.3	13.2	-1.7
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					19.5	19.8	20.3	18.5	16.9	15.6	-2.1
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006					19.5	28.0	40.5	38.5	36.3	34.1	-3.9
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006					19.5	24.5	28.4	26.3	24.5	23.2	-1.9
B5. Combination of 2-5 using one standard deviation shocks					19.5	27.8	37.7	34.3	31.6	29.6	-3.1
B6. One time 30 percent nominal depreciation in 2005					19.5	26.4	24.7	22.8	21.1	19.6	-2.5

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

2/ The contribution from price and exchange rate changes is defined as [-r (1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes price and exchange rate changes

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

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

6/ The implied change in other key variables under this scenario is discussed in the text.

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

Table 3. Ukraine: Low Case Scenario: Public Sector Debt Sustainability Framework, 2002-2009

(In percent of GDP, unless otherwise indicated)

	2002	Est. 2003	7-Year Historical Average	7-Year Standard Deviation	Projections 2004	2005	2006	2007	2008	2009	
					I. Baseline Projections						**Debt-stabilizing primary balance 11/**
1 **Public sector debt 1/**	36.9	32.1			**28.2**	**29.2**	**30.3**	**31.6**	**33.1**	**34.5**	**1.5**
o/w foreign-currency denominated	27.8	25.2			22.3	20.4	18.6	16.9	15.4	14.4	
2 Change in public sector debt	-2.5	-4.8			-3.8	0.9	1.1	1.4	1.5	1.4	
3 Identified debt-creating flows (4+7+12)	-3.8	-5.6			0.7	1.6	1.9	2.2	2.1	1.7	
4 Primary deficit	-1.9	-0.3			2.1	1.2	1.2	1.2	0.9	0.2	
5 Revenue and grants	36.8	37.7			36.6	36.6	36.1	36.1	36.1	36.8	
6 Primary (noninterest) expenditure	34.9	37.5			38.6	37.8	37.3	37.3	37.0	37.0	
7 Automatic debt dynamics 2/	-1.5	-4.1			-0.9	0.5	0.8	1.1	1.3	1.6	
8 Contribution from interest rate/growth differential 3/	-1.6	-4.2			-0.9	0.5	0.8	1.1	1.3	1.6	
9 Of which contribution from real interest rate	0.1	-1.5			0.2	1.0	1.4	1.6	1.9	2.2	
10 Of which contribution from real GDP growth	-1.7	-2.7			-1.2	-0.5	-0.5	-0.6	-0.6	-0.6	
11 Contribution from exchange rate depreciation 4/	0.2	0.0			...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.5	-1.1			-0.4	-0.1	-0.1	-0.1	-0.1	-0.1	
13 Privatization receipts (negative)	-0.5	-1.1			-0.4	-0.1	-0.1	-0.1	-0.1	-0.1	
14 Recognition of implicit or contingent liabilities	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.3	0.7			-4.5	-0.7	-0.8	-0.8	-0.6	-0.3	
Public sector debt-to-revenue ratio 1/	100.3	84.9			77.2	79.7	83.9	87.7	91.9	93.8	
Gross financing need 6/	4.4	6.0			8.9	9.5	10.2	13.1	14.7	14.3	
in billions of U.S. dollars	1.8	2.9			4.8	5.5	6.2	8.5	10.1	10.4	
Key Macroeconomic and Fiscal Assumptions			7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.8	8.5	3.3	5.0	4.0	2.0	2.0	2.0	2.0	2.0	2.3
Average nominal interest rate on public debt (in percent) 7/	3.7	3.2	5.5	1.6	8.2	8.4	9.2	9.8	10.6	11.1	9.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.4	-4.0	-9.0	7.6	1.0	4.0	5.2	5.8	6.6	7.1	4.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.6	0.0	-11.6	19.3	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.3	7.2	14.5	8.8	7.1	4.4	4.0	4.0	4.0	4.0	4.6
Growth of real primary spending (deflated by GDP deflator, in percent)	10.4	16.4	3.6	12.9	7.3	-0.3	0.6	2.0	1.2	2.0	2.1
Primary deficit	-1.9	-0.3	-0.1	1.8	2.1	1.2	1.2	1.2	0.9	0.2	1.1
					II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 8/					**28.2**	**24.2**	**20.4**	**17.1**	**14.4**	12.3	**-1.5**
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006					**28.2**	**29.7**	**31.1**	**32.5**	**34.1**	**35.5**	**1.6**
B2 a. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 (unchanged nominal expenditure)					**28.2**	**35.3**	**47.0**	**56.0**	**65.6**	**75.7**	**3.5**
B2 b. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 (expenditure ratio adjusts to baseline average after the two shock years)					**28.2**	**35.3**	**47.0**	**49.0**	**51.6**	**54.3**	
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006					**28.2**	**31.5**	**35.1**	**36.6**	**38.3**	**39.9**	**1.8**
B4. Combination of 2-4 using one standard deviation shocks					**28.2**	**29.3**	**30.1**	**31.4**	**32.9**	**34.2**	**1.5**
B5. One time 30 percent real depreciation in 2005 10/					**28.2**	**40.7**	**42.1**	**43.9**	**46.0**	**47.9**	**2.2**
B6. 10 percent of GDP increase in other debt-creating flows in 2005					**28.2**	**39.2**	**40.6**	**42.3**	**44.2**	**46.1**	**2.1**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - p (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ The implied change in other key variables under this scenario is discussed in the text.

10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 4. Ukraine: Low Case Scenario: External Debt Sustainability Framework, 2002-2009

(In percent of GDP, unless otherwise indicated)

	2002	Est. 2003	7-Year Historical Average	7-Year Standard Deviation	Projections 2004	2005	2006	2007	2008	2009	
					I. Baseline Projections						Debt-stabilizing non-interest current account 7/
1 **External debt**	24.6	22.5			19.9	18.1	16.4	14.8	13.5	12.6	-1.6
2 Change in external debt	-2.0	-2.1			-2.6	-1.7	-1.7	-1.6	-1.3	-0.9	
3 Identified external debt-creating flows (4+8+9)	-7.1	-9.0			-4.2	-2.7	-2.1	-1.7	-1.0	-1.5	
4 Current account deficit, excluding interest payments	-8.9	-7.1			-4.6	-3.0	-1.7	-0.6	0.3	-0.4	
5 Deficit in balance of goods and services	-4.5	-2.9			12.4	13.7	13.9	13.9	13.8	13.8	
6 Exports	56.3	60.1			56.2	54.8	53.8	53.1	52.3	51.5	
7 Imports	51.8	57.2			68.6	68.6	67.7	66.9	66.1	65.3	
8 Net non-debt creating capital inflows (negative)	2.7	0.6			0.1	-0.3	-1.0	-1.5	-1.7	-1.6	
9 Automatic debt dynamics 1/	-1.0	-2.4			0.2	0.6	0.5	0.5	0.5	0.5	
10 Contribution from nominal interest rate	1.2	1.0			1.0	0.9	0.8	0.8	0.8	0.7	
11 Contribution from real GDP growth	-1.2	-1.8			-0.8	-0.4	-0.3	-0.3	-0.3	-0.3	
12 Contribution from price and exchange rate changes 2/	-1.1	-1.6			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	5.1	6.9			1.6	1.0	0.4	0.1	-0.3	0.6	
External debt-to-exports ratio (in percent)	43.7	37.5			35.4	33.1	30.5	27.9	25.8	24.5	
Gross external financing need (in billions of US dollars) 4/	-1.8	-1.1			0.0	0.8	1.6	1.9	2.1	1.3	
in percent of GDP	-4.3	-2.4			0.0	1.5	2.7	2.9	3.1	1.9	
Key Macroeconomic Assumptions											Projected Average
Real GDP growth (in percent)	4.8	8.5	3.3	5.0	4.0	2.0	2.0	2.0	2.0	2.0	2.3
GDP deflator in US dollars (change in percent)	4.2	7.1	-1.0	14.7	7.2	4.4	4.0	4.0	4.0	4.0	4.6
Nominal external interest rate (in percent)	4.9	4.9	6.6	2.2	5.0	5.0	4.9	5.0	5.5	5.8	5.2
Growth of exports (US dollar terms, in percent)	10.7	24.0	5.8	12.4	4.3	3.9	4.1	4.5	4.5	4.5	4.3
Growth of imports (US dollar terms, in percent)	5.0	28.3	4.9	17.0	33.7	6.4	4.8	4.8	4.8	4.8	9.9
Current account balance, excluding interest payments	8.9	7.1	4.9	4.2	4.6	3.0	1.7	0.6	-0.3	0.4	1.7
Net non-debt creating capital inflows	-2.7	-0.6	0.5	1.8	-0.1	0.3	1.0	1.5	1.7	1.6	1.0
					II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 6/
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 5/					19.9	17.3	13.8	9.8	5.2	1.3	-1.5
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006					19.9	19.3	18.7	17.1	15.7	14.8	-1.6
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					19.9	20.1	20.2	18.5	16.8	15.8	-1.9
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006					19.9	28.7	41.2	38.4	35.0	33.5	-3.7
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006					19.9	24.7	28.1	26.4	25.0	24.1	-1.7
B5. Combination of 2-5 using one standard deviation shocks					19.9	27.4	35.6	32.9	30.7	29.2	-2.7
B6. One time 30 percent nominal depreciation in 2005					19.9	27.2	25.4	23.4	21.4	20.3	-2.3

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

2/ The contribution from price and exchange rate changes is defined as $[-t(1+g) + ea(1+r)]/(1+g+t+gt)$ times previous period debt stock. t increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes price and exchange rate changes

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

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

6/ The implied change in other key variables under this scenario is discussed in the text.

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

March 11, 2004

Ms. Anne O. Krueger
Acting Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Krueger,

The attached Memorandum of Economic and Financial Policies (MEFP) describes the policies that the Government of Ukraine and the National Bank of Ukraine (NBU) intend to implement in 2004. These policies are aimed at ensuring continued macroeconomic stability and supporting sustainable economic growth. In this context we view as central to our economic program the maintenance of prudent fiscal and monetary policies, as well as the implementation of our structural reform agenda. In support of these policies, we are requesting a 12-month stand-by arrangement in an amount equivalent to SDR 411.6 million (30 percent of quota). Ukraine's balance of payments position has improved substantially since 1999 and we do not intend to effect any purchases under the arrangement.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of our economic program, but we will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. We will provide the Fund with information it requests for monitoring progress in program implementation. After the arrangement expires, and while Ukraine has outstanding financial obligations to the Fund, we will consult with the Fund on Ukraine's economic and financial policies at the initiative of the Government of Ukraine or at the request of the Managing Director, in line with the Fund's policies on such consultations.

The program will be evaluated on the basis of quarterly quantitative performance criteria, as well as structural performance criteria and benchmarks. These are summarized in Tables 1 and 2 of the MEFP and the attached Technical Memorandum of Understanding (TMU). We will also conduct with the Fund one review of economic developments under the program in September 2004. The review will focus on fiscal developments, in particular the implementation of tax reforms, and the monetary program, as well as on measures to strengthen the banking system, develop the domestic securities market, and monitor quasi-fiscal deficits in the energy sector. Quantitative performance criteria have been specified for end-March 2004 and end-June 2004, and will be specified for end-September 2004 and end-December 2004 at the time of the review.

Sincerely yours,

/s/	/s/
Viktor Yanukovich	Serhiy Tihipko
Prime Minister	Governor
Government of Ukraine	National Bank of Ukraine

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. Background

1. Following a decade of output contraction and an economic crisis in 1998-99, Ukraine's economy has entered a phase of recovery and stabilization. Real GDP grew on average by almost 7 percent per year during 2000-2003, inflation fell to single digits, and the exchange rate remained stable. International trade with countries outside the CIS has grown rapidly, the current account surplus has increased substantially, and the NBU's gross international reserves position has strengthened markedly. Access to international capital markets has recently been restored. These achievements have been supported by prudent fiscal and monetary policies. The consolidated budget has maintained a primary surplus during 2000-2003 and Ukraine has reduced its debts to the IMF, allowing for a substantial reduction in public debt. Monetary policy has accommodated a rapid increase in money demand.

2. Recent trends have continued to be mostly positive. Real GDP growth increased to an estimated 8½ percent in 2003, despite the poor grain harvest, on account of strong growth in industry, construction, transportation, and trade. Consumer price inflation picked up as a result of poor weather conditions in agriculture, but remained in single digits. Money, credit, and deposits continued to grow rapidly in 2003, reflecting strong domestic confidence. The central bank's international reserves increased substantially, reaching about 3 months of imports. In contrast to previous years, the 2003 budget was based on realistic parameters and was fully implemented. Public debt ratios continued to decline. The government issued US$1 billion in new 10-year Eurobonds at relatively low interest rates, reflecting renewed confidence by international investors.

3. There has also been progress on structural reforms in recent years. Noncash transactions in the economy have fallen drastically, reflecting the ban on noncash offsets with the budget and increased cash collections in the energy sector. Budgetary wage arrears have been sharply reduced, while pension arrears have been fully eliminated. The treasury system has been reformed, including through the introduction of a treasury single account. Intergovernmental fiscal relations were reformed and a modern budget code was adopted in 2001. A broad reform of the pension system has recently been approved by parliament. Improved tax, customs and pension administration procedures have boosted revenues substantially. Recently approved tax reforms have reduced rates, while broadening the tax base. Financial sector reforms have contributed to an increase in public confidence in the banking sector, as evidenced by the rapid growth in banking deposits. Productivity in agriculture has increased, reflecting ongoing land reforms and the privatization and dismantling of collective and state-owned enterprises. There has also been progress in privatizing the power sector. Judicial reform has been initiated and the legal framework has been strengthened by the adoption of a new criminal code, customs code, and civil code, as well as the law on mortgages and recent amendments to anti-money laundering legislation.

4. Notwithstanding these positive developments, the economy remains vulnerable to economic shocks, and the recent pace of structural reform would need to be maintained to ensure sustainable growth over the long run. While an improved macroeconomic outlook

contributed to a rebound in investment in 2003, remaining distortions in the tax regime and an unstable legal environment have kept domestic and foreign direct investment below its potential. The financial sector and the securities market remain underdeveloped and interest rates remain high, partly reflecting credit risk. The energy sector remains in financial difficulties, despite the improved payments discipline by energy consumers. Problems remain regarding governance and transparency, especially in the gas sector. Despite rapid wage growth, living standards of large parts of the population remain low. While poverty and unemployment have declined, the social safety net is not fully effective.

5. Our broader economic program is set out in the "Program of Activities of the Cabinet of Ministers," which was approved by parliament in 2003. The policies described below, for which we are seeking support under an IMF stand-by arrangement, are central elements of our program.

II. Program Objectives

6. Our economic program is aimed at moving towards a well-functioning market economy with an effective social safety net, based on EU standards of the rule of law and public institutions. The program is intended to promote economic growth and employment, in order to raise the living standards of the population and help lay the foundations for membership in the WTO and eventually the European Union.

7. Our program is designed to support strong economic growth and maintain stability. Apart from sound fiscal and monetary policies, this will require continued progress on structural reforms, described in Section III C, to improve the conditions for domestic and foreign direct investment. Tax reforms, including the normalization of the VAT refund process and the elimination of tax preferences, will allow a reduction in the tax burden on enterprises and individuals, which should help to support investment and economic growth. Expenditures will be rationalized, including through pension and social safety net reforms. The financial sector will be strengthened to support well-functioning credit and securities markets, with a particular focus to reduce credit risk in the banking sector. In order to improve the investment climate and reduce the shadow economy, the rule of law will be strengthened and economic policy will become more transparent and less discretionary.

8. The macroeconomic program for 2004 and beyond aims to keep inflation in the low-to-mid single digits, underpinned by prudent fiscal and monetary policies. The current account surplus is expected to unwind gradually as investment and import demand pick up, while foreign direct investment should continue along the positive trend seen in 2003. We intend to maintain a level of gross international reserves equivalent to about 3 months of imports, which should ensure adequate coverage of near-term external debt service by the government and the central bank. The program aims to bolster debt sustainability by implementing the 2004 budget and preparing a 2005 budget consistent with a further significant reduction in the government debt-to-GDP ratio.

III. Policies for 2004

A. Fiscal Policy

9. Our fiscal policies are designed to encourage economic growth and ensure debt sustainability. The 2004 budget law implies a consolidated budget deficit of 1¾ percent of GDP on a cash basis, according to IMF methodology, partly reflecting debt issued to clear VAT refund arrears and local government deficits. As in the previous three years, we intend to sustain a primary surplus (excluding the financing of VAT refund arrears clearance) and achieve a further reduction in the government debt-to-GDP ratio. Quarterly ceilings on the cash deficit of the consolidated budget are shown in Table 2.

10. Revenues are projected to increase broadly in line with GDP. The reductions in corporate and personal income tax rates, effective January 2004, will be largely offset by curtailing tax preferences and other base-broadening measures, including the taxation of interest income and replacement of occupation-based tax privileges with budgetary payments. The VAT base has also been broadened, with the suspension of many sectoral tax preferences during 2004. Other revenue measures include the reinstatement of customs fees, an export duty on natural gas, and a fee on car sales. Quarterly indicative targets for nonearmarked cash revenues of the state budget are shown in Table 2.

11. We are committed to resolve the problem of VAT refund arrears. We intend to remain current on VAT refunds, by addressing fraud through an improved risk-based system of verification of claims and by holding the tax administration fully accountable for refunding all valid claims, including through interest payments on refund arrears and subordinating revenue targets to the legal refund process. In 2003, we reduced the stock of refund arrears by more than a third, as a prior action under the program, and we intend to eliminate the entire outstanding stock during the program period, financed through a voluntary one-time securitization, based on the issuance of liquid domestic government bonds on market terms. Quarterly ceilings for the stock of VAT refund arrears are shown in Table 2.

12. The expenditure-to-GDP ratio is projected to increase somewhat in 2004, largely reflecting higher interest payments. To slow the growth in the wage bill, we postponed a minimum wage increase scheduled for July 2003 to December 2003, a prior action under the program. To gain better control over wages, we have reduced employment of state executive bodies and introduced amendments to the Budget Code establishing that minimum wage increases should be determined by annual budget laws. We will ensure the zero-financial balance of each social insurance fund, including through a prudent implementation of the pension reform.

B. Monetary and Exchange Rate Policy

13. The NBU will ensure that monetary policy is in line with inflation in the low-to-mid single digits and does not cause excessive credit growth. If inflation pressures emerge (other than adjustments to administered prices and temporary and fully reversible supply shocks), we stand ready to tighten monetary policy, including through the issuance of CDs and, if necessary,

by scaling down the pace of intervention in the foreign exchange market. We will also ensure that the refinancing rate remains positive in real terms.

14. We intend to allow a flexible exchange rate policy to absorb external shocks, as well as in case inflation pressures rise, credit growth is excessive, or there are risks to the international reserves target. In general, foreign exchange interventions by the NBU will be aimed at avoiding excessive short-term fluctuations in the exchange rate, while building up international reserves broadly in line with the growth of imports.

15. The monetary program for 2004 targets a decline in monetary growth, reflecting a smaller decrease in money velocity. As in 2003, reserve money growth is projected to be driven primarily by an increase in net international reserves. Quarterly floors on net international reserves and ceilings on net domestic assets are set out in Table 2.

16. Structural reforms in the banking sector and in the enterprise sector, described further below, should help reduce interest rates and lengthen loan maturities. The NBU will ensure that liquidity support provided to banks is based primarily on short-term refinancing, and interest rates reflect market conditions. We have eliminated the NBU's long-term refinancing facility, implementing ahead of time a step that was envisaged as a structural benchmark under the program. We will take steps to develop the domestic securities market, with a view to enhancing the NBU's ability to conduct open market operations and to facilitate risk management in the financial sector through the diversification of assets. In particular, as a structural benchmark under the program by end-June 2004, we will enhance the marketability of restructured treasury bills held by the NBU, and further develop and implement government debt management guidelines, with a view to establishing a yield curve.

C. Structural Reform

17. The main objective of our structural reform program is to improve the investment climate and lay the foundations for long-term growth. Tax reform is a central element of our program, with the aim to reduce the tax burden, make the tax system less discretionary, provide equal rights to taxpayers, and reduce the size of the shadow economy. On January 1, 2004, the corporate income tax rate was reduced from 30 percent to 25 percent, and a 13 percent flat tax on personal income was introduced. We have also broadened the tax base, including through a significant reduction in corporate and personal income tax exemptions. In addition, as a prior action under the program, several sectoral VAT exemptions and zero-ratings, including for housing construction, have been suspended, and the list for VAT-exempt pharmaceuticals has been narrowed. The current VAT preferences for agriculture will expire at the end of 2004. As a structural performance criterion under the program, we will by mid-August 2004 permanently eliminate sectoral exemptions from the VAT law, reducing the total fiscal cost of remaining VAT preferences (excluding agriculture) to at most Hrv 3.2 billion, and, as structural benchmark, we will reduce the overall cost of VAT preferences effective in 2005 (including agriculture) to at most Hrv 2.9 billion, based on 2003 estimates in the 2004 tax expenditure budget. We will ensure that no new tax preferences are introduced, and we have imposed a moratorium on introducing new or expanding existing free and priority economic zones in 2004. We will also rationalize the simplified fixed tax for individual entrepreneurs.

18. We are making the remaining tax preferences more transparent by improving the quality of the cost estimates of tax expenditures included in the budget documents. We will continue to refrain from using offsets and other noncash forms of payments to the budget. We will strengthen the accountability of the state tax and customs administration, and improve their collection and audit functions. We will not permit any write-offs of current tax liabilities or overdue obligations.

19. Another reform priority is to rationalize public expenditures and reduce financial deficits of public enterprises. We are establishing a monitoring system for all social privileges and have assigned these expenditure responsibilities to the central and local budgets. In addition, to help improve the targeting of benefits, we will establish a unified state register of individuals eligible for social privileges. We will continue to prepare a more comprehensive social safety net reform that would introduce a new system of targeted cash benefits. We will implement the first phase of pension reform, approved by parliament last year, ensuring the financial sustainability of the pay-as-you-go component, including by discouraging early retirement, establishing formula-based benefits, and rationalizing privileged pension regimes. We will press ahead with reforms in the agricultural and coal sectors, with a view to transforming the financial support to these sectors, as we seek accession to the WTO. Future public sector wage increases will be linked to the rationalization of employment, in the context of broader administrative reforms.

20. In order to strengthen budget implementation and controls, we have extended the coverage of the treasury system to local budgets, a step that had been envisaged as a structural benchmark under the program, but has already been completed. In addition, we will improve the management of domestic and external state debt and guarantees, including by tightening rules for subnational borrowing. We intend to establish a full-fledged system of commitments recording and ex-ante control.

21. In the banking sector, our primary goal will be to enhance prudent lending practices and reduce bad loan portfolios. A reduction in credit risk would help lower interest rates and encourage long-term lending. This will require steps to strengthen creditor rights, including through the laws on secured interest and mortgages, as well as the recently approved commercial code. It will also require judicial reform and improved financial disclosure of the enterprise sector. In order to strengthen the banking sector, the NBU will continue to improve banking supervision and intensify the enforcement of prudential regulations. In this context, we are moving towards risk-based banking supervision. As a prior action under the program, we have adopted an increase in the required minimum capital adequacy ratio from 8 to initially 10 percent, effective from March 1, 2004. We will strengthen related-party lending legislation and regulations by August 15, 2004 (structural performance criterion) by (a) requiring identification of ultimate bank owners; (b) eliminating exceptions that permit more favorable terms than market terms for related-party lending; (c) prohibiting concerned parties' involvement in the credit analysis; and (d) requiring regular disclosure of related-party lending in the banks' annual reports. In the interim, we will also amend NBU resolutions to limit related-party lending at favorable terms by April 30, 2004 (structural performance criterion). We will continue the process of strengthening the financial position of the *Savings Bank*, in line with agreements with the World Bank.

22. We will consult with the World Bank and EBRD on developing a prudent system for development lending. We have amended Ukraine's anti-money laundering legislation based on FATF recommendations and will now make progress on implementation, with a view to be taken off the list of noncompliant countries.

23. In the energy sector, we aim to raise transparency and reduce financial deficits. As a structural benchmark under the program, we will develop a monitoring system to assess the financial position and quasi-fiscal operations in the electricity, gas, and coal sectors, and report the results in the context of the budgetary submission for 2005. We aim to continue to improve cash collection ratios in the electricity and gas sectors and adjust tariffs towards short-term cost-recovery levels. We will further develop the energy debt restructuring plan, in consultation with the World Bank, EBRD, EU Commission, USAID and others, in order to set the conditions for the future privatization of the *oblenergos*. To enhance transparency in the gas sector, we will ensure the regular publication of annual financial reports by *Naftogaz* and other large public enterprises, implement a financial recovery plan for *Naftogaz*, and improve the quality and coverage of audits, in line with terms of references to be agreed with the World Bank. We will also implement procedures to measure and finance implicit subsidies in communal services, including heating and water supply. We will continue the restructuring of the coal sector, including through the liquidation of coal mines without prospects for financial recovery.

24. We will submit a new 3-year privatization program for approval by parliament this year, as well as legislation that substantially reduces the list of enterprises excluded from privatization. We intend to ensure that all sales of state assets are made under open and competitive conditions. We will also implement a unified land and real estate registration process.

25. In all of the above reforms, an overriding principle will be to strengthen governance, by making public institutions more transparent, reducing corruption, making economic policy more predictable and rules-based, and limiting discretionary government intervention. To strengthen the rule of law, we will implement a comprehensive reform of the judicial system. We will liberalize the trade regime, in line with our aim to join the WTO in 2004, and streamline foreign exchange regulations with the objective to integrate Ukraine further into the world economy. We will remain current on all external obligations. We will continue to improve the quality and availability of official data, including on GDP and short-term external debt. Under a new IMF arrangement, the NBU will undertake a full safeguards assessment.

IV. Program Monitoring

26. Performance under the program supported by the precautionary stand-by arrangement will be evaluated on the basis of quantitative performance criteria and indicative targets shown in Table 2 and on the basis of structural performance criteria and benchmarks shown in Table 1. Definitions and reporting requirements are specified in the attached Technical Memorandum of Understanding.

27. Other structural reforms are monitored under the World Bank's Programmatic Adjustment Loan (PAL) program, including steps to improve the targeting of social assistance;

strengthen the social and financial viability of the pension system; enhance the accountability of the state tax administration; strengthen the financial position of the *Savings Bank*; improve the quality and coverage of *Naftogaz* audits; implement an energy debt restructuring plan and privatize the remaining state-owned *oblenergos*; improve the transparency of the privatization process; improve the legal system to strengthen creditor and shareholder rights; establish a unified registration for land and real estate ownership; and prepare for WTO membership.

Table 1: Prior Actions and Structural Performance Criteria and Benchmarks Under the Precautionary Stand-by Arrangement

Prior Actions	
A1. Suspension of VAT exemptions and zero-ratings extended to newly-built housing construction, aircraft production, and shipbuilding (see TMU).	*Done.*
A2. A reduction in the stock of VAT refund arrears by at least Hrv 500 million between end-2002 and end-2003.	*Done.*
A3. Parliamentary approval to postpone the minimum wage increase planned for July 2003.	*Done.*
A4. Adoption of a NBU decree to increase in the minimum risk-weighted capital adequacy ratio from 8 percent to 10 percent, effective March 1, 2004	*Done.*
A5. Enactment of a 2004 budget law that provides for the clearance of the entire stock of VAT refund arrears, on market terms; is based on budgetary parameters in line with the specifications in Section III of the TMU; and provides a tax expenditure budget for information (see TMU).	*Done.*
Structural Performance Criteria and Benchmarks	***Date***
B1. Enactment of changes to the VAT law that eliminate sectoral VAT preferences, effective no later than January 2005, reducing the total fiscal cost of remaining VAT preferences (excluding agriculture) to at most Hrv 3.2 billion, based on the 2003 estimates in the 2004 tax expenditure budget (Performance criterion, see TMU).	Aug 15, 2004
B2. Submission to parliament by the NBU and enactment of amendments to the Law on Banks and Banking, and revisions of NBU resolutions, to strengthen the provisions on related-party lending, in particular by (a) requiring identification of ultimate bank owners; (b) eliminating exceptions that permit more favorable terms than market terms for related-party lending; (c) prohibiting concerned parties' involvement in the credit analysis; and (d) requiring regular disclosure of related-party lending in the banks' annual reports (Performance criterion, see TMU). 1/	Aug. 15, 2004
B3. Steps to develop the domestic securities market, including by (a) enhancing the marketability of restructured treasury bills held by the NBU and (b) further developing and implementing debt management guidelines that promote the development of the government securities market (see TMU).	End-Jun 2004
B4. Adoption of a monitoring system of quasi-fiscal operations in the electricity, gas, and coal sectors, and including the analysis for information purposes in the context of the budgetary submission for 2005 (see TMU).	End-Oct 2004
B5. Reducing the total fiscal cost of the remaining VAT preferences (including agriculture) effective in 2005 to at most Hrv 2.9 billion, based on the 2003 estimates in the 2004 tax expenditure budget (see TMU).	End-Jan 2005

1/ Amending NBU resolutions on related-party lending under (b) is a structural performance criterion for April 30, 2004.

Table 2. Ukraine: Quantitative Performance Criteria and Indicative Targets 1/
(End-of-period; in millions of hryvnia, unless otherwise indicated)

	stocks 2003	cumulative changes from end-2003 2004			
	Dec. Proj.	Mar. Prog.	June Prog.	Sep. Prog.	Dec. Prog.
I. Performance criteria 2/					
Ceiling on the cash deficit of the general government 3/ 4/	...	1,538	3,433	4,382	5,151
Ceiling on stock of budgetary arrears on wages, pensions and social benefits 4/ 5/	...	-75	-150	-225	-300
Ceiling on stock of VAT refund arrears 5/	1,828	-1,000	-1,500	-1,828	-1,828
Ceiling on the net domestic assets of the NBU 5/ 6/	12,885	241	-511	-471	305
Floor on net international reserves of the NBU (in millions of U.S. dollars) 5/ 7/	5,103	112	528	935	1,167
Ceiling on external debt contracted or guaranteed by the government or the NBU (in millions of U.S. dollars) 4/ 8/	...	1,000	1,300	1,600	1,900
Of which: Maturity of up to and including one year	...	0	0	0	0
II. Indicative Targets					
Base money 5/	40,089	839	2,304	4,514	6,527
Nonearmarked state cash revenue 4/	...	9,752	20,687	33,264	45,941
Total cash collection ratio for electricity (in percent) 4/ 9/	...	86	93	94	95
Total cash collection ratio by Naftogaz (in percent) 4/ 10/	...	64	79	90	92
III. Adjusters					
Project financing 3/ 4/	...	231	461	692	922
Non-project foreign financing (in millions of U.S. dollars) 4/ 6/ 7/	...	350	646	1,013	1,013

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

1/ Definitions are specified in the Technical Memorandum of Understanding (TMU).

2/ Targets for end-March 2004 and end-June 2004 are performance criteria; targets for end-September and end-December are indicative targets. There is also a continuous performance criterion on non-accumulation of external arrears (see TMU).

3/ The ceiling on the cash deficit will be adjusted upward (downward) by the amount that project financing exceeds (falls short of) the projections shown in Section III above. The definition of the cash deficit excludes offset-based external amortization.

4/ Cumulative flows from January 1, 2004.

5/ Changes in the stock from end-December 2003.

6/ The ceiling on NDA will be adjusted upward (downward) by the amount that foreign financing falls short of (exceeds) the projections shown in Section III above, subject to a cap on upward adjustment of $200 mn, converted at program exchange rates.

7/ The floor on NIR will be adjusted upward (downward) by the amount that non-project foreign financing exceeds (falls short of) the projections shown in Section III above, subject to a cap on downward adjustment of $500 mn.

8/ The ceiling on short-term external debt of maturities of up to one year applies on a continuous basis and does not apply to the NBU.

9/ Total cash collection ratios for payments to the wholesale electricity market cumulatively since January 1, 2004.

10/ The targets are for total cash collection ratios by Naftogaz on all its gas sales, cumulative from Jan. 1, 2004. Outcomes include mutual settlements through the banking system. Data are not independently verifiable.

UKRAINE—TECHNICAL MEMORANDUM OF UNDERSTANDING

MARCH 11, 2004

1. This memorandum sets out the understandings between the Ukrainian authorities and IMF staff regarding reporting requirements and definitions of quantitative targets and structural measures for the economic program supported under the standby arrangement, as described in the authorities' Letter of Intent dated March 11, 2004 and the attached Memorandum of Economic and Financial Policies (MEFP).

2. Quantitative performance criteria and indicative targets are shown in Table 2 of the MEFP, defined as cumulative changes from end-December 2003. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. Program exchange rates are based on actual exchange rates and cross-rates as of end-December 2003, shown in Section II below. Prior actions, structural performance criteria, and structural benchmarks are listed in Table 1 of the MEFP, with corresponding definitions in Section III below. Reporting requirements are specified in Section IV below.

I. QUANTITATIVE TARGETS

A. Net international reserves of the National Bank of Ukraine

Definition

3. Net international reserves (NIR) of the National Bank of Ukraine (NBU) are defined as the difference between usable gross international reserve assets and reserve-related liabilities to nonresidents, evaluated at program exchange rates (Section II). Usable gross international reserve assets comprise all reserve assets of the NBU (Table A, item 1), to the extent that they are readily available for intervention in the foreign exchange market and held in first-rank international banks or as securities issued by G-7 countries. Excluded from usable reserves, *inter alia*, are:

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

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

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

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

4. For the purpose of this program, reserve-related liabilities are liabilities with an original maturity of one year or less and comprise:

- all short-term liabilities of the NBU vis-à-vis non-residents with an original maturity of one year or less;
- the stock of IMF credit outstanding;
- the nominal value of all derivative positions[5] of the NBU and government, implying the sale of foreign currency or other reserve assets against domestic currency.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability[6]	NBU Balance Sheet Accounts
1. **Gross foreign reserves** *(in convertible currencies)*	
Monetary gold in vault	1100, 1107
Foreign exchange in cash, including Russian rubles	1011, 1017
Demand deposits at foreign banks[7]	1201, 1202
Short-term time deposits at foreign banks	1211
Long-term deposits at foreign banks	1212
SDR holdings and Reserve Position in the IMF	IMF, Finance Department[8]
Securities issued by non-residents	1302, 1304, 1305, 1307, 1322, 1324, 1325, 1327, 1342, 1344, 1347, minus 1306,1326, 1346
2. **Short-term liabilities to nonresidents** *(in convertible currencies)*	
Correspondent accounts of nonresident banks	3201
Short-term deposits of nonresident banks	3206, 3207, 3211
Operations with nonresident customers	3230, 3232–4
Use of IMF credit	IMF, Finance Department[5]

Adjustment mechanism

5. The floor on the NIR of the NBU is subject to an automatic adjuster, based on cumulative deviations of non-project foreign financing (for monitoring purposes defined narrowly as major

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

[6] The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on April 30, 2002. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

[7] Excluding the balances in Russian rubles on the correspondent accounts at three Russian banks, which are being liquidated or considered insolvent.

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

projected disbursements with significant uncertainty about timing, specifically the sum of: (i) World Bank disbursements under the PAL, (ii) EU disbursements under macrofinancial assistance, and (iii) new Eurobond issues by the Government of Ukraine) from program projections (specified in Table 2 of the MEFP). Specifically, if the cumulative proceeds from non-project foreign financing (in US$ evaluated at actual exchange rates):

a) exceed program projections, the NIR floor will be increased by 100 percent of the additional financing;

b) fall short of program projections, the NIR floor will be reduced by 100 percent of the shortfall, but the amount of the downward adjustment cannot exceed US$500 million.

B. Monetary base of the NBU (base money)

Definition

6. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,[9] and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts 3230, 3232, 3233, 3234, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency (NBU liability account 3238).

Adjustment mechanism

7. The target on the NBU's monetary base is not subject to an automatic adjuster.

C. Net domestic assets (NDA) of the NBU

Definition

8. The net domestic assets of the NBU are defined as the difference between the monetary base and the NIR of the NBU, with the NIR as defined above and expressed in hryvnia, evaluated at program exchange rates.

Adjustment mechanism

9. The ceiling on the NDA of the NBU is subject to an automatic adjuster for the amounts by which cumulative non-project foreign financing (for monitoring purposes defined narrowly as major

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

projected disbursements with significant uncertainty about timing, specifically the sum of: (i) World Bank disbursements under the PAL, (ii) EU disbursements under macrofinancial assistance, and (iii) new Eurobond issues by the Government of Ukraine) deviates from program projections (specified in Table 2 of the MEFP). If the cumulative proceeds from foreign financing (in US$ evaluated at actual exchange rates):

a) exceed program projections, the NDA ceiling will be reduced by 100 percent of the additional financing, evaluated at the program hryvnia/US$ exchange rate;

b) fall short of the program projections, the NDA ceiling will be increased by 100 percent of the shortfall in financing, evaluated at the program hryvnia/US$ exchange rate, but the amount of the upward adjustment cannot exceed the hryvnia equivalent of US$200 million, evaluated at the program exchange rate.

D. Cash deficit of the general government

Definition

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

- total net treasury bill sales as measured by the information kept in the NBU registry of treasury bill sales (net treasury bill sales are defined as the cumulative total funds realized from the sales of treasury bills at the primary auction less the cumulative total redemption of principal on treasury bills); plus

- other net domestic banking system credit to government as measured by the monetary statistics provided by the NBU (this consists of all non-treasury-bill financing in either domestic or foreign currency extended to the government by banks less the change in all government deposits in the banking system); plus

- total receipts from privatization received by the SPF and local governments; plus

- the difference between disbursements and amortization on any bond issued by the government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus

- the difference between disbursements of official foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of official foreign credits by the general government (including of on-lent project loans, and excluding offset-based amortization with Russia); plus

- the net change in government deposits in nonresident banks, or other nonresident institutions; plus

- net proceeds from any promissory note or other financial instruments issued by the general government.

11. For the purposes of measuring the deficit of the general government, all flows to/from the budget in foreign currency will be converted into hryvnia at the official exchange rate prevailing at close of business on the date of the transaction.

Adjustment mechanism

12. The ceiling on the cash deficit of the general government is subject to an automatic adjuster, based on deviations of external project financing (defined as disbursements from bilateral and multilateral creditors to the state budget for specific project expenditure) from program projections (shown in Table 2 of the MEFP). Specifically, if the cumulative proceeds from external project financing (in hryvnia evaluated at actual exchange rates):

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

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

E. Non-earmarked central government cash revenue

Definition

13. Non-earmarked central government cash revenue comprises all taxes, fees, and charges levied by the central government that are collected in cash and are not earmarked by law for specific expenditure programs. Not included in the definition of revenue are any proceeds from loans or other banking system credits, the issuance of securities, or privatization receipts.

Adjustment mechanism

14. The target on non-earmarked central government cash revenue is not subject to an automatic adjuster.

F. Stock of budgetary arrears on wages, pensions, and social benefits

Definition

15. Budgetary arrears on wages, pensions, and social benefits comprise all arrears of the consolidated budget on wages, pensions (including on Chernobyl pensions), and social benefits owed by the Pension Fund, the central, or local governments (including Chernobyl benefits). Budgetary arrears are defined as payments not made thirty days after they are due. Wages are defined to comprise all forms of remuneration for work performed, including, but not limited to, payments in cash and in-kind for standard and overtime work. Pension obligations of the Pension Fund comprise all pension benefits and other obligations of the Pension Fund.

Adjustment mechanism

16. The ceiling on budgetary arrears on wages, pensions, and social benefits is not subject to an automatic adjuster.

G. Stock of VAT refund arrears

Definition

17. The stock of VAT refund arrears is defined as the stock of requests for VAT refunds outstanding for more than the legal carry-forward period net of refund claims lawfully denied, in line with the VAT law.

Adjustment mechanism

18. The ceiling on the stock of VAT refund arrears is not subject to an automatic adjuster.

H. Non-accumulation of external arrears by the government and the NBU

Definition

19. External arrears comprise all payment arrears to official and nonofficial creditors on debt guaranteed or contracted by the Government of Ukraine and the NBU, and those to private creditors that did not participate in the 2000 bond exchange or its subsequent reopening. The criterion for non-accumulation of external arrears applies on a continuous basis.

Adjustment mechanism

20. The criterion for non-accumulation of external arrears is not subject to an automatic adjuster.

I. Contracting or guaranteeing external debt[10]

Definition

21. The ceilings on contracting or guaranteeing external debt apply to the contracting or guaranteeing by the central government or the NBU of new external debt with an original maturity of more than one year In addition, during the program period, the central government shall not contract or guarantee debt of an original maturity of up to and including one year, other than for normal import financing. Excluded from the limits is the use of IMF resources; but other balance of payments support—including loans from official creditors and foreign banks, and bond issues—is included within these limits. The amount of debt contracted or guaranteed will be valued at the relevant currencies of denomination and converted into dollars using the NBU's official exchange rates prevailing at the time the debt is contracted. The maturity of debt instruments with put options shall be taken to be the period from the issuance to the earliest date the option can be exercised.

[10] This performance criterion applies not only to debt as defined in point 9 of the *IMF Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274-(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.

J. Cash collection ratios for electricity and gas

Definition

22. The cash collection ratio for electricity is defined as total cash payments (including direct bank transfers, but excluding in-kind payments, offsets, and payments in a form of promissory notes, bonds, stocks) to the state enterprise "Energorynok" divided by total billings for electricity supplied. The cash collection ratio for gas is defined as total cash payments to *Naftogaz* divided by total billings for gas supplied. Both payments and billings for electricity and gas include transportation and delivery fees.

Adjustment mechanism

23. The targets for cash collection ratios for electricity and gas are not subject to automatic adjusters.

II. Exchange Rates

24. The program exchange rates are the official exchange rates determined by the NBU as of December 31, 2003, in particular Hrv 5.3315 per U.S. dollar and Hrv 6.662242 per Euro. The SDR is valued at 1.48597 U.S. dollars. Official gold holdings are valued at US$417.25 per ounce, which was the London gold price on December 31, 2003. The program exchange rate between the hryvnia and the U.S. dollar is an accounting exchange rate used for the sole purpose of converting foreign currency denominated assets and liabilities into hryvnias. According to IMF standard practice, the program exchange rate is kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing monetary aggregates does not imply that there is any target exchange rate for policy purposes.

III. Prior Actions and Structural Measures

Prior Action A1: Suspension of VAT exemptions and zero-ratings extended to newly-built housing construction, aircraft production, and shipbuilding.

25. The measure involves the adoption of a budget law for 2004 that suspends VAT exemptions and zero-ratings for newly-built housing constructions, aircraft production, and shipbuilding.

Prior Action A5: Enactment of a 2004 budget law that provides for the clearance of the entire stock of VAT refund arrears, on market terms; is based on budgetary parameters in line with the specifications in Section III of the TMU; and provides a tax expenditure budget for information.

26. The measure requires that the 2004 budget law explicitly identifies the resources and mechanisms to clear at least Hrv 1.8 billion in VAT refund arrears. If the stock of arrears is securitized, it should be on a voluntary basis, and the underlying provisions and legislation should specify that the securities are domestic government bonds, tradable on the secondary market, with a maturity no longer than 5 years and a interest rate no lower than 120 percent of the NBU discount

rate. If the arrears are cleared through cash payments, the budget law should explicitly identify these payments and their financing.

27. The measure also requires that the draft 2004 budget law is based on a central government deficit, excluding external project financing, that does not exceed Hrv 3.5 billion, using IMF methodology (i.e. privatization proceeds treated as financing, Black Sea Fleet offset excluded from amortization, and clearance of VAT refund arrears treated as negative revenue). The financing of the central government deficit should reflect privatization receipts of at most Hrv 2.5 billion, and net external non-project financing (excluding the Black Sea Fleet offset from amortization) of at most Hrv 0.5 billion. The planned reduction in the stock of arrears on wages, pensions, and social benefits should be at least Hrv 0.3 billion.

28. The measure also requires that the government submit a tax expenditure budget to parliament alongside the 2004 draft budget law for information. Tax expenditures are defined as special tax provisions that deviate from a tax structure corresponding to internationally accepted good practice, produce a revenue loss, and are in this sense equivalent to direct government expenditures. Tax expenditures can take the form of exempt, or partially exempt, bases, taxpayers, economic sectors, geographical spaces, or a combination of these options (e.g., simplified tax regimes); tax holidays; special tax credits; or preferential rates of tax. Another type of tax expenditure is the write-off of past due debts or the deferral of tax liabilities.

Structural Measure B1: Enactment of changes to the VAT law that eliminate sectoral VAT preferences, effective no later than January 2005, reducing the total fiscal cost of remaining VAT preferences (excluding agriculture) to at most Hrv 3.2 billion, based on the 2003 estimates in the 2004 tax expenditure budget.

29. The measure requires the elimination of VAT preferences (such as exemptions and zero-ratings) from the VAT law, such that the total fiscal cost of the remaining VAT preferences in the VAT law (excluding those extended to agriculture) does not exceed Hrv 3.2 billion, as measured by the estimates for 2003 provided in the tax expenditure budget submitted to parliament in September 2003, corrected for the VAT exemption for imports of goods for the publishing industry (Table B attached to the TMU). The total estimated cost for 2003 was Hrv 4.1 billion excluding agriculture.

Structural Measure B2: Submission to parliament by the NBU and enactment of amendments to the Law on Banks and Banking, and revisions of NBU resolutions, to strengthen the provisions on related-party lending, in particular by (a) requiring identification of ultimate bank owners; (b) eliminating exceptions that permit more favorable terms than market terms for related-party lending; (c) prohibiting concerned parties' involvement in the credit analysis; and (d) requiring regular disclosure of related-party lending in the banks' annual reports.

30. Tightening of related-party lending legislation and rules includes (a) a clause in the Law on Banks and Banking requiring banks to identify the ultimate owners—physical persons—of the banks, and to communicate their identity to the supervisor; (b) eliminating the clause in the Law on Banks and Banking allowing an exception for related-party lending linked to the bank's net profit (Article 52, paragraph 4); and, in the interim, amending NBU resolutions by April 30, 2004, so that lending to related parties on favorable terms must be fully matched by set-aside capital, which would be deducted from capital available to meet any other capital requirement, and be granted only on the basis of a decision by the supervisory board, with the explicit consent of the management board; (c)

adopting an NBU resolution requiring banks to introduce procedures preventing any person benefiting from the loan from being part of the credit analysis for the loan or for the credit decision itself; (d) adopting an NBU resolution requiring the description of all lending to and from related parties in separate disclosures in banks' annual reports.

Structural Measure B3: Steps to develop the domestic securities market, including by (a) enhancing the marketability of restructured treasury bills held by the NBU and (b) further developing and implementing debt management guidelines that promote the development of the government securities market.

31. The measure requires the adoption of a change in the interest formula for all restructured treasury bills held by the NBU, such that the nominal interest rate remains positive at all times and the inflation indexation is based on past inflation, not on projections. The measure also requires that the Ministry of Finance and the NBU, in consultation with banks, develop further and implement guidelines for managing the primary government debt market. The guidelines will include steps to enhance the availability of securities with maturities of one year or more, contributing to the establishment of a yield curve.

Structural Measure B4: Adoption of a monitoring system of quasi-fiscal operations in the electricity, gas, and coal sectors, and including the analysis for information purposes in the context of the budgetary submission for 2005.

32. The monitoring system, developed by the government in consultation with IMF staff, provides annual estimates of the aggregated financial position of companies in the electricity, gas and coal sectors, including detailed information in the agreed format on (a) overdue payables, broken down by creditor, (b) net borrowing, (c) budgetary subsidies, (d) actual tariff levels and the degree to which they cover costs, (e) total and cash collection rates, (f) overdue receivables, broken down by debtor, (g) technological losses. In addition, the information should include cash flow statements from the major state-owned energy companies, including *Naftogaz* and *Energoatom*. The information should be used to estimate quasi-fiscal deficits in the three sectors, based on an agreed methodology. A summary of findings for the years 2001-2003 and for the first half of 2004 will be included for information in the documents accompanying the draft budget law for 2005.

Structural Measure B5: Reducing the total fiscal cost of the remaining VAT preferences (including agriculture) effective in 2005 to at most Hrv 2.9 billion, based on the 2003 estimates in the 2004 tax expenditure budget.

33. The measure requires that VAT preferences effective in 2005 (including those extended to agriculture) under the VAT law and other relevant laws amount to a total fiscal cost of at most Hrv 2.9 billion, as measured by the estimates for 2003 provided in the tax expenditure budget submitted to parliament in September 2003, corrected for the VAT exemption for imports of goods for the publishing industry (Table B attached below). The total estimated cost for 2003 was Hrv 5.0 billion including agriculture.

IV. Reporting Requirements

A. National Bank of Ukraine

34. The NBU will continue to provide to the IMF on a monthly basis, no later than the 25th day of the following month, an aggregate balance sheet for the NBU and a consolidated balance sheet for the deposit money banks, in the format envisaged by forms 10R and 20R, respectively. All foreign assets and liabilities of the NBU will be included in the NBU balance sheet, valued at the official exchange rate prevailing on the day for which the balance sheet is compiled. All NBU claims on and liabilities to the IMF will be included in the NBU monthly balance sheet at the $/SDR exchange rate of the IMF's Finance Department at the last day of each month. All derivative transactions, and transactions involving encumbering reserves will be separately reported.

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

36. The NBU will continue to provide to the IMF the daily report on the primary treasury bill market, reports on each treasury bill auction, and the monthly report on treasury bills.

37. The NBU will provide the IMF, no later than the 25th of each month, with data on the total financing (including refinancing) issued by the NBU to commercial banks, broken down by original maturity of the financing.

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

39. The NBU will continue to provide to the IMF on a daily basis the daily operational balance sheet of the NBU and commercial banks in the standard format, including detailed information on banking sector credit to the general government.

40. The NBU will continue to provide to the IMF on a daily basis the standard daily data sheet on currency operations and weekly reports on NIR and gross foreign assets and liabilities evaluated at both actual and program exchange rates. The NBU will continue to provide daily information on exchange market transactions, including exchange rates.

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

42. The NBU will continue to provide on a monthly basis, no later than 25 days after the end of the month, banking system monitoring indicators in an agreed format.

43. The NBU will provide to the IMF consolidated banking sector data and aggregated data (without specifying the names of the banks) for the 10 largest banks on a quarterly basis, no later than 30 days after the end of the quarter: (i) balance sheet; (ii) loan classification (standard, watch, sub-standard, doubtful, loss); (iii) provisions for all assets (required and actual) (iv) foreign currency denominated lending and deposits; (v) capital adequacy ratios for normative and regulatory capital

(Tier II and I), normatives H2 and H3; weighted averages based on banks' total assets; (vi) liquidity normatives H5 and H6; weighted averages based on banks' total assets. In addition, the NBU will provide profit and loss statement for the same aggregated groups on an annual basis, no later than 60 days after the calendar year.

44. The NBU will continue to provide quarterly balance of payments data in electronic format.

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

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

47. The NBU will inform IMF staff of any changes to reserve requirements for deposit money banks. The NBU will communicate in writing to the IMF staff any changes in accounting conventions and valuation principles incorporated into the balance sheet data and will notify the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, as well as changes in the reporting forms.

B. Ministry of Finance

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

49. The Treasury will continue to provide to the IMF in electronic form monthly treasury reports on revenue and expenditure figures of the consolidated, state and local government, no later than 25 days after the end of the month. These reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications. The Treasury will report monthly data on on-budget and off-budget, cash and non-cash, netting operations.

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

51. The Ministry of Finance will continue to report the final fiscal accounts at the end of each fiscal year, no later than April of the following year. These reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications.

52. The Ministry of Finance will report any revisions to monthly and annual fiscal reports as well as any amendments to the state budget and local government budgets within a month after their approval.

53. The Ministry of Finance will report to the IMF on a monthly basis, no later than 25 days after the end of the month, the cash deficit of the general government, with details on budget execution data for privatization receipts of the state and local governments; disbursements of external credits

(including budget support and project loans for on-lending) to the consolidated budget and amortization of external debt by the consolidated budget; net domestic borrowing of the general government (state, local, and extrabudgetary funds), including net t-bill issuance, issuance of other government debt instruments, and change in government deposits.

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

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

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

57. The Ministry of Finance and the NBU will provide data on external and domestic credit to nongovernment units that is guaranteed by the government or the NBU on a monthly basis, no later than 25 days after the end of the month.

58. The Ministry of Finance will provide data on the approved budgets and quarterly operational data (monthly for the Pension Fund only) on the revenue, expenditures, and arrears, and balance sheets of the Pension Fund, Social Insurance Fund, Employment Fund, Occupational Accident and Sickness Insurance Fund, and any other extrabudgetary funds managed at the state level. Any within-year amendments to the budgets of these funds will be reported within a month after their approval. The Ministry of Finance will also report the annual financial statement including the final fiscal accounts of those funds at the end of each fiscal years, no later than April of the following year.

59. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central and local budgets, starting from January 2002. After any public sector wage increase, the Ministry of Finance will provide an estimate of its costs for the current and subsequent fiscal years, for the state and local government budgets.

C. State Tax Administration

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

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

61. The STA will provide monthly data, no later than 25 days after the end of the month, on the stock and flow of tax arrears in the energy industry, in total and separately for the electricity, gas and coal sectors; the list (identifying taxpayers) of the 10 largest accumulated stocks of tax liabilities at the end of the month, and the list (identifying taxpayers) of the 10 largest additions to the stock of arrears during that month (flow). These lists should be prepared separately for the electricity, gas and coal sectors.

62. The STA will provide on a quarterly basis, no later than 25 days after the end of the quarter, aggregate data on tax arrears in the above format for the 50 largest tax debtor enterprises, and their cumulative monthly tax payments since the beginning of the year.

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

64. The STA will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund requests; (ii) refund requests paid in cash; (iii) netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock; and (vii) stock of end-of-period requests that are overdue in accordance with the VAT law (currently, refunds are overdue after 1 month for exporters and 3 months for other VAT taxpayers). It is understood that while monthly data could be operational, quarterly figures will be subject to verification and will be final.

D. Ministry of Economy and Ministry of Fuel and Energy

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

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

E. State Statistics Committee

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

Table B: Fiscal Cost of VAT Exemptions and Privileges in 2003

Code	Exemptions	2003 tax foregone (in Hrv 1,000s)
14010076	The following operations shall not be the object of taxation: payment for public paid services that are rendered to physical or legal entities by executive power bodies and local self-government ones, the mandatory receipt of which is determined by the legislation, including the payment for the registration, receipt of a license (permit), certificates in the form of fees, state duties, etc.	37 711,6
14010080	The following operations shall be exempt: sale of domestically produced baby food stuffs by baby food shops and specialized shops, as well as special places that operate as distribution points under the order and following the list of products determined by the Cabinet of Ministers.	3 200,0
14010081	Sale (subscription) and delivery of the Ukrainian mass media periodicals shall be exempt from taxation	277 844,0
14010082	Sale of books printed in Ukraine shall be exempt from taxation	40 300
14010083	Sale of domestically produced school note-books, source books and text books shall be exempt from taxation	45 000,0
14010084	Services provided by higher, secondary and vocational educational establishments	474 258, 4
14010087	Registration of civil acts by the authorized entities	338,0
14010088	Sale of medicines that have been registered with Ukraine under the established by the legislation procedure, including sale of such products by pharmacies shall be exempt from taxation	1 218 937,5
14010089	Exempt from taxation shall be rendering health care services in line with the list established by the Cabinet of Ministers of Ukraine by health care institutions that have a special permit to render such services	99 162,8
14010090	Sale of sanatoria vouchers and rest vouchers for children under the list established by the Cabinet of Ministers of Ukraine shall be exempt from taxation. The named exemption shall not cover the sale of vouchers to non-residents	60 000,0
14010091	The following operations shall be exempt from taxation: provision of the following services within the norms established by the Cabinet of Ministers of Ukraine: maintenance of children in preschool institutions, boarding schools, shelter points of the Interior Ministry of Ukraine	4 983,6
14010092	Maintenance of elderly people and the disabled in rest houses, night shelters for homeless people in specially designated places shall be exempt	851,6
14010093	Catering for children at high and vocational schools, as well as at health care institutions shall be exempt from taxation	34 088,8
14010095	Rendering services by public centers of employment in keeping with the list established by the Cabinet of Ministers of Ukraine	621,6
14010096	Exempt from taxation shall be services provided by the archive institutions of Ukraine: issuing documents of the National archive fund of Ukraine to legal and physical entities, as well as sale of documents of the National archive fund of Ukraine that belong to legal and physical entities to archive institutions of Ukraine in keeping with the legislation of Ukraine	184,4
14010098	Religious services and sale of religious items to religious organizations in keeping with the list established by the Cabinet of Ministers of Ukraine shall be exempt from taxation	828,4
14010099	Funeral services provided by any taxpayer shall be exempt from taxation	15 902,8
14010101	Exempt from taxation shall be the transfer of land plots with immovable property objects or bare land plots in cases when such a transfer is permitted in keeping with the Land Code of Ukraine	1 324,0
14010101	Sale or transfer of the ownership of the newly built housing for natural persons	526 484,4
14010107	The following operations shall be exempt from taxation: sale of goods (works, services), except for excisable goods, gambling business, purchase of goods by enterprises and organizations of the public organizations of the disabled, owners of property, where the number of invalids working there on a full time basis constitutes not less than 50% of the total number of workers, and under the condition that over the previous reporting period the wage bill of such disabled persons constituted not less than 25% of the total spending on wages covered by the gross expenses of production (turn over). The named enterprises and organizations of the public organizations of the disabled shall be entitled to implement such an exemption should the permit to use the exemption be available. The latter shall be issued by the interdepartmental Commission for the public organizations of the disabled in keeping with the Law of Ukraine "On the fundamentals of the	25 898,4

	needs	
14010170	For the period of preparation for the closure of Chernobyl station blocks and to make the object "Shelter" an ecologically secure one, exempt from taxation shall the operations performed at the expense of international technical aid, which is provided on a free and irreversible basis for the purposes of the further exploitation, preparation for the closure and closure of the Chernobyl station, transforming the object "Shelter" into an ecologically secure one and ensuring social protection for the Chernobyl station staff, as well as the population of the town Slavutich, namely: import of goods (materials, equipment and appliances) to the customs territory of Ukraine and purchase them on the customs territory of Ukraine	4 198
14010171	For the period of preparation for the closure of Chernobyl station blocks and to make the object "Shelter" an ecologically secure one, exempt from taxation shall the operations performed at the expense of international technical aid, which is provided on a free and irreversible basis for the purposes of the further exploitation, preparation for the closure and closure of the Chernobyl station, transforming the object "Shelter" into an ecologically secure one and ensuring social protection for the Chernobyl station staff, as well as the population of the town Slavutich, namely: performing works and rendering services within the framework of international technical aid	7 292,0
14010173	Sale of space complexes, space rocket carriers, ground segments of space systems and their aggregates, systems and spare parts produced by subjects of space activities	6 572,2
14010174	Establish that for the period of the implementation of FEZ "Slavutich" import of goods and other items to the special economic zone "Slavutich" by subjects of special economic zone "Slavutich" shall be taxed, with the peculiarities established by the Law of Ukraine "On the special economic zone of "Slavutich" taken into account	8 819,6
14010175	For the period of the operation of FEZ "Azov" VAT shall be collected, with the peculiarities established by the Law of Ukraine "On free economic zone and special regime of investment in Donetsk oblast" taken into account	210
14010178	The VAT to be paid to the budget by agricultural enterprises of all forms of ownership from sold milk, cattle, poultry, wool, as well as dairy and meat products produced in one's own processing work shops shall be fully left with these agricultural enterprises for the purposes the development of poultry and cattle-breeding produce	155 410,8
14010180	Payments for the fundamental research projects, research and designing works performed at the expense of the state budget shall be exempt	61 562,8
14010183	The following operations of the ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to ship-building industry in Ukraine" shall be exempt from VAT: import of materials, equipment and spare parts (hereinafter goods), used for ship-building purposes (except for excisable goods) to the customs territory of Ukraine if such goods are not produced in Ukraine or those that do not meet the certificate requirements of the international classification unions or the requirements of ship customers determined by contract conditions. The list and the volume of these goods shall be annually approved by the Cabinet of Ministers of Ukraine in keeping with the contracts concluded by these enterprises	187,2
14010184	Zero-rated VAT shall be accrued for the following operations: sale of products manufactured at the expense of the state budget of Ukraine resources to ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to ship-building industry in Ukraine" at the expense of the state budget of Ukraine	2 000,0
14010187	Designing works performed by domestic specialists under the contracts with ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to enterprises of ship-building industry" shall be exempt from VAT	415,2
14010188	For the period of implementation of the special regime of investment activities on the territories of the priority development in Zhitomir oblast goods and other items shall be imported to the territories of the priority development, with peculiarities established by the Law of Ukraine "On the special regime of investment activities on the territories of the priority development in Zhitomir oblast" taken into account	1 694,4
14010189	The VAT sums paid to suppliers for material technical resources, which are subject to refunding from the budget in case of sale of products produced at the expense of the state budget of Ukraine to enterprises of ship-building industry	517,2
14010194	Import of inputs for enterprises of space industry	1 100,0
1401097	Services provided by libraries	696,4

	needs	
14010170	For the period of preparation for the closure of Chernobyl station blocks and to make the object "Shelter" an ecologically secure one, exempt from taxation shall the operations performed at the expense of international technical aid, which is provided on a free and irreversible basis for the purposes of the further exploitation, preparation for the closure and closure of the Chernobyl station, transforming the object "Shelter" into an ecologically secure one and ensuring social protection for the Chernobyl station staff, as well as the population of the town Slavutich, namely: import of goods (materials, equipment and appliances) to the customs territory of Ukraine and purchase them on the customs territory of Ukraine	4 198
14010171	For the period of preparation for the closure of Chernobyl station blocks and to make the object "Shelter" an ecologically secure one, exempt from taxation shall the operations performed at the expense of international technical aid, which is provided on a free and irreversible basis for the purposes of the further exploitation, preparation for the closure and closure of the Chernobyl station, transforming the object "Shelter" into an ecologically secure one and ensuring social protection for the Chernobyl station staff, as well as the population of the town Slavutich, namely: performing works and rendering services within the framework of international technical aid	7 292,0
14010173	Sale of space complexes, space rocket carriers, ground segments of space systems and their aggregates, systems and spare parts produced by subjects of space activities	6 572,2
14010174	Establish that for the period of the implementation of FEZ "Slavutich" import of goods and other items to the special economic zone "Slavutich" by subjects of special economic zone "Slavutich" shall be taxed, with the peculiarities established by the Law of Ukraine "On the special economic zone of "Slavutich" taken into account	8 819,6
14010175	For the period of the operation of FEZ "Azov" VAT shall be collected, with the peculiarities established by the Law of Ukraine "On free economic zone and special regime of investment in Donetsk oblast" taken into account	210
14010178	The VAT to be paid to the budget by agricultural enterprises of all forms of ownership from sold milk, cattle, poultry, wool, as well as dairy and meat products produced in one's own processing work shops shall be fully left with these agricultural enterprises for the purposes the development of poultry and cattle-breeding produce	155 410,8
14010180	Payments for the fundamental research projects, research and designing works performed at the expense of the state budget shall be exempt	61 562,8
14010183	The following operations of the ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to ship-building industry in Ukraine" shall be exempt from VAT: import of materials, equipment and spare parts (hereinafter goods), used for ship-building purposes (except for excisable goods) to the customs territory of Ukraine if such goods are not produced in Ukraine or those that do not meet the certificate requirements of the international classification unions or the requirements of ship customers determined by contract conditions. The list and the volume of these goods shall be annually approved by the Cabinet of Ministers of Ukraine in keeping with the contracts concluded by these enterprises	187,2
14010184	Zero-rated VAT shall be accrued for the following operations: sale of products manufactured at the expense of the state budget of Ukraine resources to ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to ship-building industry in Ukraine" at the expense of the state budget of Ukraine	2 000,0
14010187	Designing works performed by domestic specialists under the contracts with ship-building enterprises determined by Article 1 of the Law of Ukraine "On state support to enterprises of ship-building industry" shall be exempt from VAT	415,2
14010188	For the period of implementation of the special regime of investment activities on the territories of the priority development in Zhitomir oblast goods and other items shall be imported to the territories of the priority development, with peculiarities established by the Law of Ukraine "On the special regime of investment activities on the territories of the priority development in Zhitomir oblast" taken into account	1 694,4
14010189	The VAT sums paid to suppliers for material technical resources, which are subject to refunding from the budget in case of sale of products produced at the expense of the state budget of Ukraine to enterprises of ship-building industry	517,2
14010194	Import of inputs for enterprises of space industry	1 100,0
1401097	Services provided by libraries	696,4

14010198	Rendering of paid services to extra school educational institutions, their students and teachers, shall not be the object of taxation	1 415,6
14010199	Establish that for the period of operation of the tourist and resort FEZ "Kurortpolis Truskavets" VAT shall be collected taking into account the peculiarities determined by the Law of Ukraine "On FEZ Kurortpolis Truskavets"	616,0
14010200	Establish that for the period of the implementation of the special regime of investment in Kharkiv import of goods and other items to the territory of the city of Kharkiv shall be taxed taking into account the peculiarities established by the Law of Ukraine "On the special regime of investment activities on the territory of Kharkiv"	26 185,2
14010201	Establish that for the period of special regime of investment and innovation activities of technological parks "Semi-conductor technologies and materials, optic electronics and sensor machinery", "Paton Institute of electric welding" "Vuglemash", "Institute of mono-crystals", "Institute of physics", "Kiev Polytechnics", "Intellectual information technologies", "Ukrinfotech" VAT shall be collected taking into account the peculiarities determined by the Law of Ukraine "On the special regime of investment and innovation activities"	39 202,4
14010204	Exempt shall be trading and manufacturing enterprises' sale of new year, etc. gifts for children, as well as tickets to holiday concerts purchased at the expense of the Social Insurance Fund of Ukraine and trade unions	184,4
14010209	Sale of goods (works, services) used by the enterprises of "Bronetechnika Ukrainy" (performers of state defense order and international contracts) to produce and upgrade armored vehicles, the latter being determined by contracts. The list and volumes of these goods shall be annually approved by the Cabinet of Ministers of Ukraine in keeping with the contracts concluded by these enterprises	380,8
14010210	Sale of armored vehicles and spare parts to them sold to state order customers or international contract customers shall be taxed at zero-rate	4 000,0
14010213	VAT paid to the budget from sale of goods (works, services) of one's own production, including the products (except for excisable goods) produced on give-and-take basis from one's own agricultural raw materials, except for the sale of milk and live stock to processing enterprises by agricultural producers irrespective of their legal form and ownership form, in which the sum received from sale of agricultural produce of one's own production and the processed products over the previous reporting period amounts to no less than 50% of the total sum of the gross income of an enterprise	540 089,2
14010216	Establish that for the period of special investment activities on the territory of priority development in Volynskaya oblast goods shall be imported to the territory of priority development, taking into account the peculiarities established by the Law of Ukraine "On special regime of investment activities on the territory of priority development in Volynskaya oblast"	1 827,2
14010217	Imports of goods for the publishing industry	461 000,0
14010219	Import of goods for aircraft industry	23 600,0
14010220	Zero rate for sale of goods produced by enterprises of aircraft industry	280,0
14010228	Enterprises of recycling industry have the right to withhold VAT on the sales of recycled goods	3 000,0
	Total Budget Losses	**5 000 327**
	Total Budget Losses (excluding agriculture)	**4 057 229**

INTERNATIONAL MONETARY FUND

UKRAINE

Request for Stand-by Arrangement
Supplementary Information

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

Approved by Carlo Cottarelli and Michael T. Hadjimichael

March 25, 2004

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

2. **Macroeconomic developments have been stronger than expected.** Real GDP growth estimates for 2003 have been revised upwards to 9.3 percent from 8.5 percent. Activity accelerated in the final two quarters and was driven by an 18 percent increase in manufacturing, double-digit growth of transport services and domestic trade, as well as a sharp rebound in construction. Industrial production continued to soar in the first two months of 2004, by 18.2 percent compared to the same period of last year. Based in part on the recent strong economic performance, the government's annual action plan presented to parliament in March introduced a revised growth forecast of 9.5 percent in 2004, up from 4.8 percent in the last budget submission. The upturn in inflation at end-2003 to 8.2 percent (year-on-year) has slowed down somewhat in the first two months of 2004 to 7.4 percent in line with the program.

3. **Stronger than expected balance of payments has accelerated the central bank's reserve accumulation since the beginning of the year.** The increase in gross international reserves (GIR) by $1.2 billion (at program rates) until March 19, 2004 is already slightly higher than the programmed change in reserves for the whole year. At $8.2 billion, the stock of GIR covers about 45 percent of broad money and slightly above 3 months of imports. Preliminary data indicate that the growing supply of foreign exchange is due to strong exports, which surged by 43 percent (year-on-year) in January while imports rose by 29 percent, in addition to privatization proceeds and receipts from bond issuances. Receipts of $600 million resulted from a government 7-year Eurobond issuance. With a coupon rate of 6⅞ percent, it was sold at a spread of 335 basis points over U.S. treasuries at end-February and includes a collective action clause. Also in February, **FATF removed Ukraine from its list of Non-Cooperative Countries and Territories.**

4. **Through February, consolidated government income tax collections have slightly exceeded program projections and VAT refund arrears have been reduced in line with**

the program. In February itself, the first month under the new tax regime, tax collections were about 2 percent ahead of target. A small shortfall in personal income tax collection (under the new flat tax regime) was more than countered by overperformance in the profit tax. Stronger than expected GDP growth may have some impact on collections, but more data will be needed to resolve uncertainty in this area. VAT refund arrears amounted to Hrv 934 million at end-February, after taking into account Hrv 893 million which have been securitized.

5. **A tax amnesty bill was submitted to parliament by the President in March 2004.** The bill aims to legalize previously undeclared assets and income of natural persons, unless subject to a criminal case and suspected of money laundering, and would subject repatriated funds to a 10 percent stamp duty. Existing tax arrears and already assessed tax liabilities would not fall under the tax amnesty. As emphasized in the staff report, a new amnesty would threaten future tax compliance. The staff urges the authorities to reconsider and to focus on improving compliance through better tax audit.

6. **Base money growth has continued to be strong, but in line with the program due to a tight fiscal stance.** In February 2004, base money expanded by 34.5 percent (year-on-year) fuelled by the rapid increase in net international reserves while net domestic assets fell due to a strong accumulation of government deposits. Broad money increased by 47.1 percent and credit to the economy by 64.1 percent (year-on-year). At the time of the review, the monetary program will be revisited and modified as necessary. The NBU has taken modest steps to tighten its monetary policy stance. It has set the NBU overnight rate above 8.5 percent (temporarily up to 8.9 percent), introduced a 30-40 basis points higher overnight rate for unsecured overnight loans, and reduced the use of cash in vault for reserve requirements.

7. **Banks' credit quality has deteriorated somewhat but higher minimum capital adequacy ratios have been observed.** The level of non-performing loans increased to 28.3 percent of total loans by end-2003 from 26.3 percent at end-August 2003, but the share of loans in the lowest two classification categories fell from 7.9 percent to 7.2 percent. As part of the efforts to mitigate credit risk, the new minimum capital adequacy ratio of 10 percent took effect March 1, 2004 and has been observed by all but one commercial bank.

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves 12-Month Stand-By Arrangement for Ukraine

The International Monetary Fund (IMF) today approved a Stand-By Arrangement in an amount equivalent to SDR 411.6 million (about US$605 million) for a period of 12 months ending on March 28, 2005. The Ukrainian authorities intend to treat the Arrangement as precautionary.

Following the Executive Board's discussion on Ukraine, Anne Krueger, Acting Managing Director and Chair, said:

"Ukraine has achieved a broad-based and sustained economic recovery, and has subdued inflation following the 1998–99 financial crisis. Renewed confidence in macroeconomic stability has contributed to the remonetization of the economy, a strong balance of payments, the rebuilding of international reserves, and a significant improvement in the economic outlook. The latest indicators suggest that economic activity remains strong this year.

"Ukraine is well placed to consolidate these gains. Full implementation of the government's prudent financial policies and further progress on growth-oriented structural reforms will support growth and contain inflationary pressures, while bolstering debt sustainability and market confidence.

"Parliamentary approval of the government's economic reform strategy and wide-ranging tax and pension reforms, progress in eliminating VAT refund arrears, and the strengthening of banking sector capitalization are particularly welcome steps. Looking forward, the government's plan to improve governance and enhance the business climate will be key to ensure that Ukraine sustains its medium-term growth potential.

"The 2004 budget will contribute to preserving macroeconomic stability, and the recent reductions in tax exemptions and sectoral VAT preferences, and in corporate and personal income tax rates are welcome. However, government spending should remain in line with the budget, in view of the uncertainty associated with the full impact of the reductions in tax rates.

"The National Bank of Ukraine's stewardship of monetary policy has contributed to subdued inflationary pressures. Rapid credit expansion poses a risk to financial sector stability and needs to be monitored closely. In this regard, the recent strengthening of the supervisory and prudential regulatory framework is welcome, though further steps deserve consideration.

"It is essential to strengthen the role of the private sector and business climate to foster economic growth and increase foreign direct investment. Continued improvements in governance, reform of the energy sector, and the adoption of a transparent privatization process will contribute to these objectives.

"Despite the positive macroeconomic performance and outlook, vulnerabilities remain, especially in the fiscal, financial, and external areas. Full implementation of the program is critical to sustain non-inflationary economic growth and improve living standards," Ms. Krueger said.

ANNEX

Background

Ukraine's macroeconomic performance has improved substantially since the 1998-99 financial crises. Real GDP grew by an estimated 9.3 percent in 2003, despite the poor grain harvest, completing the fourth year of Ukraine's strong economic recovery. The expansion was driven by an 18 percent increase in manufacturing, double-digit growth of transport services and domestic trade, as well as a sharp rebound in construction. The sustained economic recovery has been supported by the establishment of macroeconomic stability, in particular the maintenance of a prudent fiscal stance. Ukraine has regained access to international capital markets and there is no immediate balance of payment need.

The Main Program Objectives

Support sustained economic growth. The 2004 budget is based on a conservative projection of about 5 percent real GDP. To sustain economic growth over the medium term, the authorities aim to improve the investment climate by strengthening governance, reforming the tax system, strengthening the financial sector, and joining the WTO.

Keep inflation under control. The objective for 2004 is to reduce consumer price inflation to the mid-single digits. This is likely to require a tighter monetary policy and the maintenance of prudent fiscal policy, although the high volatility of food prices implies significant uncertainty about the CPI outlook.

Reduce vulnerabilities. Executing the 2004 budget and maintaining a low deficit thereafter will support the continued reduction in public debt ratios, providing a safety net for potential fiscal costs of future structural reforms or economic shocks. Addressing the financial problems of the energy sector will help reduce quasi-fiscal deficits and contingent liabilities. To reduce credit risk in the banking sector, the National Bank of Ukraine is strengthening prudential regulations and banking supervision with a view to discourage imprudent lending practices.

Ukraine joined the IMF on September 3, 1992; its quota is SDR 1.372 billion (about US$2.018 billion). Its outstanding use of IMF credit currently totals SDR 1.201 billion (about US$1.766 billion).

Ukraine: Selected Economic Indicators, 1999–2004

	1999	2000	2001	2002	2003 Est.	2004 Prog. 1/
Output and employment						
Real GDP (annual change in percent) 2/	-0.2	5.9	9.2	5.2	9.3	6.0
Nominal GDP (in billions of hryvnia)	130.4	170.1	204.2	220.9	257.0	292.0
Nominal GDP (in billions of U.S. dollars)	31.6	31.3	38.0	41.5	48.2	54.8
Unemployment rate (ILO definition)	11.9	11.7	11.1	10.1	8.7	...
Prices and wages (percent change)						
Consumer prices, period average	22.7	28.2	12.0	0.8	5.2	7.1
Consumer prices, end of period	19.2	25.8	6.1	-0.6	8.2	6.0
Producer prices, end of period	15.7	20.6	0.9	5.7	11.1	5.5
Average monthly wages, annual average	16.1	30.2	34.9	20.7	23.0	...
Consolidated budget (in percent of GDP)						
Revenue 3/	31.9	33.4	33.5	36.8	37.7	37.3
Expenditure (cash basis)	34.2	34.7	35.1	36.3	38.5	39.0
Cash balance 3/	-2.4	-1.3	-1.6	0.5	-0.7	-1.8
Primary balance (cash basis)	0.0	1.8	0.4	1.9	0.3	-0.4
Commitments balance 4/	-1.4	2.1	-1.5	0.2	0.1	-0.8
Privatization proceeds	0.6	1.3	1.3	0.5	1.1	0.8
Net domestic financing	1.5	0.3	-0.1	-0.3	-1.2	0.5
Net external financing 3/	0.2	-0.3	0.4	-0.7	0.8	0.4
Public debt and arrears (in percent of GDP) 5/	61.3	47.7	39.4	36.9	32.1	27.7
o.w. external debt	39.5	33.1	26.6	24.6	22.5	19.5
Money and credit (end of period, percent change)						
Base money	39.2	40.1	37.4	33.6	30.1	16.3
Broad money	40.4	45.5	41.9	41.8	46.5	24.1
Credit to nongovernment	43.5	61.3	40.5	47.3	63.4	25.1
Velocity 6/	5.9	5.3	4.5	3.4	2.7	2.5
Average hryvnia lending rate (in percent, period average)	55.0	41.5	32.3	25.5	18.3	...
Average hryvnia deposit rate (in percent, period average)	20.7	13.7	11.0	7.9	7.0	...
Balance of payments						
Current account balance (in percent of GDP)	5.2	4.7	3.7	7.7	6.1	3.7
Gross reserves (end of period, in billions of U.S. dollars)	1.1	1.5	3.1	4.4	6.9	7.8
In months of next year's imports of goods and services	0.7	0.9	1.7	1.9	2.8	3.0
Debt service (in percent of exports of goods and services) 5/	15.8	10.4	6.7	5.4	6.3	6.4
Exports (annual change in percent)	-3.7	19.2	8.7	9.2	27.1	6.3
Imports (annual change in percent)	-20.5	15.4	13.0	6.3	33.7	8.4
Exchange rate						
Hryvnia per U.S. dollar, end of period	5.22	5.43	5.30	5.33	5.33	...
Hryvnia per U.S. dollar, period average	4.13	5.44	5.37	5.33	5.33	...
Real effective exchange rate, (percent change) 7/	-15.9	-4.5	7.0	-4.2	-6.8	...

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

1/ Assumes an exchange rate of 5.33 Hrv/US$.

2/ Official real GDP growth estimates were revised upwards since the issuance of the staff report from 4.8 percent for 2002 and 8.5 percent for 2003. All other data in this table reflect the status at the issuance of the staff report.

3/ From 2003 onwards, based on an accounting treatment that excludes offset-based amortization to Russia, which decreases revenues and increases net external financing (and the budget deficit) by 0.2 percent of GDP relative to previous years.

4/ Cash balance adjusted for the net accumulation of expenditure and VAT refund arrears, as well as for non-cash property income.

5/ Government and government-guaranteed debt and arrears, plus NBU debt. Excludes debt by state-owned enterprises.

6/ Annual GDP divided by end-period broad money (M3).

7/ Period averages; (+) represents real appreciation; based on CPI and average trade weights for 1996-2002.