January 2005
IMF Country Report No. 05/15

Ukraine: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 3, 2004, 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 September 28, 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 October 18, 2004 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 25, 2004 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper
Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Ukraine

Approved by Carlo Cottarelli and Michael T. Hadjimichael

September 28, 2004

Discussions for the 2004 Article IV consultation were held in Kyiv during July 19–August 3, 2004. The mission met with First Deputy Prime Minister and Minister of Finance Azarov, Minister of Economy and European Integration Derkatch, Acting Governor of the National Bank of Ukraine (NBU) Yatsenuik, and other senior officials. The mission did not meet with the governor of the NBU since he is currently on leave of absence to head the presidential campaign for the prime minister. The mission also met members of the diplomatic community, bankers, entrepreneurs' associations, and research institutes.

The mission comprised E. van der Mensbrugghe (head), M. Rossi, A. Schaechter, A. Tiffin (all EUR), M. Flanagan (FAD), and I. Halikias (PDR). C. Cottarelli, L. Figliuoli, Senior Resident Representative, (all EUR) and Y. Yakusha (OED) participated in the discussions.

A precautionary 12-month Stand-By Arrangement (SBA) was approved on March 29, 2004. Review discussions held at the same time could not be completed because of policy slippages.

Ukraine has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

The 2003 Article IV consultation was completed on May 14, 2003. Executive Directors noted Ukraine's strong macroeconomic performance, marked by robust GDP growth, low inflation, improved external position, and a rapid decline in public debt. Directors commended the authorities for their prudent demand-management policies, including tight fiscal policy, but regretted that the authorities did not seize the opportunity to accelerate structural reforms.

The discussions took place in the run-up to the October presidential elections, almost certainly a choice between Prime Minister Yanukovich and opposition leader Yuschenko. Irrespective of the results, no major policy change is expected.

Contents Page

Contents Page

Executive Summary

Background and outlook: Real GDP grew by 9.4 percent in 2003, despite a poor harvest. While growth is projected to reach 12½ percent in 2004 and the current account surplus an impressive 10 percent of GDP, the loosening of fiscal policy in the second half of the year will exacerbate emerging inflationary pressures. Consumer price index (CPI) inflation is likely to reach 9–10 percent by year's end, much above the original projection. The discussions took place in the run-up to the October presidential elections, almost certainly a choice between Prime Minister Yanukovich and opposition leader Yuschenko. Irrespective of the results, no major policy change is expected.

Policy discussions focused on the following key issues:

- the sustainability of the current economic boom;
- the immediate risks that such expansion may entail; and hence
- the need for prudent macroeconomic policies and further structural reforms.

Authorities and staff disagreed on the following:

- The risk of overheating. The authorities viewed this risk as relatively remote.
- The fiscal stance for 2004. Staff could not support the amended budget that provides for a substantial procyclical loosening. The 2005 fiscal target discussed during the mission seemed broadly appropriate, but recent policy decisions make its attainment difficult.
- The time frame for exiting the de facto peg to the U.S. dollar.

The staff recommended the following:

- A 2004 consolidated government deficit limited to the original program target of 1.8 percent of GDP. This would still provide resources to finance an increase in social and capital spending.
- Greater exchange rate flexibility. This would help restrain credit growth and inflationary pressures, while weakening the incentive to build foreign currency-denominated debt and enhancing Ukraine's resiliency to external shocks.
- A monetary tightening to contain inflationary pressures. The extent of sterilization and interest rate increases required will depend on the authorities' willingness to let the exchange rate appreciate.
- Strengthening the role of the private sector. Tax distortions, corruption, red tape, inadequate implementation of the legal framework all act as barriers to investment.

Lack of agreement on the above issues and incomplete implementation of key structural measures have so far prevented completion of the review.

I. Background

1. **Six years after the 1998 crisis, Ukraine continues to recover strongly** (Table 1). Over 2000-04, GDP growth has averaged 8.4 percent, above the Central and Eastern European average (3.8 percent), and the Commonwealth Independent States (CIS) average (8.0 percent), with a projected peak of 12.5 percent in 2004.[1] This recovery, however, comes from a low base. Compared with most other transition countries, Ukraine's output contraction in the 1990s was more pronounced (Figure 1). Moreover, delays in structural reforms and a weak business climate have hindered investment. Besides, growth appears not to have benefited everyone in the same proportion.[2]

Ukraine: Key Economic Indicators, 2000–04

	2000	2001	2002	2003	2004	
				Est.	Prog.	Proj.
	(Percent change)					
Real GDP	5.9	9.2	5.2	9.4	6.0	12.5
Consumer prices, eop	25.8	6.1	-0.6	8.2	6.0	9.0
	(In percent of GDP)					
Current account surplus	4.7	3.7	7.5	5.8	3.7	10.2

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

2. **While exports have triggered the acceleration in growth, domestic demand has played an increasingly important role** (Figure 2). Rapid growth in China has boosted Ukraine's steel exports, while continued growth in Russia has benefited Ukraine's machinery exports. Consequently, annual export growth has averaged 25 percent since end-2002, yielding a sizable current account surplus and foreign reserve accumulation (Table 2). Exporters' profits have helped fuel an investment and construction boom. A surge in credit to the private sector and rising disposable incomes have also supported domestic demand.

Ukraine: Contributions to Growth, 2001–05
(Percent)

	2001	2002	2003	2004		2005
			Est.	Prog.	Proj	Proj.
Gross domestic demand	9.5	3.4	11.2	7.0	10.7	8.1
Private consumption	4.1	5.1	6.2	6.0	5.5	5.0
Public consumption	2.1	-1.3	2.6	0.6	1.8	0.6
Gross investment	1.2	0.6	2.9	1.3	3.6	2.5
Changes in inventories	2.2	-1.0	-0.5	-0.9	-0.2	0.0
Net exports	-0.4	1.9	-1.8	-1.1	1.8	-2.1
Exports of GNFS	3.6	3.2	4.5	1.7	7.6	2.4
Imports of GNFS	-4.0	-1.3	-6.4	-2.8	-5.8	-4.5
GDP	9.2	5.2	9.4	6.0	12.5	6.0

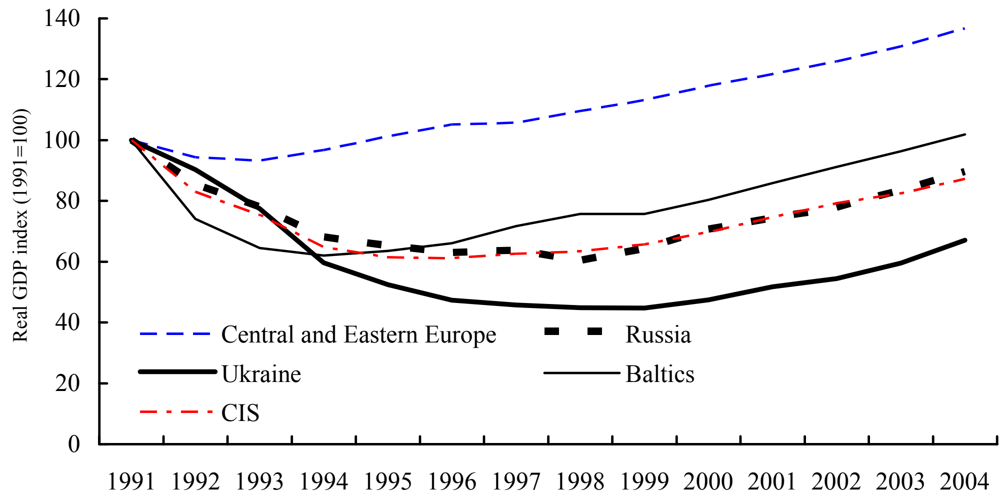
Sources: Ukrainian authorities; and Fund staff estimates and projections.

[1] These figures may reflect the emergence of the unrecorded economy, thus overstating actual growth, as discussed in IMF Country Report No. 03/173.

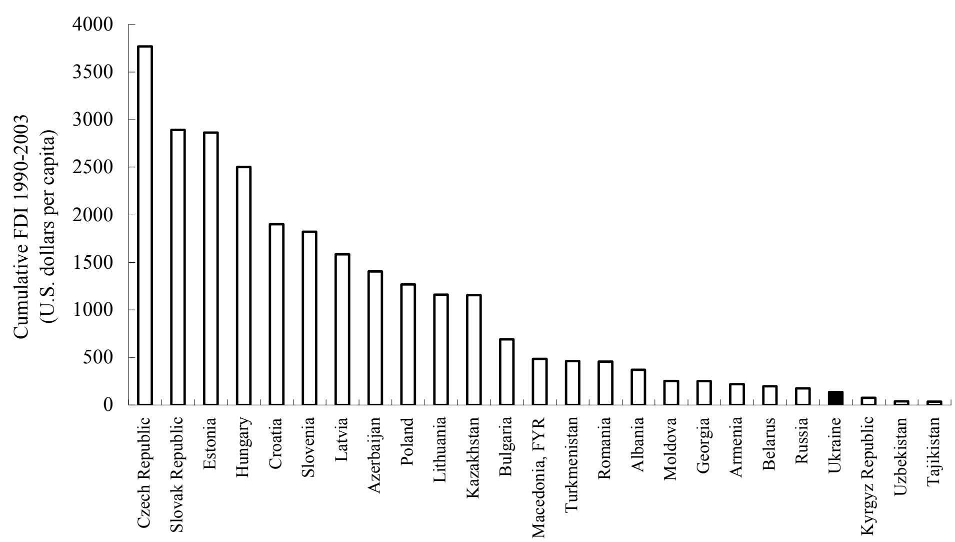
[2] See the accompanying selected issues paper on "Growth and Inequality."

Figure 1. Cross-Country Growth and Foreign Direct Investment, 1990-2004

Ukraine's delayed recovery.....

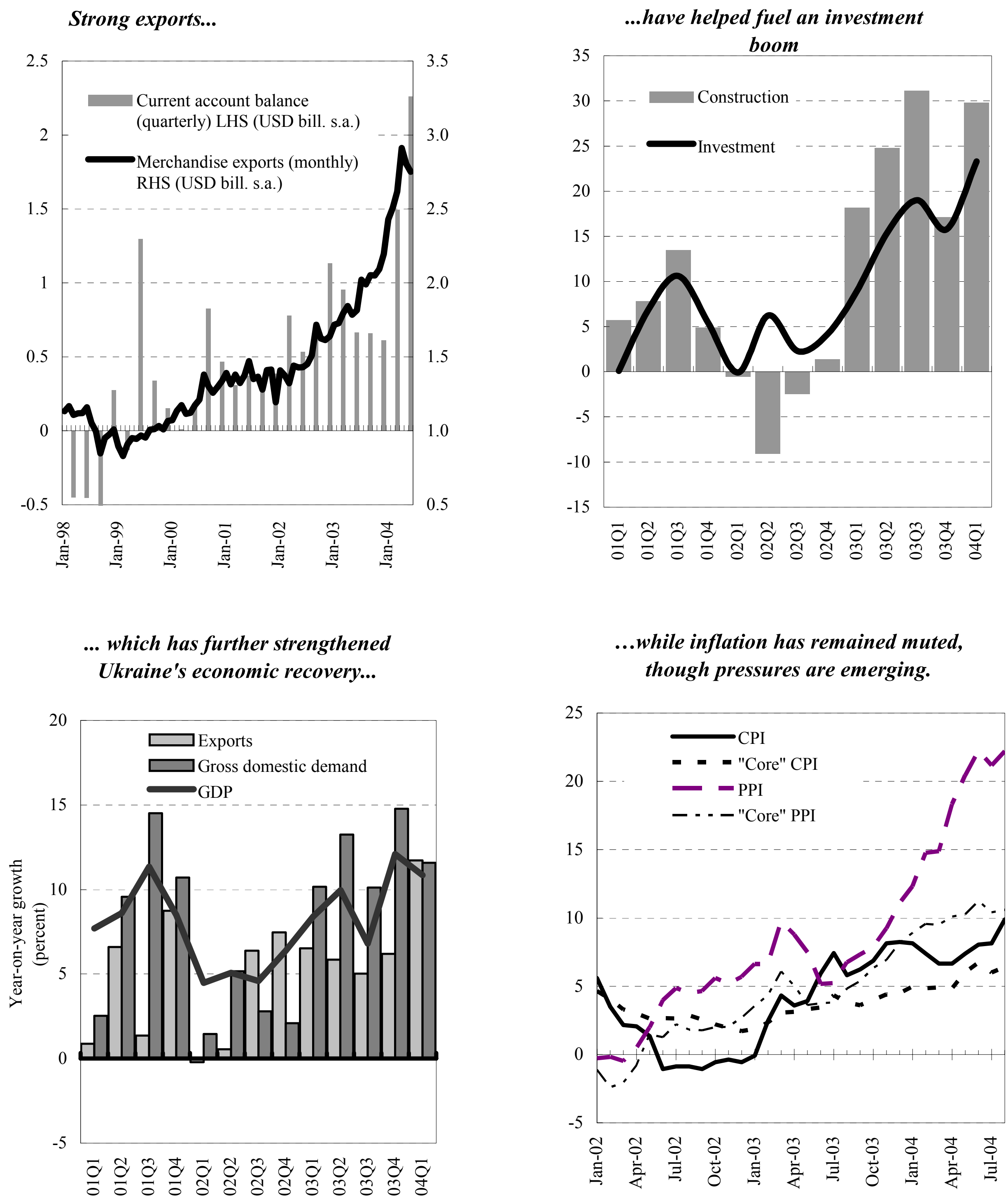


...reflects, in part, the economy's poor business and investment climate.



Sources: World Economic Outlook; and Fund staff estimates.

Figure 2. Ukraine: Exports, Growth, and Inflation, 2001-04
(Year-on-year change in percent, unless otherwise indicated)



Sources: State Statistics Committee; and Fund staff estimates.

3. **However, unemployment remains high.** The official unemployment rate (at about 4 percent since 2001) is an unreliable guide, owing to hidden unemployment and weak incentives to register for unemployment benefits. According to the International Labor Organization's definition, unemployment, although down from 12 percent in 1999, remains at about 9 percent in 2004.

4. **Inflation has been moderate, but strong upward pressures are emerging.** From a low of -0.6 percent in December 2002, the 12-month consumer price index (CPI) rate reached 8.2 percent in December 2003. While much of this increase seemed to reflect supply-side factors—especially the impact of a poor harvest—inflation had increased to 9.9 percent by August 2004. Producer price inflation index (PPI) inflation reached 22.2 percent in August 2004, reflecting mostly higher world prices for energy and metals. Even excluding these items, "core" PPI inflation would exceed 10 percent. In June 2004, the average nominal wage for the entire economy was 26.3 percent above its level the previous year.

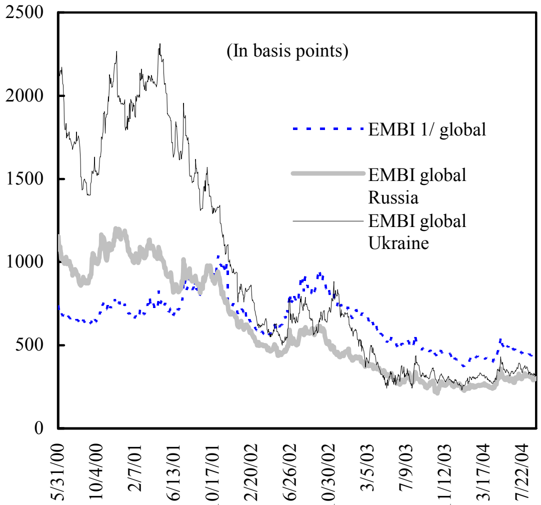
5. **Capital market access and financial indicators have improved.** After regaining access to international capital markets in 2003, Ukraine issued a $600 million seven-year Eurobond in March 2004, and a $500 million five-year floating rate Eurobond in August. Both issuances contain collective action clauses. Spreads are relatively low (about 360 basis points) but remain correlated with fluctuations in Russia. Standard and Poor's upgraded Ukraine's long-term sovereign credit rating to B+, on par with other rating agencies, and Moody's raised its outlook to positive (Table 3). Interest rates and stock prices have moved favorably (Figure 3), while the recent banking sector difficulties in Russia have not affected Ukraine.

6. **The public debt-to-GDP ratio has fallen** (Figure 4). Primary surpluses and strong growth during 1999–2003 have helped reduce the debt ratio from 61 percent of GDP to a projected 27 percent at end-2004. Revenue gains—principally from personal income and payroll taxes, and state enterprise dividends (Table 4)—have offset a rise in spending from 34 percent to almost 38 percent of GDP.

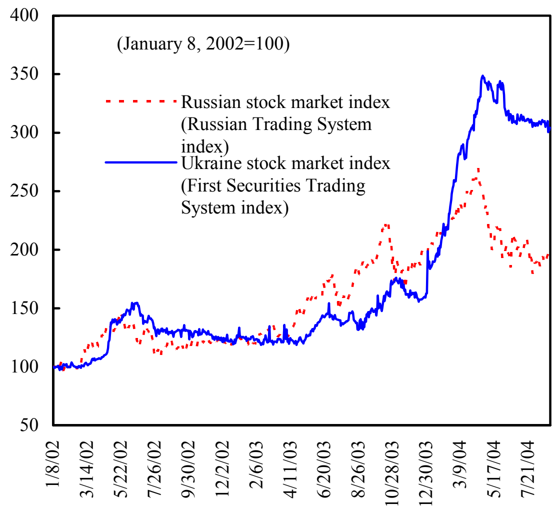
7. **Fiscal policy remained prudent through mid-2004.** The consolidated government cash deficit was 0.7 percent of GDP in 2003. Through end-June 2004, it amounted to 0.2 percent of (annual) GDP versus an end-June adjusted program ceiling of 0.9 percent. However, the outturn reflects an accumulation of value added tax (VAT) refund arrears; had the programmed reduction occurred, the deficit would have been 1 percent of GDP. Indeed, general problems with VAT administration contributed to a drop in the revenue/GDP ratio and led the president to replace senior management in the state tax administration in June.

Figure 3. Ukraine: Financial Market Indicators, 2000-04

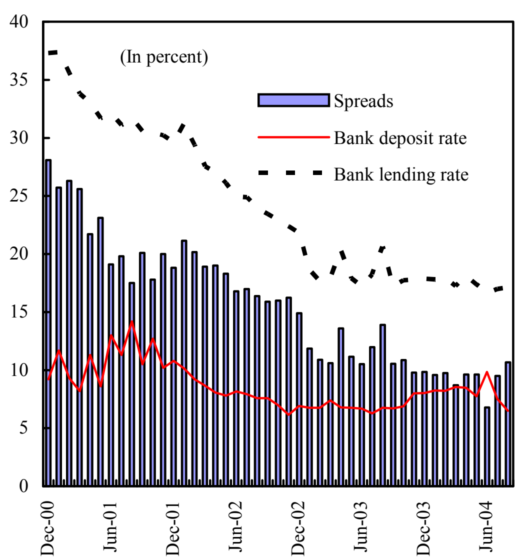
Risk premiums for Eurobonds have moved more closely with Russia.



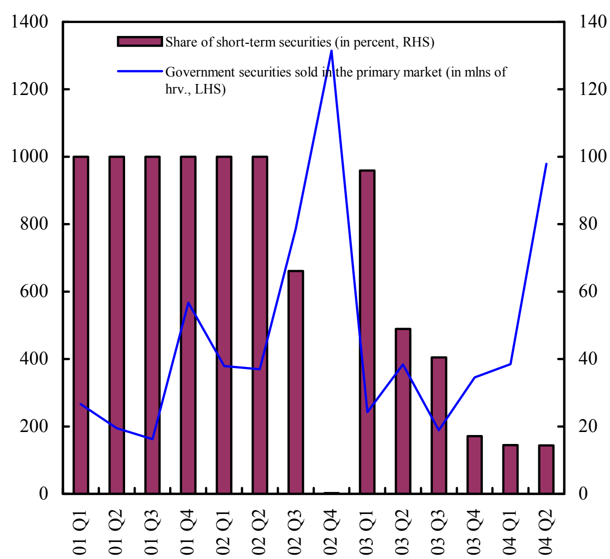
Equity prices have surged, dampened only by the Russian downturn.



Bank rates and spreads have come down.



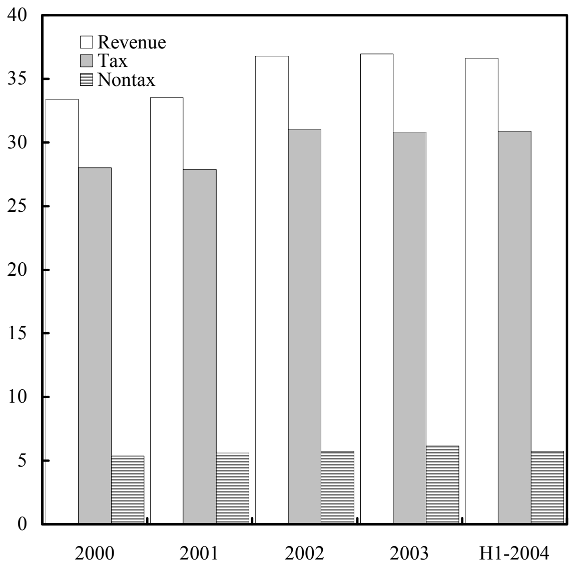
New issuance of government securities has been low but increasingly at longer maturities.



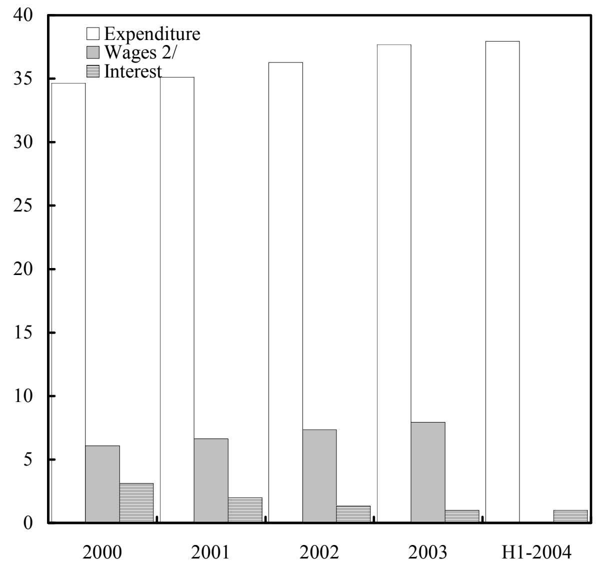
Sources: Ukrainian authorities; Bloomberg; and Fund staff estimates.
1/ Emerging market bond index.

Figure 4. Ukraine: Fiscal Policy, 2000-04 1/
(In percent of GDP)

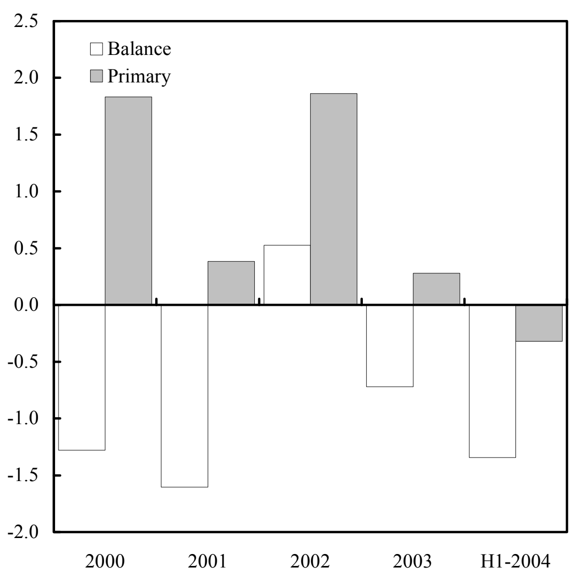
Gains in revenues ....



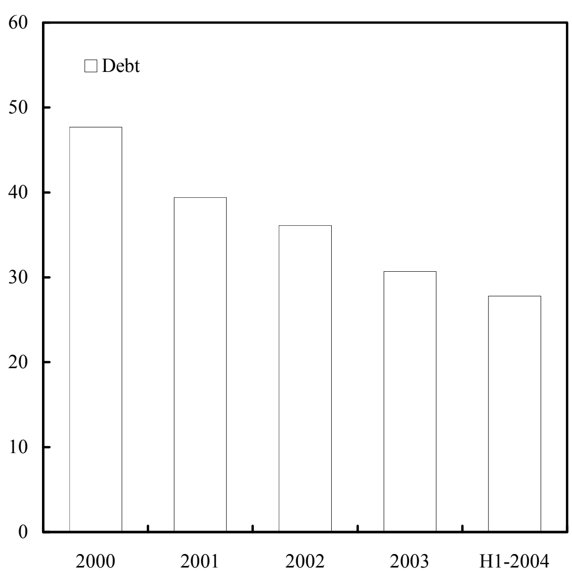
... have offset higher spending.



Consistent primary surpluses...



... have allowed for declining debt-to-GDP ratios.



Sources: Ukrainian authorities; and Fund staff estimates.
1/ Ratios for H1-2004 are based on data for June 2003 to June 2004. This eliminates seasonal effects.
2/ Expenditure for wages for H1-2004 is not yet available.

8. **In the context of a de facto peg to the dollar, strong money growth has so far been consistent with single-digit inflation, amid continued remonetization and a modest monetary policy tightening** (Figure 5). In the first part of 2004, a large buildup of government deposits helped moderate base money growth, though the NBU's pronounced interventions in the foreign exchange market led to strong net international reserves (NIR) accumulation (Table 5). Starting in May, the NBU has tightened monetary policy, including by issuing certificates of deposit (CDs) (although in small volumes) and raising reserve requirements. The discount rate was also raised by 50 basis points to 7.5 percent.

9. **Competitiveness remains strong** (Figure 6). In the 12 months to June 2004, the real effective exchange rate depreciated by 4 percent, reflecting mainly Ukraine's low inflation vis-à-vis Russia, and the strengthening euro. Average wages remain less than half Russia's wages.

10. **Despite the NBU's ongoing steps to strengthen prudential regulation and banking supervision, credit expansion and credit quality remain a concern** (Figure 7 and Table 6). The credit-to-GDP ratio stands at 29.5 percent compared to 12.4 percent in 2000. While credit expansion has decelerated since early 2004, loans have increased to about two-thirds of bank assets—higher than in most transition economies. Nonperforming loans classified by past due criteria are estimated at 8 percent of total loans. The buildup of bank capital and provisions has not kept pace with the credit expansion. The fall in the ratio of regulatory capital to risk-weighted assets was only reversed in April 2004. The ratio stood at 15.2 percent in June, but for the 10 largest banks, it was only 1½ percentage points above the minimum requirement. While relatively low bank profitability has inhibited direct replenishment of capital from retained earnings, tax avoidance tactics are a major factor behind the official profitability data. Provisions, as a share of total loans, have fallen steadily despite a tightening in loan classification in mid-2003.[3]

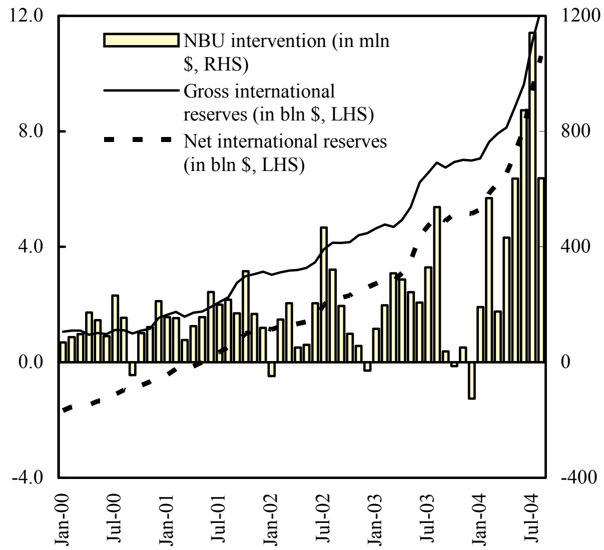
11. **The pace of structural reforms has slowed**. After progress in late 2003–early 2004, thus allowing agreement on the SBA (Table 7), several actions under program conditionality—concerning related-party lending, tax preferences and exemptions, and VAT refund arrears—have not been completed. Also, legislation on joint-stock companies has lingered in parliament for quite some time. The European Commission has recently announced that, to be granted market economy status, Ukraine needs to make further progress implementing the legal framework for bankruptcy and eliminating state influence on prices. According to the World Bank, the UN Millennium Development Goal regarding the prevention of HIV/AIDS and tuberculosis is the only goal that is unlikely to be met by 2015.

---

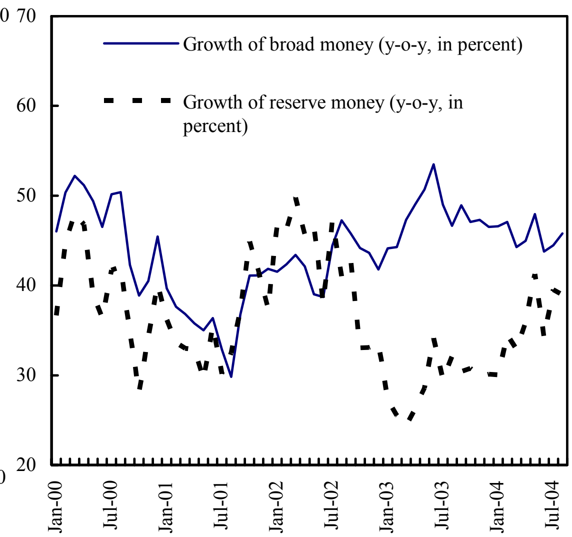
[3] See the accompanying selected issues paper on "Credit Boom in Ukraine: Risks for Banking Sector Stability."

Figure 5. Ukraine: Monetary Indicators, 2000-04

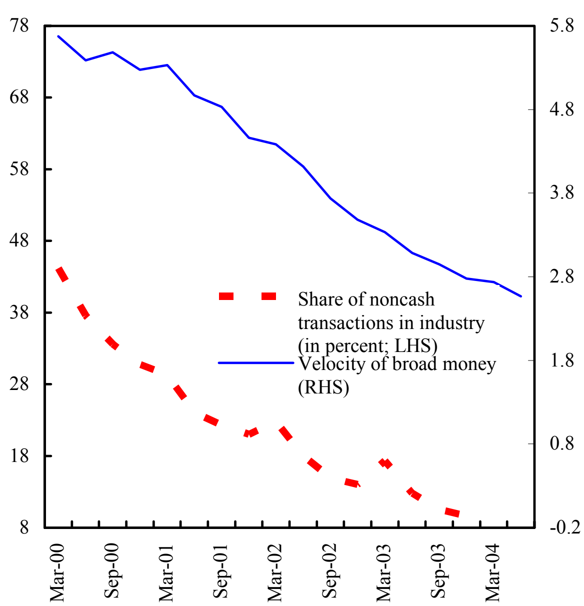
Stronger-than-expected purchases of foreign exchange by the NBU...



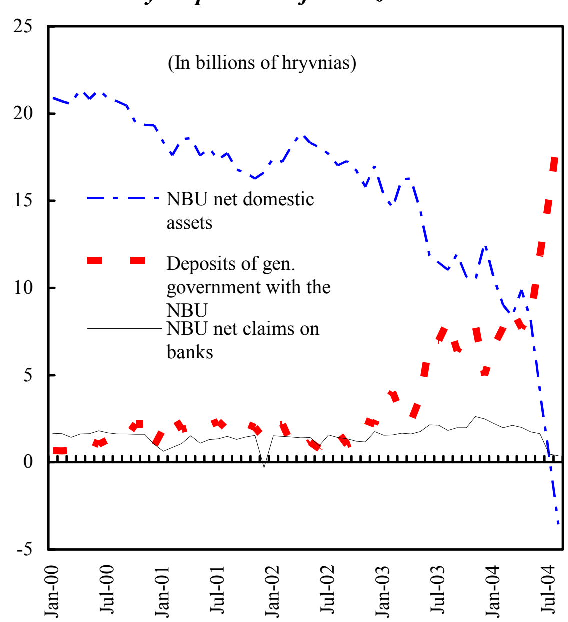
… have fueled rapid growth of monetary aggregates.



Owing to rising money demand ...



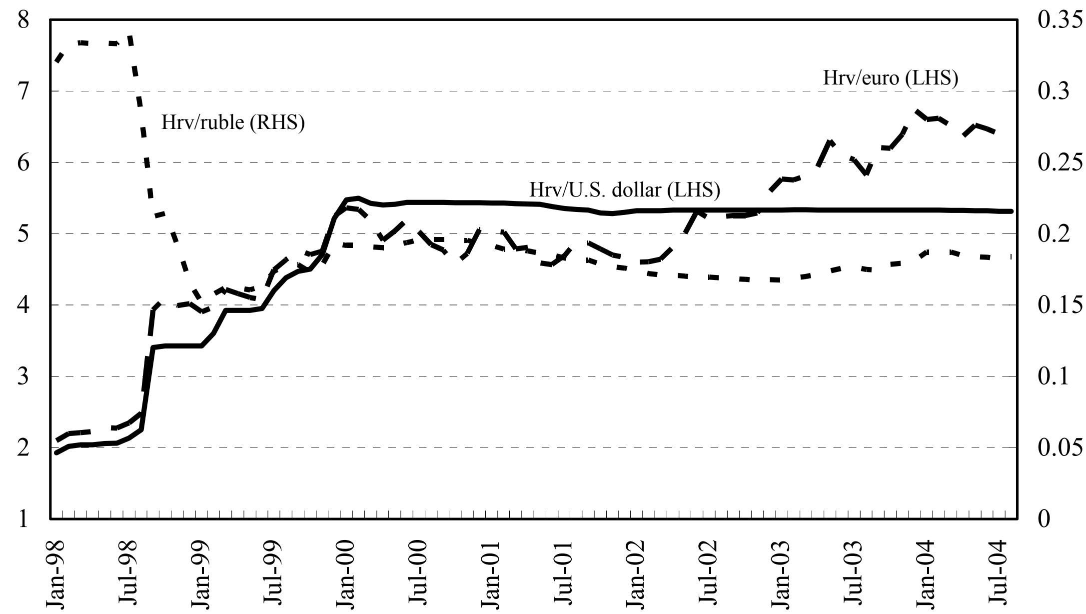
… and tight fiscal policy, inflationary pressures have remained subdued until recently despite lack of sterilization.



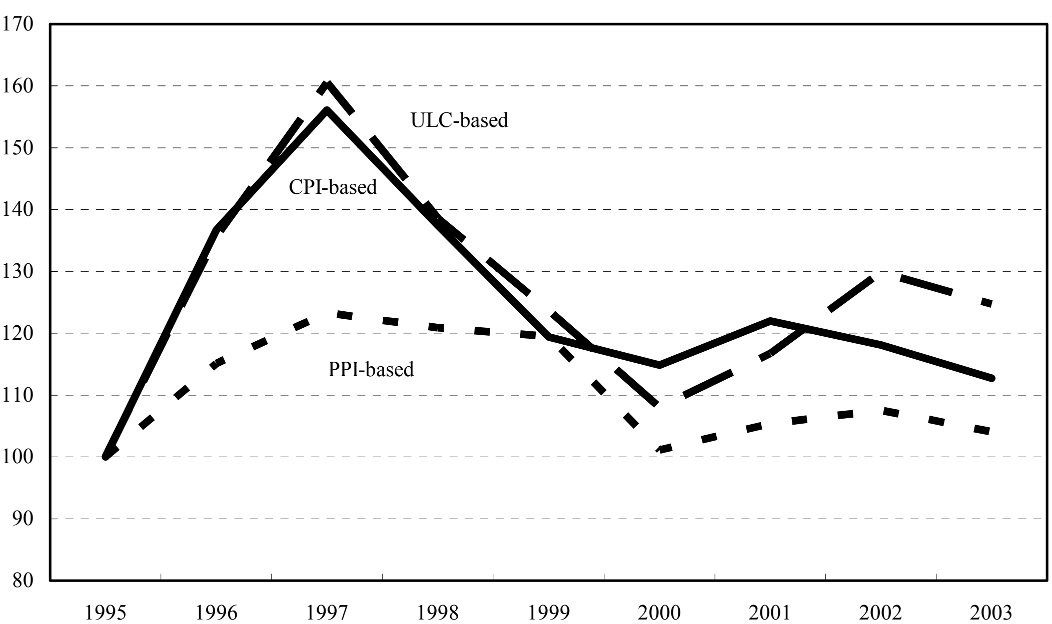
Sources: Ukrainian authorities; and Fund staff estimates.

Figure 6. Ukraine: Exchange Rates

Bilateral Exchange Rates, January 1998-August 2004



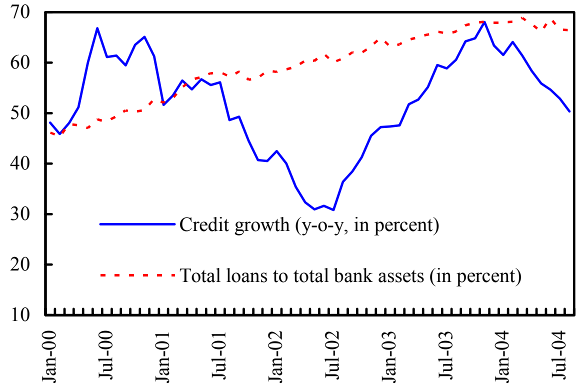
Real Effective Exchange Rate Indices, 1995-2004
(1995=100)



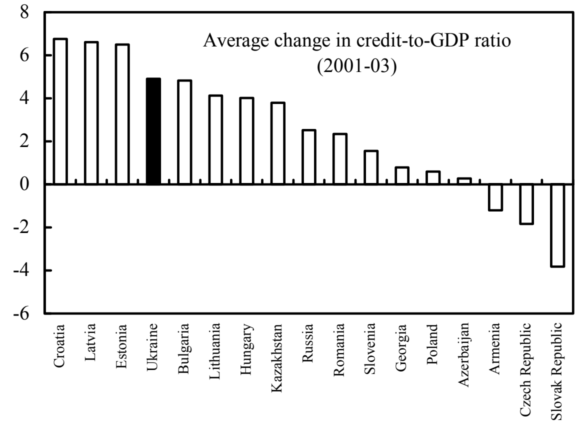
Sources: National Bank of Ukraine; and Fund staff estimates.

Figure 7. Ukraine: Banking Sector Indicators, 2000-04

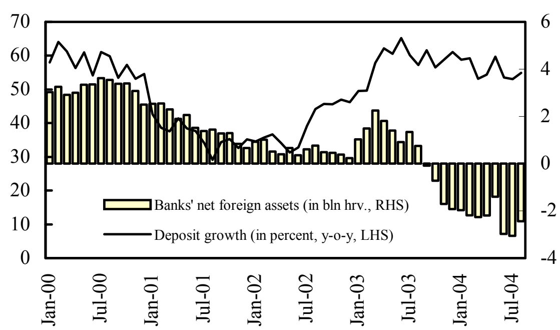
Rapid credit growth has recently decelerated somewhat ...



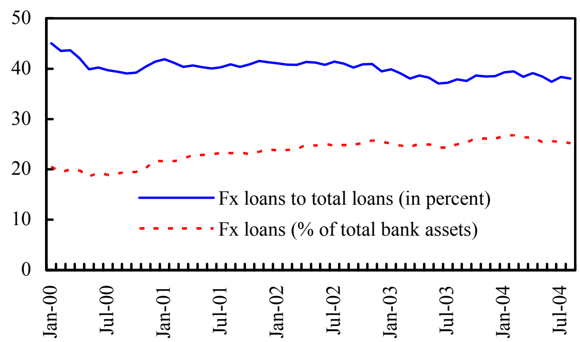
... but has been among the highest in the region.



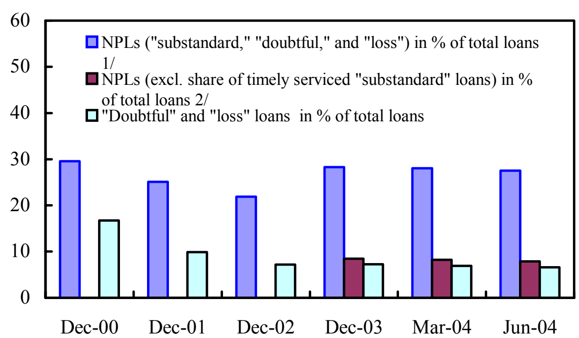
The credit boom was funded mainly by deposits, but increasingly also by foreign borrowing.



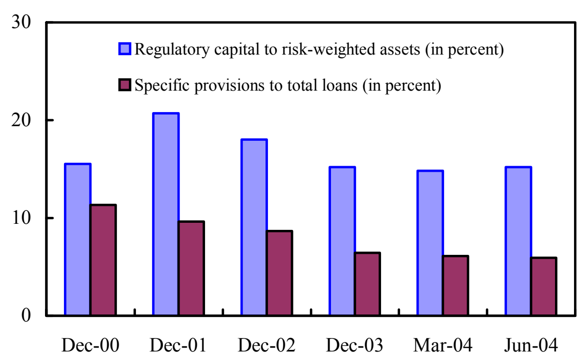
Indirect exchange rate risks results from the large share of foreign currency-denominated loans.



Credit quality needs to be monitored...



… in particular in light of concerns about capital adequacy and provisioning.



Sources: Ukrainian authorities; and Fund staff estimates.

1/ The increase in nonperforming loans in 2003 is largely due to a change in loan classification rules.

2/ The NBU estimates that about 94 percent of "substandard" loans are serviced in a timely fashion.

12. **The energy sector quasi-fiscal deficit has narrowed.** Improved payments discipline and a buoyant economy have helped strengthen cash-collection ratios in both the electricity and gas sectors. In stark contrast to previous years, this has allowed both sectors not only to remain current on their tax obligations, but also to lower their tax arrears.[4]

13. **The authorities felt they had benefited from Fund's advice.** While in the case of Ukraine, it is difficult to assess the effectiveness of Fund's surveillance *per se*, given the existence of Fund-supported programs, the authorities indicated that Fund recommendations had helped them focus and coordinate their macroeconomic policy, particularly in areas such as tax reform and banking prudential regulation and supervision. Moreover, even when the authorities and staff have disagreed, dialogue with the Fund has fostered internal debate. It is, however, the case that key policy commitments under successive Fund-supported programs have not been followed through.

II. Policy Discussions

14. **The focus of the discussions was threefold:**

- **The sustainability of the current positive economic outlook.** The most noticeable development this year is the impressive growth performance. While this is a welcome development, can growth be sustained at the same pace? Also, are the expansionary fiscal stance, sizable foreign exchange inflows, strong credit growth, and the authorities' reluctance to allow for greater exchange rate flexibility likely to exacerbate inflationary pressures in an economy already showing signs of overheating, at least in some sectors?

- **The risks that this expansion may generate.** Ukraine is particularly susceptible to external shocks given its dependence on international trade. Moreover, the strong growth of the last two years has occurred amid the rapid expansion of banks' loan portfolios. Can banks then easily cope with a sudden stop in economic growth triggered by an external shock?

- **How to respond to the outlook and the risks.** The immediate challenge for the authorities is to manage their recent success carefully and ensure that this benefits an increasing share of the population. In the current circumstances, the authorities may be tempted to relax macroeconomic policy or set it on the basis of overoptimistic assumptions, while weakening their resolve to pursue structural reforms, thus undermining growth prospects in the medium term.

[4] See the accompanying selected issues paper on "Energy Sector Quasi-Fiscal Deficit."

A. Short- and Medium-Term Macroeconomic Outlook

15. **The pace of economic growth in 2004 is unlikely to be sustained** (Table 8). Authorities and staff agreed that the impressive growth performance in 2004 reflected in part short-term external factors and rapid credit growth, with staff also emphasizing the competitive exchange rate. Staff projects growth at 6 percent in 2005, supported by domestic demand, and at around 5 percent in the outer years. The authorities felt these projections were too pessimistic: they saw growth at 8.6 percent in 2005 and averaging 6.5 percent over the medium term. While agreeing the risks were on the upside, in particular in 2005, staff noted that, given Ukraine's shrinking labor force, a 5 percent growth rate over the medium term will require an investment/GDP ratio higher than the current 20 percent level, and stronger factor productivity growth. This pointed to the need for deeper and faster structural reforms and better governance.

16. **A substantial current account surplus is projected for 2004, but Ukraine's development in the medium term will eventually require tapping foreign savings.** Authorities and staff agreed that exceptionally high oil and commodities prices, strong demand from Russia and China, and a competitive currency had resulted in an impressive current account surplus, which was projected at 10 percent of GDP in 2004.[5] Staff noted that, over the medium term, sustained investment growth was required to upgrade Ukraine's productive capacity, absorbing an increasing share of domestic savings. Also, further expansion in the still undersized financial sector might help finance higher consumption at a time when rising incomes might raise the propensity to import. Authorities and staff agreed that EU enlargement will likely have a negligible impact, given Ukraine's export mix, assuming the EU steel quota is adjusted quickly.[6]

17. **Inflationary pressures are on the rise** (Figure 8). Staff noted that inflation had edged up and there were signs that some sectors of the economy were overheating.[7] Cost pressures were increasing with strong wage growth and the PPI/CPI differential was at historical peak; an

---

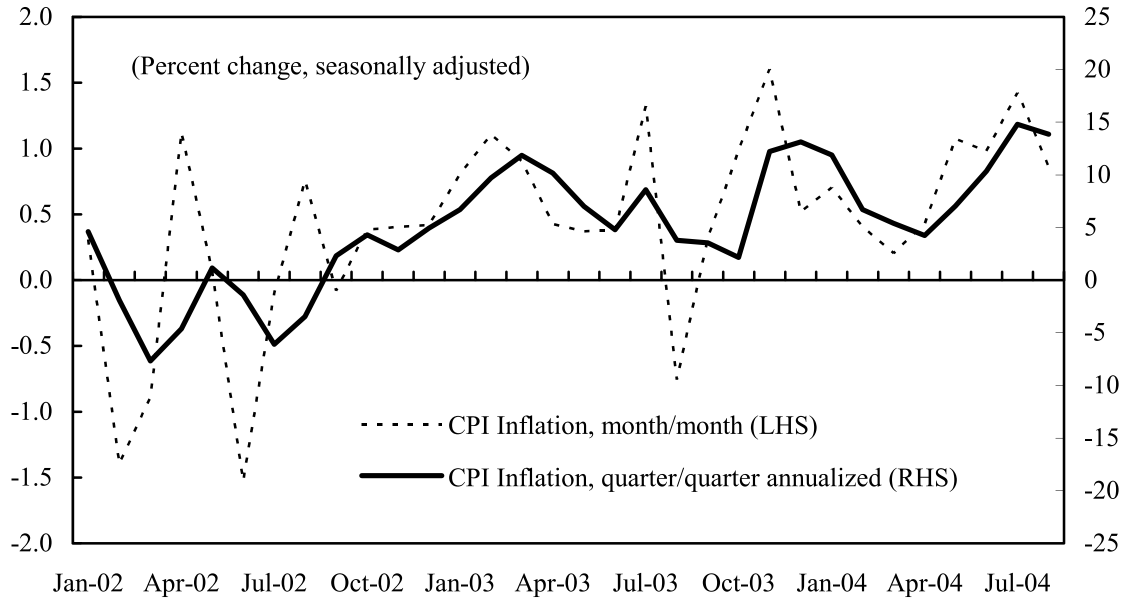
[5] The current account surplus is likely overstated in light of the large negative errors and omissions. See the selected issues paper on "The Impact of Oil Prices on Ukraine's External Balance."

[6] See the selected issues paper on "The EU Enlargement: The Impact on Trade with Ukraine."

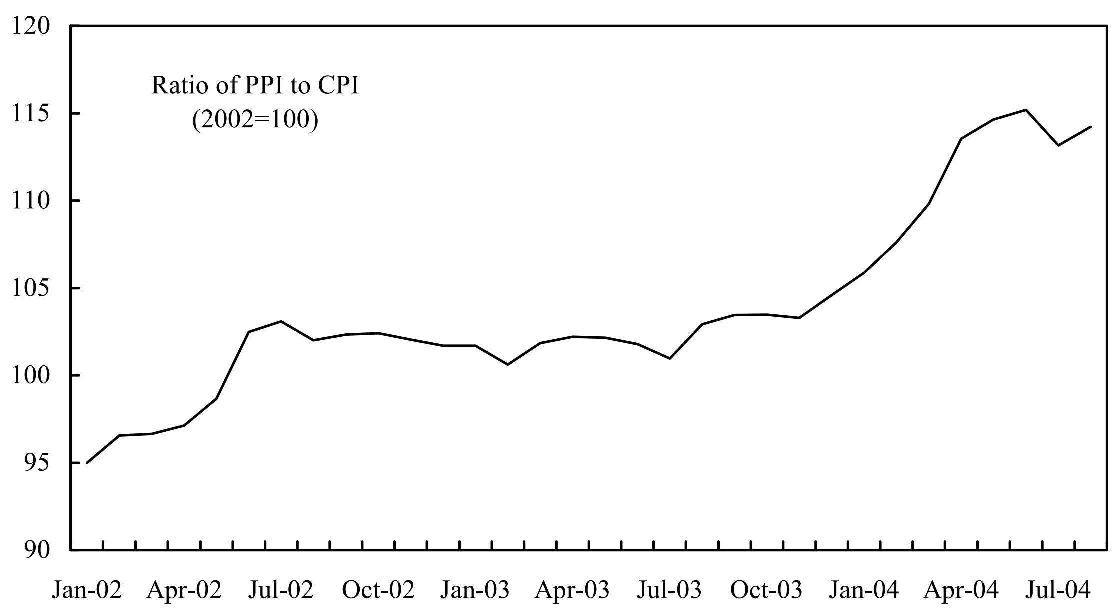
[7] While estimating the output gap is difficult in Ukraine, given the short time span since the beginning of transition, recent developments suggest the economy is now operating close to its potential in some sectors. New mortgage lending and high demand for housing have stretched the supply of construction materials, significantly raising their price. Similarly, in the fast-growing metallurgical sector (the largest export sector), supplies of key inputs are running low. In such circumstances, it is likely that any additional increase in aggregate demand will be mainly inflationary.

Figure 8. Ukraine: CPI and PPI Inflation, 2002-04

Inflationary pressures are emerging...



...and an increasing PPI threatens to spill over onto CPI inflation.



Sources: State Statistics Committee; and Fund staff estimates.

indication that CPI inflation may rise further, owing to spill-over effects. While noting that it would be reasonable to accommodate into domestic inflation the first round impact of higher global commodities prices, staff stressed the risk that inflation could reach 9-10 percent this year and rise further in 2005, depending on the implementation of the amended budget and the steps that the NBU adopts to counter the fiscal impulse and large foreign exchange inflows. The authorities did not share staff's views. In particular, they saw the risk of overheating as somewhat remote and, hence, did not perceive the need to tighten macroeconomic policies as urgent, while remaining committed to single-digit inflation for this year and the medium term. Over the medium term, staff noted that, while the authorities' policies were still to be spelled out in detail, a realignment of the real exchange rate will likely occur through higher inflation in light of the authorities' reluctance to allow nominal appreciation.

B. Risks

18. **Ukraine remains vulnerable to a sudden reversal in external conditions** (Table 8). Exports account for around 60 percent of GDP, and their buoyant performance over the past couple of years has supported the recovery in domestic demand. Given the surge in private sector debt, a significant drop in external demand could prompt substantial banking losses via the private sector's diminished capacity to repay its domestic debts. This vulnerability also underscores the need to bring the fiscal deficit down from the level projected for 2004 (3-4 percent of GDP) to prevent a sudden shock from raising it to levels that could make financing problematic. Around a baseline involving a significant fiscal adjustment, broadly in line with the authorities' announced targets, and real exchange rate appreciation, public debt dynamics look resilient to various types of shocks (see Appendix V). But given the high uncertainty of growth trends, staff cautioned the authorities against basing financial policies, including the 2005 budget, on optimistic assumptions. The sustainability of private sector external debt also raised some concerns. Net private debt stood at about one-fifth of GDP at end-2003 but external private sector assets may be underreported. Moreover, the large share of short-term debt (70 percent) makes it susceptible to rollover risk.[8] In light of these risks, staff encouraged the authorities to build buffers against contingent liabilities that could emerge should economic conditions reverse. These buffers will also help provide the necessary resources to sustain the medium-term reform effort (see below).

[8] See the accompanying selected issues paper on "Assessing Ukraine's Vulnerabilities from a Balance Sheet Perspective."

C. Fiscal Policy and Reform

19. **Reacting to stronger-than-expected growth and privatization proceeds, the authorities in June relaxed the fiscal stance for 2004, but envisaged a tightening for 2005**. The June budget amendment raised the 2004 deficit target by *at least* 1 percent of GDP. The target, however, is still undetermined, since the authorities intend to return to the parliamentary budget committee in September for permission to channel privatization receipts exceeding the June projection into additional spending. However, while not committing to a target, the authorities expected the deficit not to exceed 3 percent of GDP, partly reflecting technical constraints in capital spending. Staff noted that, even assuming that (i) not all excess privatization proceeds were spent, (ii) not all VAT refund arrears were repaid, and (iii) not all capital spending was implemented because of technical constraints, the deficit could still reach about 3½ percent of GDP. Be that as it may, the authorities did not regard the 2004 relaxation as problematic. *First*, the extra 2004 spending was fully financed by privatization proceeds. *Second*, the spending was well targeted toward pressing social and infrastructure needs. *Third*, its inflationary impact should not be large (in light of the good harvest) and would be continuously monitored by the NBU. Most important, they regarded the 2004 fiscal expansion as temporary: indeed, in June parliament approved a 2005 budget resolution, that provided for a central government deficit ceiling of 1 percent of GDP, consistent with a consolidated budget deficit of about 1.6 percent of GDP. However, in mid-September the authorities submitted to parliament a 2005 budget that aims at a somewhat larger budget deficit. The government has also more recently increased significantly pensions, thus making it difficult to achieve the 2005 deficit target. Staff will prepare a supplement with an assessment of the 2005 budget, the fiscal impact of the pension increase, and, more generally, the risks to the attainment of the fiscal targets.

Ukraine: Fiscal Policy (Consolidated Government), 2003-05
(In percent of GDP)

	2003	2004	2004			2005
	Est.	Prog.	H1 (est.)	H2 (proj.)	Year (proj.)	Proj.
Revenues	37.0	37.3	16.0	19.5	35.5	33.7
Expenditures	37.7	39.0	16.1	22.8	38.9	35.3
Overall balance	-0.7	-1.8	-0.1	-3.3	-3.4	-1.6
Financing	0.7	1.8	0.1	3.3	3.4	1.6
External	0.8	0.4	0.4	1.3	1.7	0.4
Domestic	-1.2	0.5	-2.1	1.2	-0.9	0.0
Privatization	1.1	0.8	1.7	0.9	2.6	1.2

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

20. **The proposed fiscal loosening in 2004, even if limited to 3 percent of GDP, is inappropriate for several reasons.** *First*, it would increase the deficit despite a booming economy. Given the uncertainty of where the economy stands vis-à-vis its potential, fiscal prudence dictates that additional resources this year be saved to allow for a future countercyclical fiscal policy. *Second*, additional fiscal expansion exacerbates already existing inflationary pressures. *Third*, since only 20 percent of the extra spending could clearly be identified as one-off—about one-third appears recurrent while the remainder could be either—this year's fiscal loosening could undermine the fiscal target for 2005 and beyond, contributing eventually to higher borrowing costs.

21. **Against this backdrop, the authorities should save the additional resources stemming from higher growth and privatization proceeds, or, at least, confirm the original program fiscal stance in 2004—a deficit of 1.8 percent of GDP**. With nominal revenues boosted by growth, the original target would allow new spending of about HRV 3.6 billion (1.1 percent of GDP) during the second half of the year. While this would be less than the HRV 8 billion (or 2.4 percent of GDP) envisaged under the amended budget, it would cover the approved wage increase (along with some additional social and capital spending), provide full repayment of VAT refund arrears, and allow for a significant accumulation of deposits at the NBU. Under this scenario, excess privatization proceeds would not be spent.

22. **For 2005, staff viewed the target set in the budget resolution as reasonable**. However, reaching that target, while implementing the amended 2004 budget and reducing the VAT rate from 20 percent to 17 percent, as the authorities intended, requires substantial spending cuts, in contrast with the spending increases envisioned in the budget resolution. The authorities acknowledged the problem, but were not in a position to discuss the budget in detail. In this context, staff encouraged the authorities to use prudent growth assumptions in setting up the budget framework and to resist calls for additional spending throughout parliamentary discussions.

23. **Over the medium term the authorities will need to implement far-reaching structural fiscal reforms.** The authorities estimate that about 3½ percent of GDP in additional annual resources may be necessary to address obsolete and depreciated public infrastructure. Civil service reform is a priority—pay levels are low compared to the private sector (in part because public employment is very high by regional standards). Pension reform will likely be needed to prevent a decline in the income replacement rate for pensioners (the present level of 35 percent leaves pensioners no more subject to poverty than the population at large, but the replacement rate would fall to less than 30 percent by 2040). Social spending remains inadequate and poorly targeted, with widespread informal fees presenting a barrier to education and health care access. Staff estimated that spending initiatives to address these problems—if not matched by equivalent measures—could result in some 8-9 percent of GDP a year in additional spending.[9] This was another reason to avoid unnecessary spending outbursts in the near future, and a clear indication that reforms would need to proceed slowly, as measures were put into place.

24. **The high cost of structural reforms underscores the importance of generating adequate revenues**. The authorities and staff agreed on the need for an extensive base-broadening effort if taxes were to be cut—the authorities are planning to reduce the VAT rate by 5 percentage points by 2006 and might also consider cutting payroll taxes, which remain high. To help cover costs, which could amount to 2-3 percent of GDP annually, staff stressed

---

[9] See accompanying selected issues paper on the "Medium-Term Fiscal Priorities."

that there was scope to eliminate more VAT exemptions (totaling about 1 percent of GDP even after the envisioned reductions). In this context, staff noted the authorities' revised VAT regime for agriculture (which reduces the rate and eliminates refunding) but saw a need to eliminate the continued ability of producers to retain the VAT collected for their own use. There was also much scope to improve tax administration, where a combination of poor management practices (including a badly targeted audit program) and serious internal control problems have combined to undermine tax compliance and the overall business climate. In this regard, staff regretted the lack of progress in VAT collection and refunding. The authorities stressed that the scope for submitting fraudulent refund claims was large, and that a fully-fledged review of these claims was under way. Staff saw much value in the authorities' reform strategy, especially the move to a better-targeted audit, but expressed concern about allowing in-kind payment of tax debts, the potential fragmentation of tax administration responsibilities, the absence of measures to address registration and internal audit shortcomings, and the potential for neglecting VAT refund obligations in order to meet cash revenue targets. The authorities expect to put the bulk of the new VAT measures into place in the autumn, once parliament reconvenes.

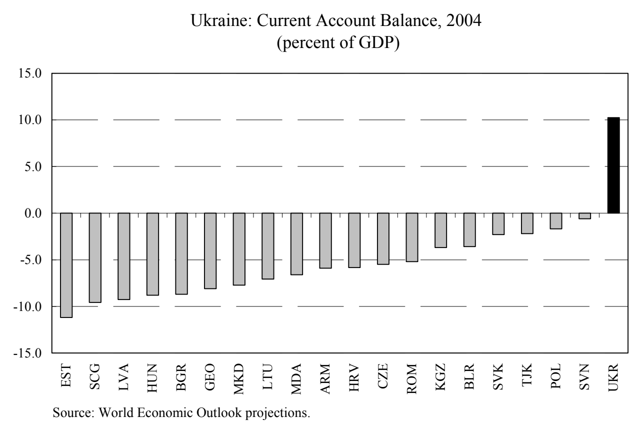
25. **Careful budget management will also be needed to provide resources for further fiscal structural reforms**. Staff saw room to accommodate some one-off investment costs without undermining debt sustainability. However, project appraisal, selection, and execution should first be improved. To generate resources for recurrent costs, the authorities and staff agreed on the need to fully develop and use the medium-term expenditure framework to assist in reprioritizing spending. Staff also emphasized that civil service pay increases should be matched to employment reductions, that parametric changes in the pension fund (including a higher retirement age) should be used to support higher pensions, and that industrial and agricultural subsidies were key areas in which to look for cuts. Better management of state enterprises was also needed. While there had been progress in reducing the quasi-fiscal deficit of the energy sector, staff noted that the almost 4,000 state enterprises should be subjected to better monitoring and control, and encouraged the authorities to further develop and extend to all public enterprises their new reporting templates.

D. Exchange Rate and Monetary Policy

26. **Staff argued that the real exchange rate was substantially undervalued as highlighted by wage and price levels that were very low compared with those of other transition countries, and by the large current account surpluses** (Box 1). Staff concurred with the NBU that the surpluses had resulted in a helpful strengthening of international reserves, but noted that further sharp increases in official international reserves were no

Box 1. Competitiveness

Various indicators suggest Ukraine's exchange rate is significantly undervalued. First, Ukraine's current account has shown in the last few years persistently high surpluses. In 2004 the surplus stands alone relative to other (non-energy-producing) transition economies. Second, as discussed in the text, signs of overheating in the export sectors have emerged. Third, average wages remain less than half the wages in Russia. A more formal analysis of wage levels is detailed in the Selected Issues Paper on "Competitiveness, Convergence, and the Equilibrium Real Exchange Rate".



The estimates in this paper are based on a large cross-country panel-data model, using data from 1990-2000 across 85 countries. The results suggest that the equilibrium real exchange rate (RER) is less than half that of many other transition countries, reflecting Ukraine's economy's lower capital stock and level of development. However, even considering this lower equilibrium, Ukraine's RER was undervalued by about two-thirds in 2002 (the appreciation since then has been modest; see Figure 6). The results are similar to those of an earlier study, which found that Ukraine's RER was only 28-33 percent of its equilibrium value in 1995.[1/] Further, the estimated degree of undervaluation for Ukraine is comparable with a PPP-based estimate of the equilibrium RER, which suggests that the exchange rate may be undervalued by as much as 80 percent.

Given possible problems associated with cross-country heterogeneity, such results should be treated cautiously, and they say little about the *pace* of adjustment to equilibrium. However, they do suggest that Ukraine will likely experience sustained upward pressure on its real exchange rate over the medium term.

1/ Krajnyák, Kornélia and Jeromin Zettlemeyer, 1998, "Competitiveness in Transition Countries," in *IMF Staff Papers,* Vol.45, pp.309-362.

longer necessary.[10] More generally, surpluses of this size were not desirable over the medium term. The exchange rate misalignment had thus brought about a distorted saving-investment balance: Ukraine was, in effect, using a large portion of the economy's export proceeds to finance investment and consumption abroad, rather than at home—a somewhat puzzling result, given the domestic economy's low living standards, pressing private investment

[10] The ratio of gross reserves to short-term debt (by residual maturity) and broad money is 2.5 and 0.6, respectively. Import coverage is 3½ months.

needs, and high rate of return on capital. Finally, while exports had been key to support growth, the economy was now growing at an unsustainable pace. While conceding that the exchange rate was competitive, the NBU took the view that the undervaluation was more modest than that estimated by staff, and had already allowed the currency to appreciate by 0.4 percent vis-à-vis the U.S. dollar since the beginning of the year.

27. **Against this background, staff argued that a shift towards a more flexible exchange rate would be helpful both in controlling inflation and in reducing risks to the financial sector**. The current exchange rate regime has served the authorities well in stabilizing the economy in the aftermath of the 1998 crisis. But, keeping the exchange rate vis-à-vis the U.S. dollar at a level that staff regards as substantially undervalued exacerbates the NBU's challenge to meet its inflation objective, a task already made difficult by strong credit growth and a looser fiscal policy. In addition, the peg provided an implicit exchange rate guarantee, with attendant risks for the stability of the financial sector and the balance sheet of the private sector as a whole. The first-best policy response was then to switch to a more flexible exchange rate regime in the run-up to an inflation-targeting framework, allowing the exchange rate to appreciate faster. The authorities were not convinced and intended to continue to allow for only extremely gradual appreciation of the hryvnia. They argued that greater flexibility would create adverse expectations and instability in the market. Moreover, the NBU expressed concern about the potential temporary nature of current account receipts, and the adequacy of the current stock of international reserves. It agreed that a flexible exchange rate arrangement, in the context of inflation targeting, would eventually be appropriate. But, on balance, it argued that greater exchange rate flexibility was premature until domestic demand had become a more reliable source of growth, inflation forecasting had improved, structural reforms had deepened, and foreign direct investments increased. In the meantime, MFD will provide technical assistance on inflation targeting as requested by the NBU.

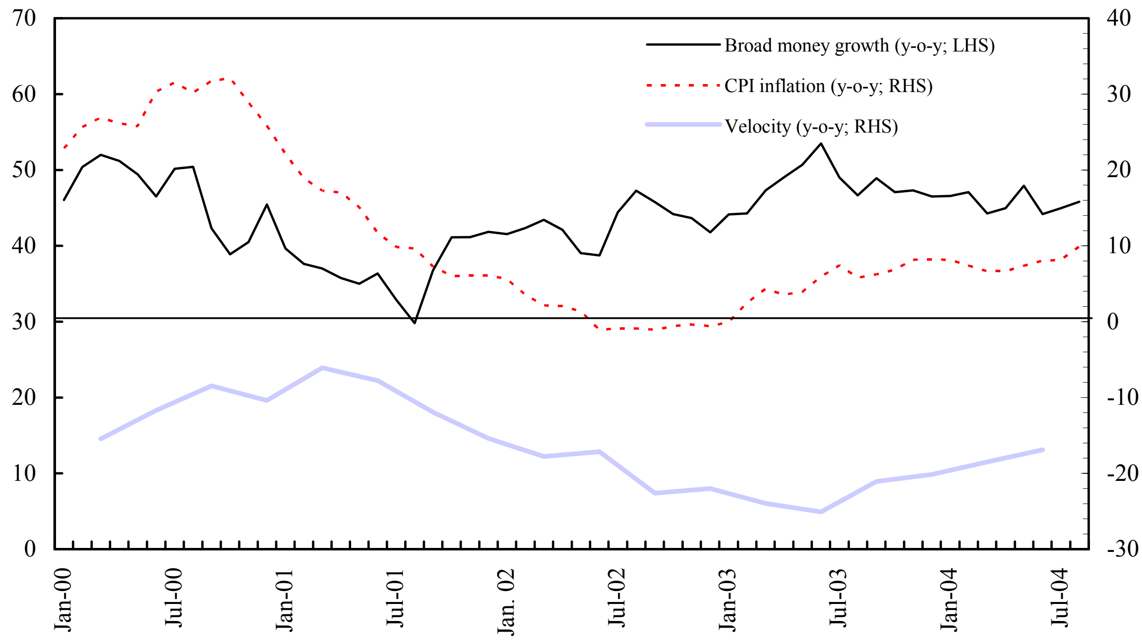
28. **Staff noted that containing inflation, while maintaining the peg to the U.S. dollar, would be difficult and would require tighter monetary policy, including higher interest rates, in a context of still-restricted capital flows** (Figure 9).[11] Staff welcomed the NBU's recent sterilization operations but noted these had not prevented a large increase in base money, which had pushed real interest rates down. The NBU was concerned about the inflationary consequences of the current fiscal stance. It indicated that it would embark on more extensive sterilization operations and allow interest rates to rise, as necessary, to avoid

---

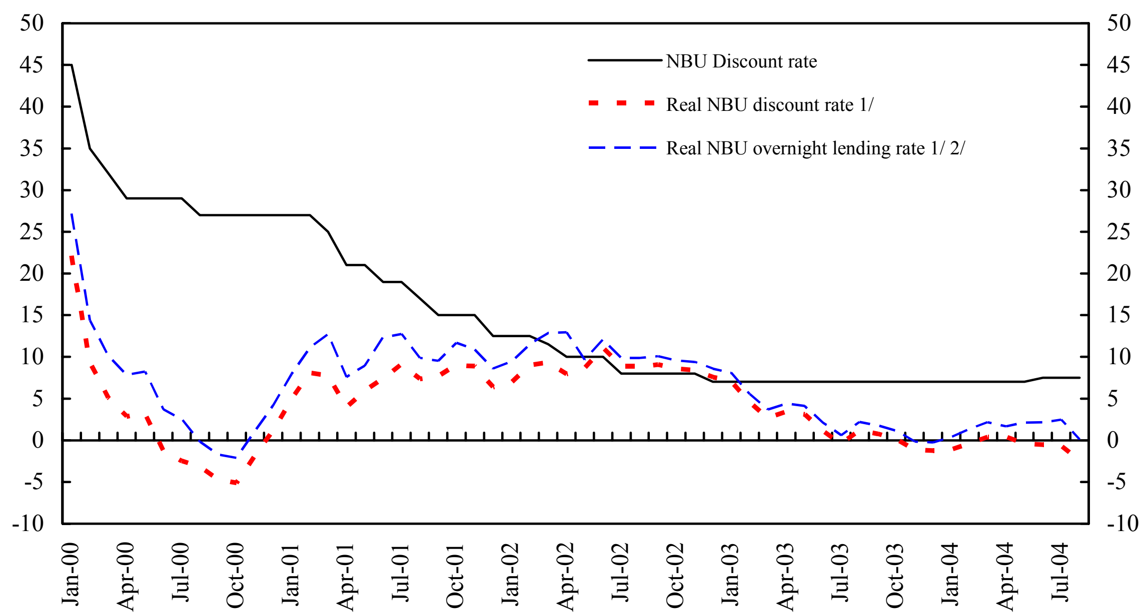
[11] There are restrictions on all capital account transactions, mainly taking the form of licensing and registering requirements.

Figure 9. Ukraine: Monetary Transmission Mechanism, 2000-04

With money demand slowing down in light of reemerging inflationary pressures ...



... tighter NBU interest rate policy is needed in light of low and falling real NBU policy rates.



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

1/ Deflated by CPI inflation.
2/ Until April 2001, Lombard rate. Until March 2004, NBU overnight lending rate. Since April 2004, NBU overnight lending rate against collateral.

double-digit inflation. Effective October 1, minimum reserve requirements will be unified and effectively raised by about 1 percentage point. Staff encouraged the use of money market instruments to tighten monetary conditions and assist in the development of the domestic capital market.[12] Staff emphasized also the need for the NBU (and its management) to establish its independence and improve the transparency of its monetary policy framework and operations—such as clarity of objectives, use of instruments, and communications to the public about policy actions.

E. Financial Sector Soundness and Reform

29. **Credit risk remains the main risk for the banking sector, despite a recent deceleration in credit growth**. Staff noted concerns about credit quality in light of weaknesses in banks' risk assessment practices and the widespread practice of related-party lending. The continuing difficulty in identifying the banks' ultimate owners has exacerbated these weaknesses. Also, weak accounting and reporting standards for corporations have inhibited the ability to identify risks, while institutional weaknesses have made the seizure of collateral and enforcement of contracts more difficult. The NBU agreed with the staff's assessment but stressed that recent improvements had reduced vulnerabilities. Although the NBU also viewed credit as the major risk, it considered credit quality as less of a concern than staff did when measuring nonperforming loans as only those not serviced in a timely fashion. Moreover, it pointed to the deceleration in credit growth, the slight strengthening of the capital adequacy ratio (CAR), and its various regulatory and supervisory responses. Staff encouraged the NBU to maintain its tight loan classification rules and the related provisioning requirements until institutional weaknesses are overcome.

30. **Recognizing these risks, the NBU has stepped up prudential regulations and supervision.** Since the beginning of the year, the NBU raised the minimum CAR, tightened related-party lending rules, strengthened the definition of capital, set interest rate ceilings for banks borrowing abroad, introduced a real-time monitoring system for interbank activities, and put in place a new risk assessment methodology for its supervisors. The setting up of a credit bureau, with the support of the World Bank, is under way. Staff commended the NBU for these developments, but regretted that the amendments to the Banking Act that would require identification of banks owners and further tighten related-party lending had not been approved by parliament, as called for under the program. Staff also raised concerns about possible conflicts of interest in enforcing banking supervision. Staff recommended raising the minimum CAR to 12 percent, upgrading risk management systems and practices for foreign currency-denominated lending, tightening provisioning requirements for unhedged foreign currency loans, and adopting tighter accounting and reporting standards for corporations. The NBU reiterated its commitment to ensure the stability of the banking system but did not see higher minimum CAR or provisioning as necessary now given the

---

[12] See the accompanying selected issues paper on "Capital Markets in Ukraine."

number of resolutions it had recently adopted to ensure banks' capital and its quality. MFD will provide technical assistance on banking supervision as requested by the authorities.

F. Improving the Business Climate

31. **The business climate should be enhanced to sustain growth in the medium term**. The authorities should proceed by reducing the share of the public sector in the provision of goods and services, facilitating private sector activities, and improving governance.

- **Privatization procedures must be in line with best international practices**. Staff noted that recent privatizations to well-connected members of the establishment, in which proceeds have totaled more than $1 billion, were not conducive to greater foreign investment.

- **Staff regretted that the authorities had not seized the current economic situation to proceed more vigorously with other important measures to improve the business climate**. The authorities should reduce further the burden of licensing and inspection regimes at all levels to improve transparency in the use of public resources while eliminating the scope for corrupt practices, and to strengthen the judiciary and contract enforcement. Ukraine ranked 106th out of 132 countries in Transparency International's corruption perception index in 2003. Also urgent is the parliamentary approval of the joint-stock company law, which strengthens the rights of minority shareholders and upholds higher reporting standards. Staff encouraged the authorities to address the outstanding requirements for gaining EU market economy status. The authorities are confident they will soon demonstrate compliance with all EU requirements. Staff also encouraged further progress on those energy sector reforms agreed with the World Bank (Table 9).

G. Trade Policy

32. **While Ukraine has been liberalizing its trade system, it is unlikely that World Trade Organization (WTO) negotiations can be concluded this year**. Following successive reductions in recent years, Ukraine's average effective tariff stands at about 7 percent, lower than in other transition economies. However, nontariff barriers are similar on average to other transition economies and somewhat more restrictive than in EU-accession countries. Indeed, agricultural quotas are one of the main outstanding issues in the negotiations for Ukraine's WTO membership. Other areas where legislative action is needed include the tax treatment of domestic versus foreign producers; export duties; market access in banking, insurance, and audiovisual services; and intellectual property rights. Staff encouraged the authorities to address urgently the main outstanding issues in the WTO negotiations. It noted that the single economic space (with Russia, Belarus, and Kazakhstan) could also impact the negotiations with both the WTO and the EU.

H. Statistics

33. **The quality and timeliness of statistics and data provision to the Fund are broadly adequate, though further improvements are needed.** A key challenge for the authorities will be the development of a formal "core" inflation index. Another priority is the provision of consistent historical time-series measures of real GDP, and the publication of seasonally adjusted data. Enhanced progress in estimating the informal economy would also provide a better basis for measuring GDP. Better accounting of external transactions for the balance of payments is also required.

I. Safeguards Assessment

34. **As mandated under Fund policies, the NBU was subject to a safeguards assessment**. The assessment completed on July 14, 2004 found that the NBU has in recent years strengthened its safeguards framework. However, further improvements could be made in financial reporting, and in its legal structure and independence. The main recommendations of the assessment included (i) an NBU Board's resolution to adopt International Financial Reporting Standards, (ii) a detailed review of the NBU Law, and other legislation affecting the NBU, aimed at strengthening its independence, and (iii) semi-annual audits, by the NBU's internal audit function, of the monetary data reported to the Fund. The NBU indicated that its Board had approved an action plan for implementing these recommendations and that a six-month audit of NIR and NDA had already been completed.

III. The Stand-By Arrangement

35. **The review could not be completed as originally scheduled because of slippages in program implementation.** Staff indicated to the authorities that the procyclical amended 2004 budget was inconsistent with policies agreed under the program. All end-June quantitative performance criteria, except that on VAT refund arrears, were met (Table 10). However, several actions in the fiscal and banking areas have not been completed as agreed under the program. Completion of the review will be pending until the government (i) provides concrete assurances that fiscal policy, including the 2005 budget, remains consistent with its undertakings under the program, and (ii) takes the actions required to observe the structural performance criteria and benchmarks.

IV. Staff Appraisal

36. **Recent macroeconomic developments have been striking.** Growth has been booming, the external current account surplus has reached record levels, and gross official international reserves are likely to rise by 75 percent this year. These developments owe much to prudent policies and structural reform over the last few years. They also reflect the favorable external environment, as well as specific domestic factors—the credit boom and an undervalued exchange rate. On a less positive note, inflation is creeping upward, hovering in the high single digits.

37. **These developments have implications for economic policies.** On the internal balance, the fast pace of growth is putting pressure on inflation, and there is evidence that bottlenecks are emerging. The fiscal expansion embedded in the amended budget will exacerbate inflationary pressures. The very large external imbalance poses considerable challenges to the achievement of the monetary authorities' inflation objectives and is not in itself desirable. Also, the fact that current activity is largely supported by exports is a reminder that the economy remains vulnerable to external shocks.

38. **To preserve the hard-won gains of the past few years, prudent macroeconomic and strong structural policies are required.** Accordingly, the authorities should resist succumbing to short-term pre-electoral policies, while setting their policies on the basis of realistic projections. Over the longer term, strong growth can be sustained only through macroeconomic stability, enhanced investment, technical development, human capital, and improved income distribution. It is at times of robust performance that it is easier to proceed with reforms.

39. **The procyclical loosening of fiscal policy in 2004 is inappropriate.** The current strength of the economy, the emerging inflationary pressures, and the need to support further structural reforms and to build buffers against future contingencies all speak in favor of saving this year's overperformance. Although the increase in the deficit is not debt creating, spending privatization receipts adds to demand and so contributes to inflationary pressures. Moreover, only a small portion of the additional spending can clearly be identified as one-off. Resources from the sale of public assets should be used to retire existing debt or invested to increase the economy's productive capacity. Sticking to the original program fiscal target would facilitate economic management through 2005; it will also help keep the 2005 budget in line with the already-approved budget resolution.

40. **Maintaining a prudent fiscal stance in 2005 and beyond remains crucial.** Fiscal discipline has served Ukraine well, contributing to strong macroeconomic fundamentals. In this regard, staff urges the authorities to tighten fiscal policy in 2005, as envisaged in July's budget resolution. While the low debt ratio provides the opportunity to finance the most urgent medium-term fiscal structural reforms without jeopardizing debt sustainability, the authorities should continue to maintain tight control over spending to ensure its effectiveness and to reduce tax loopholes and evasion.

41. **The authorities should progress steadfastly with key fiscal structural reforms.** The staff encourages the further development of a medium-term budget framework to help prioritize expenditure. Tax rate reductions will have to be balanced by tax base broadening, both by eliminating privileges and exemptions, and by improving tax administration. Staff welcomes the permanent elimination of some VAT tax exemptions and encourages bolder action. It regrets, however, the lack of sustained progress in administering the VAT and cautions the authorities against implementing rate reductions until performance improves. Resources for further structural reforms can be found by better managing state enterprises.

42. **While the existing monetary and exchange rate regime has served Ukraine well, particularly after the financial crisis, it is now time to allow for greater exchange rate flexibility**. At the prevailing exchange rate, a significant current account surplus will persist, and the real exchange rate is bound to appreciate. It would be preferable to achieve this through nominal appreciation rather than inflation. The authorities' attention to the level of international reserves is commended, but the staff notes the opportunity costs of further sizable increases in reserves.

43. **Meanwhile, since there are considerable upside inflation risks, staff urges the NBU to further tighten monetary policy**. The NBU's recent increases in reserve requirements and imposition of stricter lending terms are welcome. Absent greater flexibility in the exchange rate, staff recommends that the NBU step up its sterilization operations and raise its interest rates.

44. **Continued progress in strengthening prudential banking regulation and supervision, as well as the institutional environment, is needed to ensure the stability of the banking system**. Staff commends the authorities on the various actions taken to improve the monitoring of credit growth and of the adequacy of banks' risk management practices, as well as banks' capital. However, staff regrets that adoption of the draft amendments to the Banking Act, which would identify bank owners and tighten related-party lending, has not yet been approved by parliament. Staff urges the authorities to continue addressing the banking sector's vulnerabilities to shocks in view of the economy's large exposure to credit risk. In this regard, staff encourages the authorities to raise the minimum capital adequacy ratio to 12 percent, to contain risk from foreign currency loans, and adopt tighter accounting and reporting standards for corporations, which would facilitate banks' loan evaluations.

45. **A stronger role for the private sector is crucial to sustain growth over the medium term.** While privatization has accelerated, staff regrets that procedures remain nontransparent. It urges the authorities to ensure that future privatizations are in line with best international practices. Staff welcomes the recent reduction in the energy sector quasi-fiscal deficit and encourages passage of the energy debt restructuring law to enable further privatization in the electricity sector. In addition to the elimination of tax distortions and the strengthening of the banking and corporate sector, other steps to improve the business climate should include reducing further the burden of licensing and inspection regimes; strengthening the judiciary and contract enforcement; and passing the joint-stock company law.

46. **Governance should be strengthened.** Rent-seeking activities and lack of transparent procedures are widespread, from tax collection and public procurement to law enforcement and divestment of public assets. The authorities should address heads on these issues, which are deterring domestic and foreign investment, and hence, the prospect for strong and sustainable growth.

47. **Statistical data are broadly adequate for surveillance.** The quality and timeliness of data dissemination has improved with Ukraine's subscription to the Special Data

Dissemination Standard (SDSS) in 2003. However, a number of data weaknesses should be addressed, particularly in the national accounts and balance of payments.

48. Staff recommends that the next Article IV consultation with Ukraine be held in accordance with the July 15, 2002 decision on consultation cycles.

Table 1. Ukraine: Selected Economic Indicators, 1999–2005

	1999	2000	2001	2002	2003	2004		2005
					Est.	Prog. 1/	Proj.	Proj.
Output and employment								
Real GDP (annual change in percent)	-0.2	5.9	9.2	5.2	9.4	6.0	12.5	6.0
Nominal GDP (in billions of hryvnias)	130.4	170.1	204.2	225.8	264.2	292.0	328.5	379.5
Nominal GDP (in billions of U.S. dollars)	31.6	31.3	38.0	42.4	49.5	54.8	61.7	75.1
Unemployment rate (ILO definition)	11.9	11.7	11.8	10.1	9.1	...	...	...
Prices and wages (percent change)								
Consumer prices, period average	22.7	28.2	12.0	0.8	5.2	7.1	8.3	8.1
Consumer prices, end of period	19.2	25.8	6.1	-0.6	8.2	6.0	9.0	7.0
Producer prices, end of period	15.7	20.6	0.9	5.7	11.1	5.5	20.0	7.0
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	36.0	37.0	37.3	35.5	33.7
Expenditure (cash basis)	34.2	34.7	35.1	35.5	37.7	39.0	38.9	35.3
Cash balance 2/	-2.4	-1.3	-1.6	0.5	-0.7	-1.8	-3.4	-1.6
Primary balance (cash basis)	0.0	1.8	0.4	1.8	0.3	-0.4	-2.4	-0.6
Commitments balance 3/	-1.4	2.1	-1.5	0.2	0.1	-0.8	-3.0	-1.0
Privatization proceeds	0.6	1.3	1.3	0.5	1.1	0.8	2.6	1.2
Net domestic financing	1.5	0.3	-0.1	-0.3	-1.2	0.5	-0.9	0.0
Net external financing 2/	0.2	-0.3	0.4	-0.7	0.8	0.4	1.7	0.4
Public debt and arrears (in percent of GDP) 4/	66.7	47.0	38.6	35.7	30.3	27.7	27.1	21.6
o.w. external debt	39.5	33.1	26.6	24.0	21.9	19.5	19.2	15.7
Money and credit (end of period, percent change)								
Base money	39.2	40.1	37.4	33.6	30.1	16.3	45.0	19.7
Broad money	40.4	45.5	41.9	41.8	46.5	24.1	43.8	26.7
Credit to nongovernment	43.5	61.3	40.5	47.3	63.4	25.1	32.5	28.9
Velocity 5/	5.9	5.3	4.5	3.5	2.8	2.5	2.4	2.2
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	7.5	5.8	3.7	10.2	4.1
Gross reserves (end of period, in billions of U.S. dollars)	1.1	1.5	3.1	4.4	6.9	7.8	11.9	13.6
In months of next year's imports of goods and services	0.7	0.9	1.7	1.9	2.4	3.0	3.8	3.9
Debt service (in percent of exports of goods and services) 4/	15.8	10.4	8.7	5.7	6.3	6.4	4.8	5.2
Exports (annual change in percent)	-3.7	19.2	8.7	9.2	27.2	6.3	38.7	3.1
Imports (annual change in percent)	-20.5	15.4	13.0	6.3	33.7	8.4	25.0	10.8
Savings and investment (in percent of GDP)								
Foreign savings	-5.2	-4.7	-3.7	-7.5	-5.8	-3.7	-10.2	-4.1
Gross domestic savings	24.6	24.2	25.5	27.7	26.1	25.3	31.6	28.3
Nongovernment	25.0	23.3	24.0	24.1	22.6	24.5	30.7	26.4
Government	-0.4	0.9	1.5	3.6	3.5	0.7	0.9	1.9
Gross domestic investment	19.4	19.4	21.8	20.2	20.3	21.6	21.3	24.3
Nongovernment	17.4	17.3	18.7	17.1	16.1	19.2	17.1	20.8
Government	2.0	2.1	3.1	3.0	4.2	2.5	4.3	3.5
Exchange rate								
Hryvnia per U.S. dollar, end of period	5.2	5.4	5.3	5.3	5.3	…	...	...
Hryvnia per U.S. dollar, period average	4.1	5.4	5.4	5.3	5.3	…	...	...
Real effective exchange rate, (percent change) 6/	-16.3	-4.4	6.0	-4.1	-6.3	…	...	...

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 Balance of Payments, 2001-09
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003	2004		2005	2006	2007	2008	2009
			Prel.	Prog.	Revised	Projections				
Current account balance	1,402	3,173	2,891	2,052	6,327	3,045	1,628	174	-788	-1,948
Merchandise trade balance	198	710	-269	-816	2,932	713	-458	-1,617	-2,239	-3,066
Exports	17,091	18,669	23,739	25,212	32,932	33,953	36,330	39,236	42,924	47,088
Imports	-16,893	-17,959	-24,008	-26,028	-30,000	-33,240	-36,788	-40,853	-45,163	-50,154
Services (net)	415	1,147	1,557	1,597	1,680	1,576	1,355	1,116	839	518
Receipts 1/	3,995	4,682	5,214	5,276	5,830	6,017	6,240	6,490	6,750	7,020
Payments	-3,580	-3,535	-3,657	-3,679	-4,150	-4,441	-4,885	-5,374	-5,911	-6,502
Income (net)	-667	-606	-581	-629	-589	-644	-669	-725	-788	-800
Of which: Interest on public debt 2/	-529	-475	-496	-540	-490	-602	-597	-602	-639	-691
Current transfers (net)	1,456	1,922	2,184	1,900	2,304	1,400	1,400	1,400	1,400	1,400
Financial and capital account	122	-1,050	322	...	-733	-589	1,258	2,512	3,271	3,951
Direct investment and capital transfers (net)	772	713	1,394	1,200	1,517	1,446	1,709	2,113	2,555	3,140
Portfolio equity	-735	-1,957	-1,709	-1,266	-1,806	-684	-328	12	197	314
Bonds and medium and long-term loans (net)	-120	375	1,282	575	3,147	740	770	950	1,305	1,350
Private sector loans	241	610	976	440	1,830	510	620	710	855	1,040
Bonds and loans (official)	-361	-235	306	135	1,317	230	150	240	450	310
Disbursements	475	444	1,342	1,258	2,376	1,422	1,314	1,086	1,068	1,279
Repayments 1/ 2/	-836	-679	-1,036	-1,123	-1,059	-1,192	-1,164	-846	-618	-969
Other capital (net)	205	-181	-645	-509	-3,591	-2,091	-893	-562	-786	-853
Of which: Natural gas arrears (net) 3/	137	166	…	…	…	…	…	…	…	…
Errors and omissions	-231	-885	-953	-885	-382	-382	-382	-382	-382	-382
Overall balance	1,293	1,238	2,260	1,167	5,212	2,074	2,505	2,305	2,101	1,621
Gross official reserves (- is increase)	-1,606	-1,045	-2,045	-867	-4,912	-1,773	-2,090	-1,890	-1,781	-1,536
Net use of IMF resources	-79	-191	-215	-300	-300	-301	-415	-415	-320	-85
Purchases	375	…	…	…	…	…	…	…	…	…
Repurchases	-454	-191	-215	-300	-300	-301	-415	-415	-320	-85
Official arrears to bilateral creditors (+ is increase)	148	-335	-282							
Rescheduling 4/	244	333	282							
Memorandum items:										
Total public external debt 2/	10,118	10,194	10,841	10,676	11,858	11,787	11,523	11,347	11,477	11,702
Public external debt (in percent of GDP) 2/	26.6	24.0	21.9	19.5	19.2	15.7	12.6	10.9	10.0	9.4
Stock of external gas arrears 3/	1,714	1,880	…	…	…	…	…	…	…	…
Current account (in percent of GDP)	3.7	7.5	5.8	3.7	10.2	4.1	1.8	0.2	-0.7	-1.6
Excluding transfers	-0.1	3.0	1.4	0.3	6.5	2.2	0.2	-1.2	-1.9	-2.7
Debt service ratio (in percent of exports of goods and services) 2/ 4/										
Before rescheduling	8.7	5.7	…	…	…	…	…	…	…	…
After rescheduling	6.7	5.4	6.3	6.4	4.8	5.2	5.1	4.1	3.2	3.2
Of which: Interest payments	2.5	2.0	1.7	1.8	1.3	1.5	1.4	1.3	1.3	1.3
Gross international reserves (end of period)	3,089	4,417	6,939	7,806	11,851	13,624	15,714	17,604	19,385	20,921
In months of next year's imports of goods and services	1.7	1.9	2.4	3.0	3.8	3.9	4.1	4.1	4.1	4.0
Over next year's official debt service	2.3	2.5	3.8	3.9	5.7	6.3	8.4	11.2	11.1	17.3
Merchandise export values (percent change) 5/	8.7	9.2	27.2	6.3	38.7	3.1	7.0	8.0	9.4	9.7
Merchandise import values (percent change)	13.0	6.3	33.7	8.4	25.0	10.8	10.7	11.1	10.6	11.1
Merchandise export volume (percent change) 5/	7.0	7.0	14.1	4.2	16.5	7.3	8.4	8.9	8.8	8.6
Merchandise import volume (percent change)	12.7	5.8	30.3	6.3	15.7	8.9	9.5	9.4	9.3	9.2
Terms of trade (percent change)	1.3	1.6	8.6	0.0	13.0	-6.1	-2.6	-2.6	-0.7	-0.8
Program financing 6/	310	353	1,075	1,013	1,300	950	1,050	840	850	…

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 3. Ukraine: Indicators of Vulnerability, 2000-04
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003 Prel.	2004 Latest		Date
Financial indicators							
Public debt 1/	47.0	38.6	35.7	30.3	27.8		June
Broad money (percent change, 12-month basis)	45.5	41.9	41.8	46.5	45.8		August
Private sector credit (percent change, 12-month basis)	61.3	40.5	47.3	63.4	50.8		August
Share of non-performing loans in total loans (percent)	29.6	25.1	21.9	28.3	27.5	2/	June
Share of foreign currency loans in total lending (percent)	41.4	41.3	39.5	38.5	38.1		August
Share of foreign currency deposits in total deposits (percent)	38.5	32.9	32.6	32.2	30.7		August
Ratio of the stock of treasury bills to reserves	1.3	0.7	0.5	0.3	0.2		July
Ratio of broad money to reserves	3.9	2.8	2.8	2.6	1.9		August
Ratio of hryvnia broad money to reserves	3.0	2.3	2.2	2.0	1.5		August
Ratio of foreign currency deposits to reserves	0.9	0.5	0.5	0.5	0.4		August
3 month T-bill yield (percent)	21.8	15.3	13.5	5.5	..		August
External indicators							
Exports of merchandise (percent change in US$)	19.2	8.7	9.2	27.2	44.3		June
Imports of merchandise (percent change in US$)	15.4	13.0	6.3	33.7	31.2		June
Terms of trade (percent change, 12 month basis)	-8.2	1.3	1.6	8.6	...		December
Current account balance	4.7	3.7	7.5	5.8	15.8		June
Capital and financial account balance	-2.2	0.3	-2.7	0.7	-3.6		June
Public medium and long-term external debt	33.1	26.6	24.0	21.9	19.4		June
Ratio of public external debt to reserves	6.9	3.3	2.3	1.6	1.1		June
Public medium and long-term external debt service	6.5	4.8	3.2	3.7	3.4		June
Short term external debt 3/	5.9	5.1	3.9	6.4	6.7		June
Ratio of short-term external debt to reserves 3/	1.2	0.6	0.4	0.5	0.4		June
Short-term debt of the nonbank private sector	22.1	20.4	19.1	14.6	...		December
Gross reserves in months of imports	0.9	1.7	1.9	2.4	3.5		June
Exchange rate (Hrv/US$, period average)	5.4	5.4	5.3	5.3	5.3		July
Real effective exchange rate (percent change) 4/	-4.4	6.0	-4.1	-6.3	-4.4		June
Financial market indicators							
Stock market index (PFTS) 5/	55.5	42.7	57.3	85.4	130.8		August
Foreign currency debt rating 6/	Caa1	Caa1	B2	B1	B1		August
Spread on benchmark Eurobonds (basis points, end of period) 7/	2030	974	691	275	336		August

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. NPLs are those classified as substandard, doubtful, and loss. Excluding the timely serviced "substandard" loans reduces the ratio of NPLs to total loans to 7.9 percent at end-June 2004.
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 in August 2004, Standard & Poor's upgraded Ukraine's long term sovereign rating from B to B+, on par with ratings by Fitch and Moody's. Moody's raised its outlook from "stable" to "positive" in September 2004.
7/ Emerging Market Bond Index (EMBI+) for Ukraine. December average or latest month reported.

Table 4. Ukraine: Consolidated Government Finances, 2003-05

	2003		2004							2004 (Staff recommendation)				2005	
			Suppl. Budget	Program		Staff projection 2/		Staff recommendation		Jan-Mar Actual	Apr-Jun Est.	Jul-Sep Proj.	Oct-Dec Proj.	Projection	
	Consol.	Central	Central	Consol.	Central	Consol.	Central	Consol.	Central	Consol.	Consol.	Consol.	Consol.	Consol.	Central
	(in millions of hryvnias)														
Revenue and grants	97,656	55,077	64,684	108,828	61,934	116,715	64,951	114,611	63,084	24,794	27,488	28,320	34,009	127,844	68,308
Tax revenue	81,407	40,428	52,151	92,124	47,092	101,586	51,227	99,552	49,422	21,512	24,117	24,337	29,585	111,252	53,333
Taxes on income, profit	28,053	14,371	15,063	27,934	15,455	29,452	16,462	29,318	16,387	5,812	6,631	7,665	9,210	33,874	18,934
o/w: Personal Income Tax	13,521	0	752	12,959	657	13,562	755	13,500	752	2,812	3,071	3,493	4,124	15,598	869
o/w: Enterprise Profit Tax	13,237	13,087	12,607	13,099	12,933	13,863	13,706	13,800	13,643	2,583	3,076	3,360	4,781	15,945	15,763
Taxes on payroll	23,082	0	0	27,620	0	31,147	0	31,005	0	6,538	7,501	8,023	8,943	35,823	0
o/w: Pension Fund	22,828	0	0	27,173	0	31,398	0	31,255	0	6,546	7,600	8,117	8,992	36,112	0
Property taxes	2,032	0	0	2,503	0	2,396	0	2,385	0	520	540	653	672	2,756	0
Domestic taxes on goods and services	23,481	22,196	32,016	28,710	27,306	31,034	29,228	29,321	27,524	7,140	7,774	5,889	8,518	30,108	28,031
o/w: VAT	12,598	12,598	17,918	14,533	14,533	16,145	16,145	14,500	14,500	3,968	4,158	2,267	4,108	12,984	12,984
Taxes on international trade	3,795	3,795	4,889	4,261	4,261	5,409	5,409	5,385	5,385	1,033	1,182	1,535	1,634	6,221	6,221
Other taxes	964	67	184	1,095	70	2,148	127	2,138	127	469	489	572	607	2,470	147
Nontax, capital revenue, and grants 3/	16,250	14,649	12,532	16,704	14,842	15,129	13,724	15,060	13,661	3,282	3,371	3,983	4,424	16,591	14,975
o/w: NBU profit transfers	591	591	1,209	500	500	1,209	1,209	1,209	1,209	154	157	788	110	588	588
Expenditure 4/	99,563	56,120	72,624	113,979	66,485	127,897	75,307	120,380	67,505	23,920	28,720	32,468	35,272	133,905	72,625
General public services	6,000	5,280	4,802	…	4,602	…	…	…	…	…	…	…	…	…	…
Defense	5,130	5,280	6,359	…	5,659	…	…	…	…	…	…	…	…	…	…
Public order and safety affairs	5,358	5,705	7,360	…	6,360	…	…	…	…	…	…	…	…	…	…
Education affairs and services	13,489	5,736	6,950	…	6,250	…	…	…	…	…	…	…	…	…	…
Health affairs and services	9,325	2,352	3,250	…	2,650	…	…	…	…	…	…	…	…	…	…
Social security and welfare affairs	40,317	6,816	13,530	…	12,630	…	…	…	…	…	…	…	…	…	…
o/w: Pension Fund	21,984	0	0	29,002	0	30,752	…	30,752	0	…	…	…	…	36,112	0
Housing and community services	1,822	83	764	…	564	…	…	…	…	…	…	…	…	…	…
Recreational, cultural, religious affairs	1,983	645	1,206	…	906	…	…	…	…	…	…	…	…	…	…
Energy, agriculture, and industry	9,054	7,234	13,404	…	11,504	…	…	…	…	…	…	…	…	…	…
Interest payments	2,644	2,582	3,232	4,046	3,926	3,351	3,232	3,351	3,232	687	837	821	1,006	3,807	3,644
Domestic interest payments	331	279	1,023	1,189	1,139	1,073	1,023	1,073	1,023	225	225	225	399	1,155	1,139
Foreign interest payments	2,313	2,303	2,209	2,857	2,787	2,278	2,209	2,278	2,209	463	613	596	607	2,652	2,505
Other	3,536	14,408	11,333	…	9,333			…	…	…	…	…	…	…	…
Statistical discrepancy	905	0		…	…			…	…	…	…	…	…	…	…
Overall cash balance	-1,907	-723	-7,940	-5,151	-4,551	-11,182	-10,356	-5,768	-4,422	874	-1,232	-4,148	-1,262	-6,061	-4,316
Net accumulation of VAT refund arrears	-1,114	-1,114	-1,926	-1,828	-1,828	-250	-250	-1,828	-1,828	-808	1,980	-2,500	-500	-1,578	-1,578
Net accumulation of energy & utilities arrears	80	…	0	-300	0	-300	...	-300	0	-75	-75	-75	-75	0	0
Net social arrears accumulation	-300	…	...	-300	…	-300	...	-300	…	-267	-33	0	0	0	0
Other arrears (interest)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Noncash property income	521	521	521	521	521	521	521	521	521	521	0	0	0	521	521
Commitment balance	-51	913	-5,493	-2,202	-2,202	-9,811	-9,585	-2,819	-2,073	2,545	-3,104	-1,573	-687	-3,962	-2,217
Gap to be filled	0	0	0	0	0	0	0	0	0	0.0	0.0	0.0	0.0	0	0
Financing	1,907	723	7,940	5,151	4,551	11,182	10,356	5,768	4,422	-874	1,232	4,148	1,262	6,061	4,316
Net external	2,097	1,298	1,367	1,235	1,235	5,611	4,540	5,570	4,508	1,659	-208	4,573	-454	1,655	1,655
Disbursements	7,106	6,307	6,428	6,321	6,321	10,363	9,293	10,289	9,227	3,198	244	6,625	223	6,890	6,890
o/w: project loans	201	201	935	922	922	668	668	663	663	38	48	354	223	929	929
o/w: local gvt development budgets	800	0		0	...	1,070	0	1,063	...	0	0	1,063	0	0	0
Amortization 3/	-5,009	-5,009	-5,060	-5,086	-5,086	-4,753	-4,753	-4,719	-4,719	-1,539	-452	-2,051	-677	-5,234	-5,234
Net domestic	-3,091	-2,591	1,358	1,479	1,179	-2,929	-1,684	-8,302	-7,586	-3,721	-3,055	-2,000	475	-94	-1,339
Privatization	2,901	2,016	5,216	2,437	2,137	8,500	7,500	8,500	7,500	1,188	4,495	1,575	1,242	4,500	4,000
Memorandum items:															
End-period stock of refund arrears	1,828	...		0	…	1,578	…	0	…	1,020	3,000	500	0	0	0
End-period stock of social arrears	578	...		178	…	278	…	278	…	503	428	353	278	0	0
End-period stock of energy & utilities arrears	1,157	...		777	…	857	…	857	…	890	857	857	857	0	0
Primary balance	738	1,860	-4,708	-1,105	-625	-7,830	-7,124	-2,417	-1,190	1,561	-395	-3,327	-256	-2,255	-672
Earmarked revenue	38,706	12,214	13,805	45,873	15,377	52,955	14,760	52,713	14,693	10,846	12,435	14,664	14,768	60,086	16,157
Nonearmarked cash	58,950	42,863	50,879	62,955	46,557	63,760	50,191	61,898	48,391	13,948	15,053	13,656	19,241	67,758	52,152
Nonearmarked cash-state budget				...	...	...	...	...	...	9,880	11,271	10,569	16,671	...	...
Nominal GDP	264,165	264,165	327,100	292,000	292,000	328,500	328,500	327,000	327,000	327,000	327,000	327,000	327,000	379,549	379,549

Table 4 (cont.). Ukraine: Consolidated Government Finances, 2003-05

	2003		2004							2004 (Staff recommendation)				2005	
			Suppl. Budget	Program		Staff projection 2/		Staff recommendation		Jan-Mar Prog.	Apr-Jun Prog.	Jul-Aug Prog.	Sep-Dec Prog.	Projection	
	Consol.	Central	Central	Consol.	Central	Consol.	Central	Consol.	Central	Consol.	Consol.	Consol.	Consol.	Consol.	Central
	(in percent of GDP)														
Revenue and grants	37.0	20.8	19.8	37.3	21.2	35.5	19.8	35.0	19.3	7.6	8.4	8.7	10.4	33.7	18.0
Tax revenue	30.8	15.3	15.9	31.5	16.1	30.9	15.6	30.4	15.1	6.6	7.4	7.4	9.0	29.3	14.1
Taxes on income, profit	10.6	5.4	4.6	9.6	5.3	9.0	5.0	9.0	5.0	1.8	2.0	2.3	2.8	8.9	5.0
o/w: Personal Income Tax	5.1	0.0	0.2	4.4	0.2	4.1	0.2	4.1	0.2	0.9	0.9	1.1	1.3	4.1	0.2
o/w: Enterprise Profit Tax	5.0	5.0	3.9	4.5	4.4	4.2	4.2	4.2	4.2	0.8	0.9	1.0	1.5	4.2	4.2
Taxes on payroll	8.7	0.0	0.0	9.5	0.0	9.5	0.0	9.5	0.0	2.0	2.3	2.5	2.7	9.4	0.0
Property taxes	0.8	0.0	0.0	0.9	0.0	0.7	0.0	0.7	0.0	0.2	0.2	0.2	0.2	0.7	0.0
Domestic taxes on goods and services	8.9	8.4	9.8	9.8	9.4	9.4	8.9	9.0	8.4	2.2	2.4	1.8	2.6	7.9	7.4
o/w: VAT	4.8	4.8	5.5	5.0	5.0	4.9	4.9	4.4	4.4	1.2	1.3	0.7	1.3	3.4	3.4
Taxes on international trade	1.4	1.4	1.5	1.5	1.5	1.6	1.6	1.6	1.6	0.3	0.4	0.5	0.5	1.6	1.6
Other taxes	0.4	0.0	0.1	0.4	0.0	0.7	0.0	0.7	0.0	0.1	0.1	0.2	0.2	0.7	0.0
Nontax, capital revenue, and grants 3/	6.2	5.5	3.8	5.7	5.1	4.6	4.2	4.6	4.2	1.0	1.0	1.2	1.4	4.4	3.9
Expenditure 4/	37.7	21.2	22.2	39.0	22.8	38.9	22.9	36.8	20.6	7.3	8.8	9.9	10.8	35.3	19.1
General public services	2.3	2.0	1.5	…	1.6	…	…	…	…	…	…	…	…	…	0.0
Defense	1.9	2.0	1.9	…	1.9	…	…	…	…	…	…	…	…	…	0.0
Public order and safety affairs	2.0	2.2	2.2	…	2.2	…	…	…	…	…	…	…	…	…	0.0
Education affairs and services	5.1	2.2	2.1	…	2.1	…	…	…	…	…	…	…	…	…	0.0
Health affairs and services	3.5	0.9	1.0	…	0.9	…	…	…	…	…	…	…	…	…	0.0
Social security and welfare affairs	15.3	2.6	4.1	…	4.3	…	…	…	…	…	…	…	…	…	0.0
o/w: Pension Fund	8.3	0.0	0.0	9.3	0.0	…	…	9.4	…	…	…	…	…	…	0.0
Housing and community services	0.7	0.0	0.2	…	0.2	…	…	…	…	…	…	…	…	…	0.0
Recreational, cultural, religious affairs	0.8	0.2	0.4	…	0.3	…	…	…	…	…	…	…	…	…	0.0
Energy, agriculture, and industry	3.4	2.7	4.1	…	3.9	…	…	…	…	…	…	…	…	…	0.0
Interest payments	1.0	1.0	1.0	1.4	1.3	1.0	1.0	1.0	1.0	0.2	0.3	0.3	0.3	1.0	1.0
Domestic interest payments	0.1	0.1	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.3	0.3
Foreign interest payments	0.9	0.9	0.7	1.0	1.0	0.7	0.7	0.7	0.7	0.1	0.2	0.2	0.2	0.7	0.7
Other	1.3	5.5	3.5	…	3.2	…	…	…	…	…	…	…	…	…	0.0
Statistical discrepancy	0.3	0.0	0.0	…	0.0	…	…	…	…	…	…	…	…	…	…
Overall cash balance	-0.7	-0.3	-2.4	-1.8	-1.6	-3.4	-3.2	-1.8	-1.4	0.3	-0.4	-1.3	-0.4	-1.6	-1.1
Net accumulation of VAT refund arrears	-0.4	-0.4	-0.6	-0.6	-0.6	-0.1	-0.1	-0.6	-0.6	-0.2	0.6	-0.8	-0.2	-0.4	-0.4
Net accumulation of energy & utility arrears	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net social arrears accumulation	-0.1	0.0	…	-0.1	…	…	…	-0.1	...	-0.1	0.0	0.0	0.0	...	...
Other arrears (interest)	0.0	0.0	…	0.0	…	…	…	0.0	...	0.0	0.0	0.0	0.0	...	...
Noncash property income	0.2	0.2	…	0.2	…	…	…	0.2	...	0.2	0.0	0.0	0.0	...	...
Commitment balance	0.0	0.3	-1.7	-0.8	-0.8	-3.0	-2.9	-0.9	-0.6	0.8	-0.9	-0.5	-0.2	-1.0	-0.6
Gap to be filled	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.7	0.3	2.4	1.8	1.6	3.4	3.2	1.8	1.4	-0.3	0.4	1.3	0.4	1.6	1.1
Net external	0.8	0.5	0.4	0.4	0.4	1.7	1.4	1.7	1.4	0.5	-0.1	1.4	-0.1	0.4	0.4
Disbursements	2.7	2.4	2.0	2.2	2.2	3.2	2.8	3.1	2.8	1.0	0.1	2.0	0.1	1.8	1.8
o/w: project loans	0.1	0.1	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.0	0.0	0.1	0.1	0.2	0.2
Amortization 3/	-1.9	-1.9	-1.5	-1.7	-1.7	-1.4	-1.4	-1.4	-1.4	-0.5	-0.1	-0.6	-0.2	-1.4	-1.4
Net domestic	-1.2	-1.0	0.4	0.5	0.4	-0.9	-0.5	-2.5	-2.3	-1.1	-0.9	-0.6	0.1	0.0	-0.4
Privatization	1.1	0.8	1.6	0.8	0.7	2.6	2.3	2.6	2.3	0.4	1.4	0.5	0.4	1.2	1.1
Memorandum items:															
End-period stock of refund arrears	0.7	...	…	0.0	…	…	…	0.0	...	0.3	0.9	0.2	0.0	...	...
End-period stock of social arrears	0.2	...	...	0.1	...	...	...	0.1	...	0.2	0.1	0.1	0.1	...	...
Primary balance	0.3	0.7	-1.4	-0.4	-0.2	-2.4	-2.2	-0.7	-0.4	0.5	-0.1	-1.0	-0.1	-0.6	-0.2
Earmarked revenue	14.7	4.6	4.2	15.7	5.3	16.1	4.5	16.1	4.5	3.3	3.8	4.5	4.5	15.8	4.3
Nonearmarked cash revenue	22.3	16.2	15.6	21.6	15.9	19.4	15.3	18.9	14.8	3.3	4.6	4.2	5.9	17.9	13.7

Sources: Ministry of Finance, NBU and staff projections and calculations.

1/ Based on spending authorized in the supplementary budget. Assumes that (i) all excess privatization proceeds are spent; (ii) local governments spend about three-quarters of their foreign borrowing and privatization proceeds; and (iv) VAT refunds arrears are fully eliminated during the second half of the year.

2/ Assumes: (i) Hrv 1 billion in privatization proceeds are not spent; (ii) Kyiv spends only one-quarter of its Eurobond proceeds; (iii) that the government issues only Hrv 10.8 billion in VAT refunds (consistent with the supplementary budget estimates); and (iv) the capital budget is underimplemented by Hrv 1 billion.

3/ Excludes offset with Russia involving US$ 98 million amortization for 2003-2004.

4/ Due to a new budget classification introduced for the 2002 budget, the 2002 expenditure are not strictly comparable to earlier years.

Table 5. Ukraine: Monetary Accounts, 2001-04

	2001	2002	2003	2004									
	Dec.	Dec.	Dec.	Mar.	Mar. Prog.	Jun.	Jun. Prog.	August	Sep. Prog.	Dec. Prog.	Sep. Staff Recom.	Dec. Staff Recom.	Dec. Staff Proj.
							(In millions of hryvnias)						
Monetary Survey													
Net foreign assets	6,875	13,942	25,511	30,607	26,108	40,016	28,277	54,194	30,442	31,732	50,786	48,822	52,402
(In millions of US dollars)	1,297	2,615	4,785	5,743	4,897	7,521	5,304	10,203	5,710	5,952	9,526	9,649	9,829
Net domestic assets	38,881	50,927	69,533	70,544	72,642	73,608	76,102	66,878	80,095	86,221	72,865	85,822	84,234
Domestic credit	48,074	61,986	86,505	87,850	89,863	93,183	93,525	86,042	97,763	104,192	92,839	103,551	104,477
Net credit to government	18,390	18,273	15,080	10,362	14,751	7,114	14,283	-1,680	14,197	14,856	4,283	4,477	9,850
Credit to nongovernment	29,684	43,712	71,425	77,488	75,112	86,070	79,243	87,722	83,566	89,336	88,556	99,074	94,627
Other items, net	-9,193	-11,058	-16,973	-17,306	-17,221	-19,575	-17,424	-19,164	-17,668	-17,971	-19,975	-17,729	-20,243
Broad money	45,755	64,870	95,043	101,151	98,750	113,625	104,379	121,073	110,537	117,953	123,651	134,643	136,636
Hryvnia broad money	37,097	52,324	75,074	79,242	79,197	89,774	83,920	96,324	89,093	95,070	97,671	107,358	107,928
Foreign currency deposits	8,658	12,546	19,969	21,909	19,552	23,851	20,458	24,749	21,444	22,883	25,980	27,286	28,708
Accounts of the National Bank of Ukraine													
Net international reserves 1/	6,249	13,526	27,204	32,819	27,802	42,374	30,020	56,349	32,189	33,425	53,143	51,179	54,759
(In millions of U.S. dollars)	1,179	2,537	5,103	6,201	5,215	8,011	5,631	10,684	6,038	6,269	9,968	10,114	10,314
Net domestic assets 2/	16,806	17,282	12,885	8,619	13,126	4,848	12,374	-3,235	12,414	13,190	-2,563	2,628	3,386
Net domestic credit	18,289	19,182	16,185	11,801	16,426	7,325	15,674	-1,325	15,714	16,490	64	2,759	6,031
Net credit to government	18,518	17,449	13,575	9,555	13,591	6,088	12,702	-1,846	12,516	13,325	3,508	3,806	9,863
Credit to gen. government	19,898	19,634	18,548	18,261	18,283	17,982	18,017	17,085	17,751	17,486	17,716	17,486	17,486
Deposits of gen. government	1,380	2,186	4,973	8,706	4,691	11,894	5,315	18,932	5,235	4,161	14,208	13,680	7,623
Net credit to nongovernment	69	-19	113	135	113	-400	113	138	113	113	-400	-400	-400
Claims on banks	-298	1,752	2,497	2,111	2,721	1,637	2,859	383	3,084	3,052	-3,043	-646	-3,431
Refinancing			1,867	1,466		1,326	2,229	1,096	2,454	2,422	838	838	838
Other claims on banks			630	645		604	630	555	630	630	604	604	604
Claims on NBU (Repos + CDs)			0	0		-293	0	-1,268	0	0	-4,485	-2,088	-4,873
Other items, net	-1,483	-1,899	-3,300	-3,182	-3,300	-2,477	-3,300	-1,910	-3,300	-3,300	-2,627	-131	-2,645
o/w revaluation												2,746	232
Base money	23,055	30,808	40,089	41,438	40,928	47,222	42,393	53,115	44,603	46,616	50,581	53,807	58,145
Currency in circulation	19,465	26,434	33,119	33,580	34,009	36,890	35,572	40,563	37,450	39,514	39,272	41,739	44,202
Banks' reserves	3,590	4,374	6,970	7,858	6,919	10,331	6,821	12,551	7,153	7,102	11,309	12,068	13,944
Deposit Money Banks													
Net foreign assets	656	233	-1,924	-2,265	-1,924	-2,985	-1,924	-2,441	-1,924	-1,924	-2,985	-2,985	-2,985
Net domestic assets	25,337	39,955	66,346	71,947	69,386	81,357	73,590	83,334	78,096	83,415	84,321	95,243	91,988
Domestic credit	29,377	44,350	72,740	78,102	76,082	86,899	80,633	87,692	85,057	90,677	89,136	99,549	94,418
Net credit to government	-128	825	1,505	807	1,160	1,026	1,581	166	1,681	1,531	776	671	-13
Credit to the economy	29,505	43,526	71,235	77,294	74,922	85,874	79,053	87,526	83,376	89,146	88,360	98,878	94,431
Banks' reserves	3,590	4,374	6,970	7,858	6,919	10,331	6,821	12,551	7,153	7,102	11,309	12,068	13,944
Other Items Net	-7,630	-8,770	-13,365	-14,012	-13,615	-15,874	-13,865	-16,909	-14,115	-14,365	-16,124	-16,374	-16,374
Banks' Liabilities	25,992	40,188	64,421	69,682	67,462	78,372	71,666	80,893	76,171	81,491	81,336	92,258	89,003
Credit to banks from NBU	-298	1,752	2,497	2,111	2,721	1,637	2,859	383	3,084	3,052	-3,043	-646	-3,431
Deposits	26,290	38,436	61,924	67,570	64,740	76,735	68,806	80,510	73,087	78,439	84,379	92,904	92,434
							(Percentage change from end of previous year)						
Memorandum items:													
Broad money	41.9	41.8	46.5	6.4	3.9	19.6	9.8	27.4	16.3	24.1	30.1	41.7	43.8
Credit to nongovernment	40.5	47.3	63.4	8.5	5.2	20.5	10.9	22.4	17.0	25.1	24.0	38.7	32.5
Base money	37.4	33.6	30.1	3.4	2.1	17.8	5.7	32.5	11.3	16.3	26.2	34.2	45.0
							(Percentage change year-over-year)						
Broad money	41.9	41.8	46.5	44.3	40.8	43.8	32.1	45.8	27.8	24.1	43.0	41.7	43.8
Credit to nongovernment	40.5	47.3	63.4	61.4	56.5	55.0	42.7	50.8	31.2	25.1	39.0	38.7	32.5
Base money	37.4	33.6	30.1	32.9	31.2	34.2	20.5	39.0	17.3	16.3	33.0	34.2	45.0
Real broad money 3/	35.7	42.3	38.3	37.6	32.8	35.7	25.3	35.9	20.3	18.1	34.3	34.7	35.1
Real credit to nongovernment 3/	34.4	47.8	55.2	54.8	48.4	47.0	36.0	40.9	23.7	19.1	30.3	31.7	23.8
							(Ratio)						
Velocity of broad money 4/	4.46	3.48	2.78	2.74	2.67	2.57	2.61	...	2.56	2.48	2.51	2.43	2.40
Money multiplier	1.98	2.11	2.37	2.44	2.41	2.41	2.46	2.28	2.48	2.53	2.44	2.50	2.35
							(In percent)						
Share of foreign currency loans 5/	41.3	39.5	38.5	38.4	...	37.4	...	38.1	...	...	...	...	...
Share of foreign currency deposits 6/	32.9	32.6	32.2	32.4	...	31.1	...	30.7	...	...	...	...	...

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

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

Table 6. Ukraine: Financial Soundness Indicators for the Banking System, 2000-04
(In percent, unless otherwise indicated)

	Dec-00	Dec-01	Dec-02	Dec-03	Mar-04	Jun-04
Ownership						
Number of banks	153	152	157	158	157	158
Private	151	150	155	156	155	156
Domestic	120	122	135	137	137	138
Foreign	31	28	20	19	18	18
o/w: 100% foreign-owned	7	6	7	7	6	6
State-owned	2	2	2	2	2	2
Concentration						
Share of assets of largest 10 banks	55.3	52.5	54.1	53.7	54.2	54.9
Share of assets of largest 25 banks	71.4	66.8	71.0	71.7	71.5	72.3
Number of bank with assets less than $150 million	145	141	140	132	127	127
Capital Adequacy						
Regulatory capital to risk-weighted assets	15.5	20.7	18.0	15.2	14.8	15.2
Capital to total assets	16.2	15.6	14.9	12.3	12.1	12.1
Asset Quality						
Credit growth (year-over-year)	61.3	40.5	47.3	63.4	61.4	55.0
Credit to GDP ratio	12.4	14.5	19.4	27.0	28.2	29.7
Change of loan to GDP ratio (in percentage points)	2.4	2.1	4.8	7.7	1.2	1.5
Loans in foreign currency to total loans	41.4	41.3	39.5	38.5	38.4	37.4
NPLs to total loans 1/ 3/	29.6	25.1	21.9	28.3	28.0	27.5
NPLs (excl. timely serviced substandard loans) 2/				8.5	8.2	7.9
Loans classified as doubtful and loss to total loans	16.8	9.9	7.2	7.2	6.9	6.6
NPLs net of provisions to capital 3/	68.0	62.9	63.8	143.8	150.5	147.8
Specific provisions to NPLs 3/ 4/	38.4	39.2	39.6	22.7	21.8	21.5
Specific provisions to total loans	11.3	9.6	8.7	6.4	6.1	5.9
Earnings and Profitability						
Return on assets (after tax; end-of-period)	-0.1	1.2	1.2	1.0	1.0	1.0
Return on equity (after tax; end-of-period)	-0.5	7.5	8.0	7.6	7.5	7.6
Net interest margin to total assets	6.3	6.5	5.6	5.8	5.0	4.9
Interest rate spreads (in percentage points; end-of-period)						
Between loans and deposits in domestic currency	28.5	18.9	14.9	9.9	8.7	6.8
Between loans and deposits in foreign currency	10.2	5.4	5.3	4.0	5.6	5.5
Between loans in domestic and foreign currency	21.3	18.0	10.5	6.9	5.0	4.5
Between deposits in domestic and foreign currency	3.4	4.6	0.9	1.1	2.0	3.2
Liquidity						
Liquid assets to total assets	20.8	15.3	13.5	15.3	17.3	15.5
Customer deposits to total (non-interbank) loans	59.1	87.6	87.6	86.6	87.2	89.5
of which: foreign currency deposits to total deposits	44.4	32.9	32.2	32.2	30.3	30.9
Sensitivity to market risk						
Net open positions in foreign currency to capital	32.9	22.3	21.5	17.7	17.3	17.9
Foreign currency loans minus foreign currency deposits to capital	49.6	47.2	49.2	59.1	68.3	55.1

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

1/ Increase in NPLs in 2003 is partly due to new classification rules.
2/ The NBU estimates that as of end-March 2004, 94 percent of loans classified as substandard are being timely serviced.
3/ NPLs are those classified as substandard, doubtful, and loss.
4/ About half of the drop in the provision to NPL ratio from end-2002 to end-2003 is due to new loan classification rules.

Table 7. Ukraine: Prior Actions and Structural Performance Criteria and Benchmarks Under the Precautionary Stand-By Arrangement

Prior Actions	**Status**
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/Status**
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*. Missed. Enacted legislation fell short of the requirement by HRV 200 million.
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*. Measures (a) and (b) missed. NBU's amendments submitted to parliament but not yet approved.
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*. Measure (a) done August 10, 2004. Measure (b) missed.
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.	Missed.

Table 8. Ukraine: Medium-Term Macroeconomic Framework, 2001–09

	2001	2002	2003 Est.	Baseline Scenario 1/ 2004	2005	2006	2007	2008	2009	Low-Case Scenario 2/ 2004	2005	2006	2007	2008	2009
Output and prices															
Nominal GDP (in billions of hryvnias)	204.2	225.8	264.2	328.5	379.5	420.4	459.1	501.4	547.5	328.5	365.0	402.0	434.9	474.9	518.5
Real GDP growth (percent change)	9.2	5.2	9.4	12.5	6.0	5.5	5.0	5.0	5.0	12.5	1.0	2.0	4.0	5.0	5.0
Consumer prices (percent change; period average)	12.0	0.8	5.2	8.3	8.1	4.8	4.0	4.0	4.0	8.3	9.5	8.0	4.0	4.0	4.0
Consolidated budget (in percent of GDP)															
Revenue and grants	33.5	36.0	37.0	35.5	33.7	33.6	33.6	33.6	33.6	35.5	33.7	33.3	33.3	33.3	33.7
Expenditure and net lending (cash basis)	35.1	35.5	37.7	38.9	35.3	35.2	35.2	35.2	35.2	38.9	37.7	37.2	35.1	34.9	35.2
of which: interest	2.0	1.3	1.0	1.0	1.0	0.9	0.8	0.8	0.9	1.0	1.1	1.4	1.6	1.5	1.4
Cash balance	-1.6	0.5	-0.7	-3.4	-1.6	-1.6	-1.5	-1.6	-1.6	-3.4	-4.0	-3.9	-1.8	-1.6	-1.6
Commitments balance	-1.5	0.2	0.0	-3.0	-1.0	-1.4	-1.4	-1.5	-1.5	-3.0	-3.8	-3.8	-1.7	-1.5	-1.5
Privatization receipts	1.3	0.5	1.1	2.6	1.2	0.7	0.7	0.6	0.5	2.6	0.6	0.6	0.7	0.8	0.6
Net domestic financing	-0.1	-0.3	-1.2	-0.9	0.0	0.6	0.6	0.5	0.7	-0.9	3.5	3.4	0.6	0.0	0.3
Net external financing	0.4	-0.7	0.8	1.7	0.4	0.3	0.3	0.5	0.4	1.7	-0.1	0.0	0.5	0.8	0.7
Public debt (in percent of GDP; end of period) 3/	38.6	35.7	30.3	27.1	21.6	18.7	17.6	16.8	16.4	27.1	26.7	28.4	26.0	26.0	24.3
Domestic	12.0	11.7	8.4	7.9	5.9	6.1	6.7	6.8	7.0	7.9	9.2	12.1	11.5	13.5	13.0
External	26.6	24.0	21.9	19.2	15.7	12.6	10.9	10.0	9.4	19.2	17.5	16.3	14.5	12.5	11.3
External sector															
Current account balance (in percent of GDP)	3.7	7.5	5.8	10.2	4.1	1.8	0.2	-0.7	-1.6	10.2	2.1	0.5	-0.1	-1.8	-3.1
Merchandise exports, value (percent change)	8.7	9.2	27.2	38.7	3.1	7.0	8.0	9.4	9.7	38.7	-3.9	5.0	11.0	8.4	9.2
Merchandise imports, value (percent change)	13.0	6.3	33.7	25.0	10.8	10.7	11.0	10.6	11.1	25.0	8.8	7.3	10.6	11.0	11.3
Foreign direct investment (in percent of GDP)	2.0	1.6	2.8	2.4	1.9	1.9	2.0	2.2	2.5	2.4	1.6	2.3	2.5	2.4	2.6
Gross official reserves (in percent of GDP; end of period)										11.9	10.3	9.8	11.2	12.4	13.6
In billions of U.S. dollars	3.1	4.4	6.9	11.9	13.6	15.7	17.6	19.4	20.9						
In months of imports of goods and services	1.7	1.9	2.4	3.8	3.9	4.1	4.1	4.1	4.0	3.8	3.1	2.7	2.8	2.7	2.7
External debt (end of period) 3/	26.6	24.0	21.9	19.2	15.7	12.6	10.9	10.0	9.4	19.2	17.5	16.3	14.5	12.5	11.3
External debt service (in percent of exports of goods and services) 2/	8.7	5.7	6.3	4.8	5.2	5.1	4.1	3.2	3.2	4.8	5.6	5.4	4.2	3.3	3.4
Savings-Investment Balance (in percent of GDP)															
Foreign savings	-3.7	-7.5	-5.8	-10.2	-4.1	-1.8	-0.2	0.7	1.6	-10.2	-2.1	-0.5	0.1	1.8	3.1
Domestic savings	25.5	27.7	26.1	31.6	28.3	27.8	27.1	26.4	25.8	31.6	23.2	23.7	23.8	24.6	23.5
Private	24.0	24.1	22.6	30.7	26.4	25.9	25.1	24.5	23.9	30.7	23.7	24.1	22.1	22.8	21.6
Public	1.5	3.6	3.5	0.9	1.9	1.9	1.9	1.9	1.9	0.9	-0.5	-0.4	1.7	1.9	1.9
Investment	21.8	20.2	20.3	21.3	24.3	26.0	26.9	27.1	27.3	21.3	21.2	23.2	23.8	26.4	26.6
Private	18.7	17.1	16.1	17.1	20.8	22.5	23.4	23.6	23.8	17.1	17.7	19.7	20.3	22.9	23.1
Public	3.1	3.0	4.2	4.3	3.5	3.5	3.5	3.5	3.5	4.3	3.5	3.5	3.5	3.5	3.5

Sources: Ukrainian authorities; and Fund staff estimates.

1/ Baseline scenario, based on current macroeconomic policies and the authorities' plans to accelerate structural reforms.
2/ Low case scenario, based on an external shock that results in a drop of GDP growth in 2005 and 2006. The sudden drop in GDP growth is assumed to have a negative impact on the ability of bank borrowers to repay their debt. Additional capital requirements for banks are assumed to be borne as fiscal costs.
3/ Government and government-guaranteed debt and arrears, and NBU debt. Excludes debts by state-owned enterprises.

Table 9. Ukraine: Energy Sector Conditionality Under the World Bank's PAL-II

Milestones & Benchmarks achieved prior to Board's approval	**Milestones & Benchmarks to be achieved as part of Second Tranche conditionality**
	Implementation of a short-term action plan to improve financial discipline in the energy sector. 1/
Continued improvement in payment discipline in electricity and gas. • Electricity-sector cash collections higher than 90 percent on current charges over the previous 12 months. • Naftogaz cash collections higher than 85 percent of current charges over the previous 12 months. • *Submission* to parliament of a comprehensive law on debt resolution in the energy sector.	Continued improvement in payment discipline in electricity and gas. • *Enactment* of comprehensive law on debt resolution in the energy sector; including obligatory participation of enterprises in which the state has a controlling share.
Further progress in transparent privatization of large energy-sector enterprises. • IFRS audit for 2001 completed by internationally recognized auditing company, based on financial statements of selected Naftogaz subsidiaries. • Internationally reputable auditing company contracted to prepare a 2002 audit of Naftogaz, according to terms of reference agreed with the World Bank.	Further progress in transparent privatization of large energy-sector enterprises. • Engage financial advisor for the privatization of a group of remaining state-owned power distribution companies, and *launch* of a privatization tender. • Continued progress toward completion of an unqualified 2004 IFRS audit of the consolidated financial statements of Naftogaz, as exhibited by: a) physical verification of inventory; b) professional estimate of gas and oil reserves; and c) professional estimate of "fair market value" of property, plant, and equipment.

1/ The short-term plan includes the following: a) submission to Parliament of a draft law on Charging Penalties for Untimely Payment for Consumed Electricity, Gas and Communal Services; b) local governments to be legally obliged to compensate municipal companies for setting loss-making municipal tariffs; c) an emergency reserve list of potentially environmentally hazardous enterprises, including the protected volume of electricity, to be approved by the CoM, and financing courses to be identified for each enterprise; d) procedures for compensating consumers of low quality or below-billed provision of heating and water services to be developed and made effective; and e) electricity payment and/or tariff privileges for individual business entities and/or sectors to be prohibited with the exception of the tariff level for communal service companies.

Table 10. Ukraine: Quantitative Performance Criteria and Indicative Targets 1/
(End-of-period; in millions of hryvnias, unless otherwise indicated)

	Stocks	Cumulative changes from end-2003			
	2003	2004			
	Dec.	Mar.	Mar.	June	June
	Proj.	Prog.	Actual	Prog.	Actual
I. Performance criteria 2/					
Ceiling on the cash deficit of the general government 3/ 4/	...	1,327 3/	-836	2,847	647
Ceiling on stock of budgetary arrears on wages, pensions and social benefits 4/ 5/	...	-75	-292	-150	-256
Ceiling on stock of VAT refund arrears 5/	1,828	-1,000	-810	-1,500	991
Ceiling on the net domestic assets of the NBU 5/ 6/	12,885	-1,092 6/	-4,496	-511	-8,288
Floor on net international reserves of the NBU (in millions of U.S. dollars) 5/ 7/	5,103	362 7/	1,098	528	2,908
Ceiling on external debt contracted or guaranteed by the government or the NBU (in millions of U.S. dollars) 4/ 8/	...	1,000	607	1,300	1,280
Of which: Maturity of up to and including one year	...	0	0	0	0
II. Indicative Targets					
Base money 5/	40,089	839	1,349	2,304	7,133
Nonearmarked state cash revenue 4/	...	9,752	9,867	20,687	21,851
Total cash collection ratio for electricity (in percent) 4/ 9/	...	86	91	93	95
Total cash collection ratio by Naftogaz (in percent) 4/ 10/	...	64	87	79	95
III. Adjusters					
Project financing 3/ 4/	...	231	19	461	86
Non-project foreign financing (in millions of U.S. dollars) 4/ 6/ 7/	...	350	600	646	600

Sources: Ukrainian authorities; and Fund staff estimates.

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. For March 2004, project financing fell short of the adjuster by $212 million and the ceiling in the cash deficit was adjusted downward by that amount.
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 non-project 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. For March 2004, non-project foreign financing exceeded the adjuster by $250 million and the NDA ceiling was adjusted downward accordingly by Hrv 1,333 million.
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. For March 2004, non-project foreign financing exceeded the adjuster by $250 million and the NIR floor was adjusted upward by that amount.
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.

Table 11. Ukraine: Millennium Development Goals

	1990	1995	2001	2002
Goal 1. Eradicate extreme poverty and hunger				
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.				
1. Population below $1 a day (%)	...	...	2.9	...
2. Poverty gap at $1 a day (%)	...	...	0.6	...
3. Percentage share of income or consumption held by poorest 20%	...	...	8.8	...
Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger.				
4. Prevalence of child malnutrition (% of children under 5)	...	...	3.0	...
5. Population below minimum level of dietary energy consumption (%)	...	...	...	...
Goal 2. Achieve universal primary education				
Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.				
6. Net primary enrollment ratio (% of relevant age group)	...	...	...	...
7. Percentage of cohort reaching grade 5 (%)	59.1	...	...	...
8. Youth literacy rate (% ages 15-24)	99.8	99.9	99.9	99.9
Goal 3. Promote gender equality				
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.				
9. Ratio of girls to boys in primary and secondary education (%)	...	...	...	...
10. Ratio of young literate females to males(% ages 15-24)	100	100.1	100.1	100.1
11. Share of women employed in the nonagricultural sector (%)	...	...	...	...
12. Proportion of seats held by women in the national parliament (%)	...	4	8	8
Goal 4. Reduce child mortality				
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.				
13. Under-five mortality rate (per 1,000)	22.0	24.0	20.0	19.8
14. Infant mortality rate (per 1,000 live births)	18.0	20.0	17.0	16.4
15. Immunization , measles (% of children under 12 months)	90.0	97.0	99.0	...
Goal 5. Improve maternal health				
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.				
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	45.0	...	...
17. Births attended by skilled health staff (% of total)	...	99.9	99.9	...
Goal 6. Combat HIV/AIDS, malaria and other diseases				
Target 7: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.				
18. Prevalence of HIV, female (% ages 15-24)	...	...	0.9	...
19. Contraceptive prevalence rate (% of women ages 15-49)	...	...	71.6	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...

Table 11. Ukraine: Millennium Development Goals (concluded)

	1990	1995	2001	2002
21. Incidence of tuberculosis (per 100,000 people)	...	...	78.8	...
22. Tuberculosis cases detected under DOTS (%)	...	...	...	...
Goal 7. Ensure environmental sustainability				
Target 8: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.				
23. Forest area (% of total land area)	16.0	...	16.5	...
24. Nationally protected areas (% of total land area)	...	1.6	1.6	3.9
25. GDP per unit of energy use (PPP $ per kg oil equivalent)	1.5	1.3	1.4	...
26. CO2 emissions (metric tons per capita)	11.5	8.3	7.5	...
27. Access to an improved water source (% of population)	...	...	98.0	...
28. Access to improved sanitation (% of population)	...	...	99.0	...
29. Access to secure tenure (% of population)	...	...	...	...
Goal 8. Develop a global partnership for development				
Target 9: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.				
30. Youth unemployment rate (% of total labor force ages 15-24)	...	14.3	...	...
31. Fixed line and mobile telephones (per 1,000 people)	...	161.2	256.4	...
32. Personal computers (per 1,000 people)	1.9	8.3	18.3	...
General indicators				
Population	51.9 million	51.5 million	49.1 million	48.7 million
Gross national income ($)	83.0 billion	49.0 billion	35.3 billion	37.7 billion
GNI per capita	1600	950	720	770
Adult literacy rate (% of people ages 15 and over)	99.4	99.5	99.6	99.6
Total fertility rate (births per woman)	1.9	1.4	1.2	1.2
Life expectancy at birth (years)	70.1	67.1	68.2	68.2
Aid (% of GNI)	0.3	0.7	1.4	...
External debt (% of GNI)	0.6	17.5	34.3	...
Investment (% of GDP)	27.5	26.7	21.3	20.4
Trade (% of GDP)	56.4	97.2	109.3	110.2

Source: World Bank Millennium Development Goals website, April 2004.

UKRAINE: FUND RELATIONS

(As of July 31, 2004)

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	2499.40	182.2
Reserve position in Fund	0.00	0.0

III. **SDR Department:**	**SDR Million**	**%Allocation**
Holdings	8.49	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**% Quota**
Extended arrangements	1,065.07	77.63
Systemic transformation	62.33	4.54

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR Million)
Stand-by	03/29/04	03/28/05	411.60	0.00
EFF	09/04/98	09/03/02	1,919.95	1,193.00
Stand-by	08/25/97	08/24/98	398.92	181.33
Stand-by	05/10/96	02/23/97	598.20	598.20

VI. **Projected Payments to Fund (Expectations Basis)**[13] (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	93.73	202.83	278.97	278.98	215.62
Charges/Interest	16.36	29.04	22.40	14.03	6.02
Total	110.09	231.86	301.38	293.01	221.64

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

Projected Payments to Fund (Obligation basis)[14] (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	93.73	171.15	198.83	198.83	198.83
Charges/Interest	16.36	29.21	23.99	18.02	12.07
Total	110.09	200.36	222.82	216.86	210.90

VII. **Safeguards Assessments:**

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

VIII. **Exchange Arrangements:**

In September 1996, the authorities introduced the hryvnia (HRV) at a conversion rate of karbovanets (Krb) 100,000 to HRV 1. The rate was initially informally pegged to the dollar. In September 1997, the peg was replaced by a formal band of HRV 1.7–HRV 1.9 per U.S. dollar. The limits of the band were moved on several occasions, most recently on February 9, 1999, to HRV 3.4–4.6 per U.S. dollar. Since March 19, 1999, the exchange rate for the hryvnia has been allowed to be determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention of allowing the free float of the hryvnia. However, the authorities intervene regularly to limit fluctuations in the exchange rate, so the exchange rate arrangement has been reclassified, effective January 1, 2001, as a conventional pegged arrangement. On August 31, 2004 the hryvnia stood at HRV 5.31 per U.S. dollar.

---

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

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

IX. **Article IV Consultation:**

Ukraine is on the standard 12-months consultation cycle. The staff report (IMF Country Report No. 03/172), and the Selected Issues (IMF Country Report No. 03/173) and Statistical Appendix (IMF Country Reports No. 03/174) 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 (IMF 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 Practices; World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights System; and AML/CFT Methodology. A Data ROSC Module was conducted in April 3–17, 2002, and was considered by the Executive Board on August 5, 2003 (IMF Country Report No. 03/256). A Fiscal Transparency Module (experimental) was issued in September 1999, and an update in March 2004 (IMF Country Report No. 04/98).

XI. Fund Technical Assistance Missions, 1999-2004

(As of June 30, 2004)

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
	Review of TA needs	February 9–11, 2004
	Banking supervision, monetary framework and operations, government securities market	April 13–26, 2004
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

XII. FUND RESIDENT REPRESENTATIVES AND ADVISORS, 1998-2004

Purpose	Representatives/Advisors	Assignment
Resident Representatives		
Senior Resident Representative	Mr. Lenain	January 1997–February 1999
	Mr. Ghesquiere	March 1999–August 2001
	Mr. Figliuoli	August 2001–August 2004
	Mr. Franks	Since September 2004
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 Advisor	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 Mr. Lopes	July 1998–July 2000 March 2001–June 2002
Treasury Advisor	Mr. Platais Mr. Lepage	July 1998–June 2001 July 2001–January 2002
Multisector Statistics Advisor	Mr. Piché	March 2000–March 2002

UKRAINE: RELATIONS WITH THE WORLD BANK
(September 2004)

Country Assistance Strategy

1. 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).

2. 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.

3. 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

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

5. 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 was approved by the Board in March 2004.

6. 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.

7. 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).

8. 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.

9. **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.

10. 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.

11. **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.

12. 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.

13. 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.

14. 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, health, education, energy and agriculture. Reports under preparation include a new CEM, a Trade Study, and a package of policy notes linked to the PAL program.

World Bank Contact: Paul Bermingham, Country Director (Tel.: 473-3985).

UKRAINE: RELATIONS WITH THE EBRD
(September 2004)

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

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

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

4. In its last Country Strategy, which was approved by the EBRD Board in September 2002, the EBRD resolved to further expand its activities in Ukraine, building on the period of rapid economic growth, the progress in reform in some sectors, for example energy and agriculture, as well as its success in attracting more non-EBRD financing. The main elements of the EBRD's operational strategy since have been:

- encouraging sustained momentum in privatization and commercialization of major utilities.
- encouraging energy efficiency in both the state and private sectors;

- providing funding through the banks to develop the small 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 financing of the K2R4 project.

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

5. This approach was endorsed in a Program of Co-operation signed in April 2003 by the Government of Ukraine and the EBRD during a visit to the EBRD by the (then recently appointed) Prime Minister, Victor Yanukovich. The agreement identified several priority projects in the public sector including those in the transport, energy and municipal infrastructure sectors, and emphasized the importance of nuclear safety. The EBRD also stressed its support for the development of the private sector, particularly the banking sector.

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

7. The project is smaller than that originally considered by the Board in late 2000 and 2001 (when the Ukraine authorities decided that the project was not then ready for Board approval). Since then the Ukraine authorities have completed most of the construction of the two plants. In addition the financial position of the nuclear generator, Energoatom, improved significantly owing to large increases in collection ratios and the adoption of an appropriate tariff methodology.

8. The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 62 by the end of July 2004. These amount to a historical net business volume of EUR 1,492.9 million. Of this amount EUR 900.0 million represented the Portfolio (operating assets plus undrawn commitments), of which 70 percent were assigned to the private sector (EUR 632.8 million)

and 30 percent to the state sector (EUR 267.1 million). Operating assets amounted to EUR 575.5 million at the end of July 2004.

9. The outstanding commitments to Ukraine represent almost 5.9 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 216 projects with a total value of commitments of almost EUR 44.6 million. These are mainly related to project preparation and implementation.

10. Projects in the financial sector account for slightly over 25 percent of the EBRD's commitment to Ukraine, with much of this represented by the loans provided under sovereign guarantee to support the development of small and medium size companies (SME) 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. It was only approved by the Rada in early 2000, but is now almost fully committed. The SME lines of credit have been one of the main forms of long-term foreign currency lending in Ukraine during these years. The EBRD is now considering plans to continue financing SMEs by lending directly to participating banks. The energy sector accounts for a further 19 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 18 percent, telecommunications 1.4 percent, municipal infrastructure 2.4 percent, with tourism and property accounting for the remaining 2.2 percent of all commitments.

11. The EBRD will prepare a new country strategy for Ukraine during the first quarter of 2005.

STATISTICAL ISSUES APPENDIX

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

2. 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). Statistical deficiencies remain including in national accounts, which suffer from a variety of methodological problems, and balance of payments data. Publication of external debt data is delayed.

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

Real sector

4. 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.

5. 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 a 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 improvement of the data collection and production environment is needed, in particular, through greater use of sample surveys, and improving data flow management and processing. To address the shortcomings, it is important to revive the Statistical Council to provide guidance, *inter alia*, to the SCS, on the quality of the statistical series and on strategies for improving data production.

Government finance statistics

6. 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.

7. 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 authorities partially complied with the data ROSC recommendations and reported central and local government data for 1999-2002 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.

8. 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

9. Ukraine has received extensive technical assistance in money and baking statistics, and substantial improvements have already been made. The data ROSC reports recommended 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 timelines for these accounts rather than exercise the flexibility option on this data category. SDDS allows subscribers to use up to two flexibility options on some data categories. Ukraine uses both such options for financial sector data categories: one for timeliness of the analytical accounts of the banking sector and the other, also for timeliness of the analytical accounts of the central bank.

10. 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, they are establishing a migration plan to adopt the recommendations included in the *Monetary and Financial Statistics Manual (MFSM)*.

11. 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 internal 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

12. Ukraine's balance of payments statistics are compiled in broad conformity with the conceptual framework of the *BPM5* and are reported to STA on a quarterly basis with a lag of about ten weeks. The principal data sources are a closed ITRS, administrative data sources, and a survey of enterprises. Following the recommendations of the data ROSC, the authorities have expanded the survey on inter-enterprise arrears to include information relevant for balance of payments purposes, and intend to implement lower reporting thresholds for banks. 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 still does not disseminate external debt data that meet all SDDS requirements.

Ukraine: Core Statistical Indicators

(as of August 31, 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	August 30, 2004	August 2004	July 31, 2004	July 31, 2004	July 31, 2004	August 30, 2004	July 2004	May 2004	Q1 2004	March 2004	Q1 2004	July 2004	July 2004
Date received	August 31, 2004	August 31, 2004	August 25, 2004	August 25, 2004	August 25, 2004	August 31, 2004	August 2004	August 2004	July 2004	July 2004	August 2004	August 2004	August 2004
Frequency of data	D	D	M	D	M	D	M	M	Q	M	Q	M	M
Frequency of reporting	D	D	M	D	M	D	M	M	Q	M	Q	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	M	M	M	M	M	M	M	Q	Q	M	Q	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 data: 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.

MEDIUM-TERM OUTLOOK, RISKS, AND DEBT SUSTAINABILITY

Baseline scenario

1. **Achieving a path of high sustained growth depends critically on stronger investment.** In addition to maintaining sound macroeconomic policies, sustained economic growth over the medium term will require persistent efforts to address weaknesses in the business climate. In particular, uncertainties in the legal system need to be overcome, corporate governance needs to be strengthened, and transparency needs to be increased, so that a level playing field can be established.

2. **Based on significant progress in structural reforms, the staff estimates real GDP to grow by 5 percent per year over the medium term.** With a decline in population and the depreciation of a large share of the current capital stock, such a growth path requires much stronger investment in addition to the expected increase in productivity. The baseline scenario assumes an average increase in the private investment to GDP ratio by 1½ percentage point over the next four years. Additional FDI of about $8 billion until 2008 is also assumed to stimulate growth.

3. **Fiscal policy would be geared to address pressing social and infrastructure needs while further reducing public debt levels.** A fiscal deficit of 1½ percent over the medium term would allow the public debt stock to fall gradually to below 20 percent starting in 2006. In view of the need to develop the domestic government securities market and risks from the large share of foreign debt (72 percent of total public debt at end-June 2004), a shift towards domestic debt financing is projected.

4. **The hryvnia is assumed to appreciate gradually contributing to the unwinding of the current account surplus and the reduction of external debt.** The current account surplus is expected to turn around into a deficit from 2007 as investment and import demand increase. The capital account is projected to strengthen as portfolio outflows subside and FDI increases. Gross international reserves are projected to exceed 4 months of imports.

5. **Under the baseline scenario, public and external debt levels remain robust.** Public debt is projected to fall to about 17 percent by 2009, 60 percent of which would be external debt.

Risks to the baseline scenario

6. **A sharp drop in external demand could temporarily impede the debt consolidation path.** Ukraine's strong dependence on external demand—exports contribute to 60 percent of GDP—make it particularly susceptible to external shocks. In a scenario in which exports decline by 4 percent compared to 2004, GDP growth could drop to 1 percent in 2005—5 percentage points below the projected baseline growth—before it would slowly recover to its medium-term path (see low case scenario in the Medium-Term Framework Table). Such a sharp reduction in GDP could also have serious implications for bank

borrowers' abilities to repay their rising level of bank debt and cause distress in the banking system. Assuming that for the largest 25 banks one third of adversely classified loans ("substandard", "doubtful" and "loss") would not be repaid and achieve a recovery value of only 25 percent, this would require additional bank capital of about HRV 7½ billion. If the government were to bear the costs of such banking sector distress, one can expect fiscal costs of about 1.2 percent of GDP over two years.

7. **Under such a shock scenario, the current account deficit is projected to deteriorate, the exchange rate to temporarily depreciate, and the fiscal deficit to rise briefly.** The sharp downturn in GDP growth and banking sector distress could result in a temporary loss of confidence with adverse effects on investment—domestic as well as foreign—portfolio investment, and the exchange rate. Debt ratios could rise to 29 percent of GDP by 2006—compared to the projected 19 percent under the baseline scenario—before reverting to its consolidation path. However, appropriate handling of the distress in the banking sector and adequate macroeconomic responses are key to keep such a shock short-lived, regain confidence, and put Ukraine back on a sustained growth path.

8. **All in all, public debt levels are robust to various types of shock as long as macroeconomic policy responses are appropriate.** In addition to the shock discussed above, sensitivity analysis of the baseline projections based on various types of one-time shocks, which reflect historical volatilities of key economic indicators, is shown in Tables 1 and 2.[15] The sensitivity analysis suggests that a large output shock—negative real growth rates of 6.9 percent for two consecutive years—could push the public debt to GDP ratio to nearly 40 percent. As long as fiscal policy responds, such a development would be relatively short-lived and the debt to GDP ratio would reverse to about 35½ percent by 2009. 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 12 percentage points above the baseline. However, under all other baseline scenarios the debt ratios would converge to below or close to 30 percent of GDP by 2009.

9. **Thus, Ukraine's most immediate vulnerabilities are not related to public debt levels but its dependence on external demand, potential imbalances in the financial sector, and domestic confidence reversals.**

- **Credit and exchange rate risk in the banking sector**: Rapid credit growth, including in foreign currency denominated loans, has exposed the banking sector to significant credit risk, especially given banks' limited risk management capacities, relatively weak financial conditions of some banks, and institutional weaknesses,

---

[15] The caveat of such analysis, however, is that it does not combine the different effects of potential shocks as discussed under the previous scenario.

such as weak accounting and reporting requirements for corporations and weak corporate governance.

- **External shocks**: Ukraine's open economy is highly dependent on international trade. In particular, 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. The large share of metallurgical products in exports (about one third) is another risk factor should the trend in world market prices suddenly reverse.

- **A loss of domestic confidence**: Confidence could suffer under various circumstances. If not counteract decisively, reemerging inflationary pressures could fuel inflationary expectations and trigger a loss of confidence in the currency. Combined with political uncertainties and developments that are potentially detrimental to the investment climate, this could trigger capital flight.

Table 1. Ukraine: Public Sector Debt Sustainability Framework, 2002-2009
(In percent of GDP, unless otherwise indicated)

	Est. 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/**	35.7	30.3			**27.1**	**21.6**	**18.7**	**17.6**	**16.8**	**16.4**	**-1.0**
o/w foreign-currency denominated	27.2	21.9			18.4	15.2	12.3	11.2	10.5	9.8	
2 Change in public sector debt	-2.9	-5.4			-3.2	-5.5	-2.9	-1.1	-0.8	-0.4	
3 Identified debt-creating flows (4+7+12)	-4.5	-5.6			-5.1	-3.2	-1.2	-0.7	-0.5	-0.3	
4 Primary deficit	-1.8	-0.3			2.4	0.6	0.7	0.7	0.7	0.7	
5 Revenue and grants	36.0	37.0			35.5	33.7	33.6	33.6	33.6	33.6	
6 Primary (noninterest) expenditure	34.2	36.7			37.9	34.3	34.3	34.3	34.3	34.3	
7 Automatic debt dynamics 2/	-2.2	-4.2			-4.9	-2.6	-1.3	-0.8	-0.6	-0.6	
8 Contribution from interest rate/growth differential 3/	-2.4	-4.2			-4.9	-2.6	-1.3	-0.8	-0.6	-0.6	
9 Of which contribution from real interest rate	-0.5	-1.3			-1.9	-1.2	-0.2	0.1	0.2	0.2	
10 Of which contribution from real GDP growth	-1.8	-2.9			-3.1	-1.4	-1.1	-0.9	-0.8	-0.8	
11 Contribution from exchange rate depreciation 4/	0.2	0.0			...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.5	-1.1			-2.6	-1.2	-0.7	-0.7	-0.6	-0.5	
13 Privatization receipts (negative)	-0.5	-1.1			-2.6	-1.2	-0.7	-0.7	-0.6	-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/	1.6	0.2			1.9	-2.3	-1.7	-0.4	-0.3	-0.1	
Public sector debt-to-revenue ratio 1/	99.2	82.1			76.4	64.2	55.6	52.4	50.0	48.8	
Gross financing need 6/	4.3	5.9			7.5	4.4	4.1	3.8	3.8	3.2	
in billions of U.S. dollars	1.8	2.9			4.6	3.3	3.7	4.0	4.3	4.1	
Key Macroeconomic and Fiscal Assumptions			7-Year Historical Average	7-Year Standard Deviation						For de stabiliza	Projected Average
Real GDP growth (in percent)	5.3	9.4	3.5	5.2	12.5	6.0	5.5	5.0	5.0	5.0	6.5
Average nominal interest rate on public debt (in percent) 7/	3.7	3.3	5.6	1.8	4.2	4.3	4.4	4.8	5.2	5.6	4.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.3	-3.7	-9.1	7.6	-6.4	-4.7	-0.7	0.8	1.2	1.6	-1.4
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)	5.0	6.9	14.7	8.4	10.5	9.0	5.0	4.0	4.0	4.0	6.1
Growth of real primary spending (deflated by GDP deflator, in percent)	8.6	17.5	3.5	13.0	16.3	-4.1	5.7	5.0	5.0	4.9	5.4
Primary deficit	-1.8	-0.3	-0.1	1.8	2.4	0.6	0.7	0.7	0.7	0.7	1.0
							II. Stress Tests for Public Debt Ratio				**Debt-stabilizing primary balance 11/**
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 8/					**27.1**	**20.5**	**15.7**	**12.7**	**10.2**	**8.3**	**-1.5**
A2. Primary balance under no policy change in 2005-09					**27.1**	**22.3**	**19.3**	**17.6**	**16.8**	**16.4**	**-1.0**
A3. Country specific low case scenario 9/					**27.1**	**26.7**	**28.4**	**26.0**	**26.0**	**24.3**	**-1.2**
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006					**27.1**	**24.0**	**22.2**	**21.0**	**20.0**	**19.5**	**-1.1**
B2 a. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 (unchanged nominal expenditure)					**27.1**	**29.3**	**38.5**	**46.2**	**54.1**	**62.2**	**-2.6**
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)					**27.1**	**29.3**	**38.5**	**36.9**	**35.7**	**35.1**	**1.7**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006					**27.1**	**24.6**	**24.1**	**22.8**	**21.9**	**21.3**	**-1.2**
B4. Combination of 2-4 using one standard deviation shocks					**27.1**	**25.2**	**24.1**	**22.7**	**21.5**	**20.9**	**-1.2**
B5. One time 30 percent real depreciation in 2005 10/					**27.1**	**33.8**	**29.4**	**27.9**	**26.7**	**26.0**	**-1.3**
B6. 10 percent of GDP increase in other debt-creating flows in 2005					**27.1**	**31.6**	**27.5**	**26.1**	**25.0**	**24.3**	**-1.3**

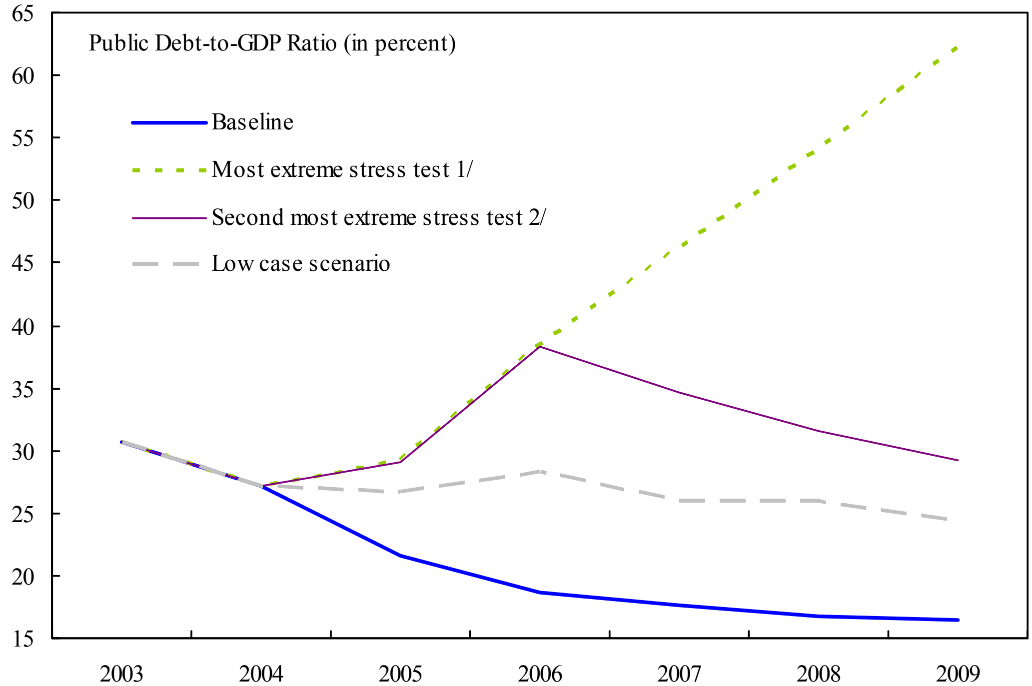
1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ 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 low case scenario is shown in detail in the Medium-Term Framework Table and discussed in the text. It assumes an external shock that reduces GDP growth to 1 percent in 2005 and 2 percent in 2005. The sudden drop in GDP growth is assumed to also have a negative impact on the ability of bank borrowers to repay their debt. Additional capital requirements for banks are assumed to be borne as fiscal costs.
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.

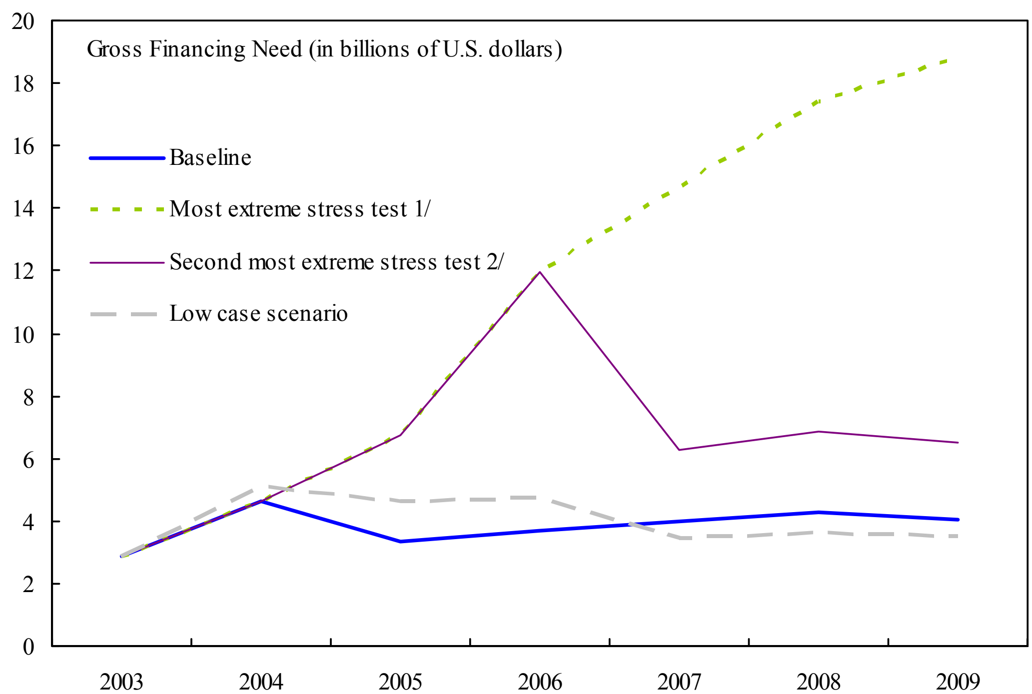
Table 2. Ukraine: Baseline Scenario: External Debt Sustainability Framework, 2002-2009
(In percent of GDP, unless otherwise indicated)

	2002	Est. 2003	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**	24.0	21.9			**19.2**	**15.7**	**12.6**	**10.9**	**10.0**	**9.4**	**-3.5**
2 Change in external debt	-2.6	-2.2			-2.7	-3.5	-3.1	-1.7	-0.8	-0.7	
3 Identified external debt-creating flows (4+8+9)	-7.8	-10.4			-13.9	-6.3	-4.5	-3.3	-2.8	-2.2	
4 Current account deficit, excluding interest payments	-8.6	-6.9			-11.0	-4.9	-2.4	-0.7	0.1	1.0	
5 Deficit in balance of goods and services	-4.4	-2.6			-7.5	-3.0	-1.0	0.5	1.2	2.0	
6 Exports	55.1	58.4			62.8	53.2	46.6	43.8	43.4	43.3	
7 Imports	50.7	55.8			55.3	50.1	45.6	44.2	44.7	45.4	
8 Net non-debt creating capital inflows (negative)	2.4	-1.0			-1.5	-1.3	-2.0	-2.5	-3.0	-3.3	
9 Automatic debt dynamics 1/	-1.6	-2.5			-1.4	-0.2	-0.1	0.0	0.1	0.1	
10 Contribution from nominal interest rate	1.1	1.0			0.8	0.8	0.7	0.6	0.6	0.6	
11 Contribution from real GDP growth	-1.3	-1.9			-2.2	-1.0	-0.7	-0.5	-0.5	-0.5	
12 Contribution from price and exchange rate changes 2/	-1.5	-1.5			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	5.3	8.2			11.3	2.8	1.4	1.5	2.0	1.5	
External debt-to-exports ratio (in percent)	43.7	37.4			30.6	29.5	27.1	24.8	23.1	21.6	
Gross external financing need (in billions of US dollars) 4/	-2.2	-1.6			-5.0	-1.6	0.0	1.1	1.7	3.0	
in percent of GDP	-5.3	-3.3			-8.0	-2.1	-0.1	1.0	1.5	2.4	
Key Macroeconomic Assumptions			7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	5.3	9.4	3.5	5.2	12.5	6.0	5.5	5.0	5.0	5.0	6.5
GDP deflator in US dollars (change in percent)	5.9	6.8	-0.8	14.8	10.8	14.8	15.3	8.9	4.2	4.0	9.7
Nominal external interest rate (in percent)	4.7	4.9	6.6	2.3	4.5	5.1	5.1	5.2	5.6	6.0	5.3
Growth of exports (US dollar terms, in percent)	10.7	24.0	5.8	12.4	33.9	3.1	6.5	7.4	8.6	8.9	11.4
Growth of imports (US dollar terms, in percent)	5.0	28.7	4.9	17.1	23.4	10.3	10.6	10.9	10.5	10.9	12.8
Current account balance, excluding interest payments	8.6	6.9	4.8	4.2	11.0	4.9	2.4	0.7	-0.1	-1.0	3.0
Net non-debt creating capital inflows	-2.4	1.0	0.8	1.6	1.5	1.3	2.0	2.5	3.0	3.3	2.3
							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 6/					**19.2**	**20.5**	**20.7**	**19.8**	**19.1**	**17.5**	**-2.6**
A2. Country-specific low case scenario 8/					**19.2**	**17.5**	**16.3**	**14.5**	**12.5**	**11.3**	**-4.6**
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006					**19.2**	**16.6**	**14.3**	**12.4**	**11.5**	**10.8**	**-3.6**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					**19.2**	**18.5**	**17.6**	**15.5**	**14.3**	**13.1**	**-4.6**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006					**19.2**	**29.1**	**43.3**	**39.1**	**36.3**	**32.5**	**-9.9**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006					**19.2**	**24.0**	**25.8**	**23.0**	**21.7**	**20.7**	**-3.9**
B5. Combination of 2-5 using one standard deviation shocks					**19.2**	**30.4**	**42.4**	**37.4**	**35.2**	**33.3**	**-8.0**
B6. One time 30 percent nominal depreciation in 2005					**19.2**	**26.1**	**22.3**	**19.8**	**18.4**	**16.8**	**-5.4**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, 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 [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 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.
8/ The low case scenario is shown in detail in the Medium-Term Framework Table and discussed in the text. It assumes an external shock that reduces GDP growth to 1 percent in 2005 and 2 percent in 2005. The sudden drop in GDP growth is assumed to also have a negative impact on the ability of bank borrowers to repay their debt. Additional capital requirements for banks are assumed to be borne as fiscal costs.
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) rema at their levels of the last projection year.

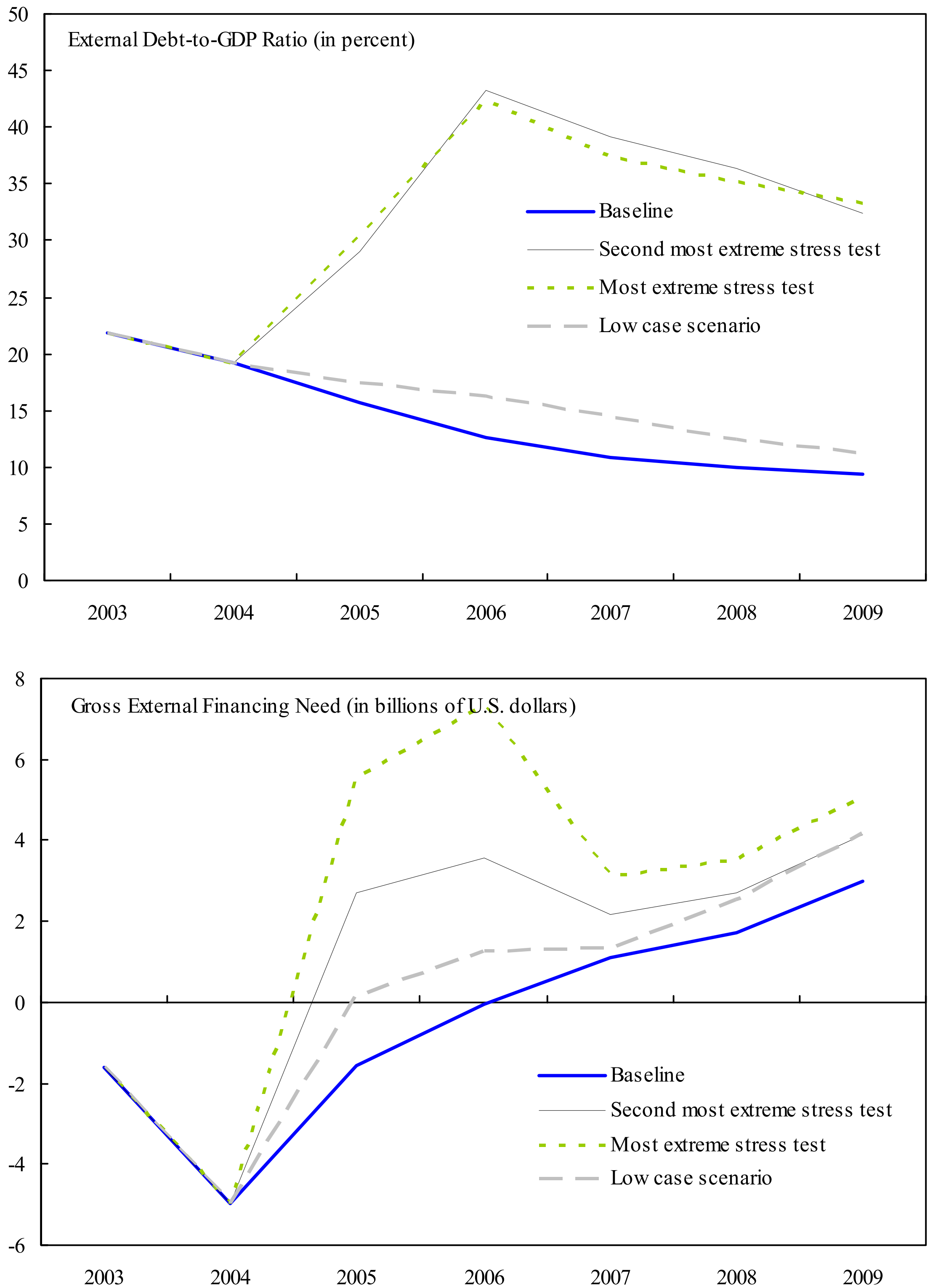
Figure 1. Ukraine: Public Debt Sustainability:
Debt Ratio and Gross Financing Need, 2003-09





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: External Debt Ratio and Gross External Financing Need, 2003-09



Source: IMF staff calculations.

INTERNATIONAL MONETARY FUND

UKRAINE

Staff Report for the 2004 Article IV Consultation

Supplementary Information

Prepared by the European Department

(In consultation with the Fiscal Affairs
and Policy Development and Review Departments)

Approved by Carlo Cottarelli and Michael T. Hadjimichael

October 18, 2004

1. This supplement provides information on developments since the staff report was issued. The new information strengthens the concerns expressed in the staff appraisal (see below), particularly with regard to the procyclical loosening of fiscal policy.

2. **Inflation continues to edge up.** Despite the government's attempt to contain increases in gasoline and food prices, modest central bank sterilization operations, and an excellent harvest, annual CPI inflation rose to 10.7 percent in September, thus hitting double digits for the first time since June 2001. In response, the National Bank of Ukraine raised its discount and overnight refinance rates by 50 basis points in October. Since May seasonally-adjusted monthly inflation has remained, at 1 percent, more than double the average over the first four months of the year. Annual PPI inflation also continued to increase and reached 23.2 percent. Moreover, recently released data on household income and consumption show a sharp acceleration of expenditure in August. This and the recent loosening of fiscal policy are clear harbingers of further inflationary pressures. As a result, the staff projects that CPI inflation could reach 11 percent by year end. The authorities maintain that inflation will revert to single digits.

3. **In the run-up to the presidential election, spending pressures are rising.** The government approved an increase in the minimum monthly pension from HRV 130 ($25) to HRV 284.6 ($54), effective retroactively September 1, 2004. This increase—which follows two earlier sizeable increases in the year—boosts the monthly pension bill by 36 percent for the remaining four months of the year, raising government expenditure by about 1¼ and 3 percent of GDP in 2004 and 2005, respectively. The government has also decided to clear wage arrears at state and bankrupt agricultural enterprises, and to increase social spending. Looking ahead, both leading presidential candidates have announced new plans for more aggressive tax rate reductions than envisaged so far, and additional compensation for lost savings from the hyperinflation of the early 1990s, adding yet more uncertainty about the stance of future fiscal policy.

4. **With much of the increase in government spending now clearly recurrent and in the absence of offsetting measures, the fiscal outlook for 2004 and 2005 has deteriorated substantially.** More specifically:

Ukraine: Consolidated Budget Deficit, 2004-05

	2004			2005		
	Prog.	Staff report (proj.)	Oct. (proj.)	Staff report (proj.) 1/	Budget 2/	Oct. (proj.) 3/
			(In percent of GDP)			
1. Revenues	37.3	35.5	35.6	33.7	35.7	35.0
2. Expenditures	39.0	38.9	40.2	35.3	37.5	41.2
o.w. pensions	9.9	9.7	10.9	9.7	9.3	12.2
3. Corrective measures to be identified 4/	**...**	**...**	**...**	**...**	**...**	**4.4**
4. Overall balance (1+2+3)	-1.8	-3.4	-4.6	-1.6	-1.8	-1.8
Financing	1.8	3.4	4.6	1.6	1.8	1.8
External	0.4	1.7	1.7	0.4	0.1	0.5
Domestic	0.5	-0.9	-0.2	0.0	0.6	0.1
Privatization	0.8	2.6	3.1	1.2	1.1	1.1
Memorandum items		(Annual change in percent, unless otherwise indicated)				
Revenues	11.4	19.5	21.0	9.5	17.0	12.2
Expenditures	14.5	28.5	34.0	4.7	8.9	19.4
Pensions	31.9	44.3	64.3	13.8	-0.4	31.0
GDP (in billions of hryvnias)	292.0	328.5	332.0	379.5	387.3	387.1

Sources: Ukrainian authorities; and Fund staff projections.

1/ Staff report projections assume a reduction in the VAT rate from 20 percent to 17 percent in 2005 (accounting for 0.8 percent of GDP), based on the July discussions.
2/ The budget assumes that the VAT rate is not cut in 2005 (since planned legislation has not yet been approved); and does not incorporate the recent pension increase. Note also that the actual budget numbers for revenues and expenditures are 2 percent of GDP higher than reported in the table, reflecting offset transactions.
3/ Staff assessment of the fiscal stance in 2005 is based on the draft budget and the recently approved measures.
4/ Corrective measures needed to achieve the target envisaged in the draft 2005 budget submitted to parliament in September.

- **Without corrective measures, the consolidated government deficit would rise to about 4½ percent of GDP in 2004.** To finance the pension increase and clear wage arrears over the rest of the year, the government has secured the budget committee's approval to spend HRV 4 billion of additional privatization proceeds (i.e., exceeding those projected under the amended budget). Staff estimates this additional spending to add about 1¼ percent of GDP to the staff report projection of the consolidated budget deficit. In September alone, the budget deficit was 1 percent of annual GDP. In communications with staff, the authorities have, however, reiterated their intentions to limit the consolidated budget deficit to 3 percent of GDP; this would be accomplished through a combination of more effective tax administration, spending delays, and under-spending of budget limits. In addition, the authorities have also noted that in 2002, despite parliamentary elections, government spending was successfully curbed at the end of the year when faced with budgetary difficulties; indeed the fiscal outturn was a surplus.

- **Given recent developments and policy measures, particularly on pensions, the draft 2005 budget, which was submitted to parliament in mid-September, is now obsolete.** While the draft 2005 budget—which targets a consolidated budget deficit of

1.8 percent of GDP—appears broadly in line with staff recommendations, it does not incorporate any of the recently approved measures. Thus, in the absence of adjustment, the consolidated budget deficit in 2005 could be much larger. First, spending would be up considerably. The pension increase will add about 3 percent of GDP to the deficit. Based on higher planned foreign borrowing and staff projections for local government own revenues, the staff expects local government expenditure to be ¾ percent of GDP above budget projections. Moreover, despite local government revenue overperformance, staff projects that consolidated overall budget revenues will fall short of budget target by ¾ percent of GDP, reflecting a less optimistic assumption about improvements in VAT administration. Altogether, achieving the 2005 budget target would require corrective measures of some 4½ percentage points of GDP. The necessary adjustment would become larger if the authorities proceeded with reducing VAT rates. This measure (rate cut from 20 percent to 17 percent) envisaged during the July discussions, is not included in the budget but the Prime Minister recently announced that he would soon submit it to the Cabinet of Ministers. Again in communications with staff, the authorities have indicated they expect that the approved 2005 budget will limit the consolidated deficit to about 2 percent of GDP.

5. **The authorities have budgeted substantial tax offsets in 2005.**[1] Total transactions would amount to HRV 7.4 billion (2 percent of GDP). Communal services arrears or a portion of the ratepayer's current bill would be netted against (a small portion of) lost savings from the 1990s hyperinflation; agriculture sector tax arrears would be netted against a contribution to food stock building; and Naftogaz tax arrears would be netted against further efforts by Naftogaz to improve its metering. Based on past experience with offsets, these transactions may add to, rather than correct, the arrears problems since new arrears could help economic agents secure their participation in a new offset round.

6. **VAT refund arrears have been drastically reduced.** The authorities have indicated that VAT refund arrears declined to HRV 295 million at end-August. This result reflected (i) a large surge in securitization of these claims, virtually exhausting the securitization scheme in the 2004 budget, (ii) increased use of netting against other taxes, and (iii) a significant increase in rejections of new VAT refund claims (40 percent of claims rejected in July and August in contrast to a rejection rate of 9 percent in the first half of the year). Based on past experience, it is uncertain whether the good performance in July and August will be sustained.

Staff Appraisal

[1] In principle, these offsets affect revenues and spending by the same amount. In order to facilitate the comparison with the staff report projections, they are not included in the last two columns of the text table in paragraph 4 (see footnote 2 of that table).

7. **The recent fiscal developments require prompt correction**. The significant increase in recurrent government spending, particularly pensions, resulting from the amended budget's use of one-off privatization receipts, is inappropriate and places public finances on less firm footing, thus compromising the 2005 budget. Indeed, the authorities' objectives of cutting the VAT rate, spending more on infrastructure and social needs, raising pensions, and reversing the fiscal expansion are incompatible. The fiscal discipline that has been implemented over the past few years has served Ukraine well and has been instrumental in bringing about strong macroeconomic fundamentals. The staff therefore urges the authorities to adopt corrective measures as soon as possible in order to prevent hard-won stabilization gains, particularly low inflation, and a sound fiscal outlook from slipping away.

Table 1. Ukraine: Selected Economic Indicators, 1999–2005

	1999	2000	2001	2002	2003 Est.	2004 Prog. 1/	2004 Proj.	2005 Proj.
Output and employment								
Real GDP (annual change in percent)	-0.2	5.9	9.2	5.2	9.4	6.0	12.5	6.0
Nominal GDP (in billions of hryvnias)	130.4	170.1	204.2	225.8	264.2	292.0	328.5	379.5
Nominal GDP (in billions of U.S. dollars)	31.6	31.3	38.0	42.4	49.5	54.8	61.7	75.1
Unemployment rate (ILO definition)	11.9	11.7	11.8	10.1	9.1	...	...	...
Prices and wages (percent change)								
Consumer prices, period average	22.7	28.2	12.0	0.8	5.2	7.1	8.3	8.1
Consumer prices, end of period	19.2	25.8	6.1	-0.6	8.2	6.0	9.0	7.0
Producer prices, end of period	15.7	20.6	0.9	5.7	11.1	5.5	20.0	7.0
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	36.0	37.0	37.3	35.5	33.7
Expenditure (cash basis)	34.2	34.7	35.1	35.5	37.7	39.0	38.9	35.3
Cash balance 2/	-2.4	-1.3	-1.6	0.5	-0.7	-1.8	-3.4	-1.6
Primary balance (cash basis)	0.0	1.8	0.4	1.8	0.3	-0.4	-2.4	-0.6
Commitments balance 3/	-1.4	2.1	-1.5	0.2	0.1	-0.8	-3.0	-1.0
Privatization proceeds	0.6	1.3	1.3	0.5	1.1	0.8	2.6	1.2
Net domestic financing	1.5	0.3	-0.1	-0.3	-1.2	0.5	-0.9	0.0
Net external financing 2/	0.2	-0.3	0.4	-0.7	0.8	0.4	1.7	0.4
Public debt and arrears (in percent of GDP) 4/	66.7	47.0	38.6	35.7	30.3	27.7	27.1	21.6
o.w. external debt	39.5	33.1	26.6	24.0	21.9	19.5	19.2	15.7
Money and credit (end of period, percent change)								
Base money	39.2	40.1	37.4	33.6	30.1	16.3	45.0	19.7
Broad money	40.4	45.5	41.9	41.8	46.5	24.1	43.8	26.7
Credit to nongovernment	43.5	61.3	40.5	47.3	63.4	25.1	32.5	28.9
Velocity 5/	5.9	5.3	4.5	3.5	2.8	2.5	2.4	2.2
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	7.5	5.8	3.7	10.2	4.1
Gross reserves (end of period, in billions of U.S. dollars)	1.1	1.5	3.1	4.4	6.9	7.8	11.9	13.6
In months of next year's imports of goods and services	0.7	0.9	1.7	1.9	2.4	3.0	3.8	3.9
Debt service (in percent of exports of goods and services) 4/	15.8	10.4	8.7	5.7	6.3	6.4	4.8	5.2
Exports (annual change in percent)	-3.7	19.2	8.7	9.2	27.2	6.3	38.7	3.1
Imports (annual change in percent)	-20.5	15.4	13.0	6.3	33.7	8.4	25.0	10.8
Savings and investment (in percent of GDP)								
Foreign savings	-5.2	-4.7	-3.7	-7.5	-5.8	-3.7	-10.2	-4.1
Gross domestic savings	24.6	24.2	25.5	27.7	26.1	25.3	31.6	28.3
Nongovernment	25.0	23.3	24.0	24.1	22.6	24.5	30.7	26.4
Government	-0.4	0.9	1.5	3.6	3.5	0.7	0.9	1.9
Gross domestic investment	19.4	19.4	21.8	20.2	20.3	21.6	21.3	24.3
Nongovernment	17.4	17.3	18.7	17.1	16.1	19.2	17.1	20.8
Government	2.0	2.1	3.1	3.0	4.2	2.5	4.3	3.5
Exchange rate								
Hryvnia per U.S. dollar, end of period	5.2	5.4	5.3	5.3	5.3	…	...	...
Hryvnia per U.S. dollar, period average	4.1	5.4	5.4	5.3	5.3	…	...	...
Real effective exchange rate, (percent change) 6/	-16.3	-4.4	6.0	-4.1	-6.3	…	...	...

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.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/7
FOR IMMEDIATE RELEASE
January 24, 2005

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

IMF Executive Board Concludes 2004 Article IV Consultation with Ukraine

On October 25, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.[1]

Background

Six years after the 1998 financial crisis, Ukraine continues to recover strongly. In 2003 real GDP grew by 9.4 percent, despite a poor harvest and reached 13.5 percent through July 2004. Growth in 2003–04 has been prompted by favorable external demand, a competitive cost structure, and dynamic domestic demand. Export growth has averaged 25 percent (year-on-year) since end-2002, yielding a sizeable current account surplus and foreign reserve accumulation. Despite the strong growth, unemployment remains high at about 9 percent, according to International Labor Organization's definitions.

Inflation has been moderate, but strong upward pressures are emerging. From a low of -0.6 percent in December 2002, the 12-month Consumer Price Index (CPI) rate reached 8.2 percent in December 2003 and increased to 10.7 percent in September 2004. Producer Price Index (PPI) inflation was 23.2 percent in September 2004 reflecting mostly higher world prices for energy and metals. Even excluding these items, core PPI inflation exceeded 10 percent. Wages continue to grow strongly. In June 2004, the average nominal monthly wage for the entire economy was 26.3 percent above its level the previous year.

---

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

Fiscal policy remained prudent through mid-2004. The consolidated government cash deficit was 0.7 percent of GDP in 2003. Through end-June 2004, it amounted to 0.2 percent of (annual) GDP versus an end-June adjusted program ceiling of 0.9 percent. However, the outturn reflects an accumulation of VAT refund arrears; had the programmed reduction occurred, the deficit would have been one percent of GDP. Indeed, general problems with VAT administration contributed to an overall drop in the revenue/GDP ratio, and led the president to replace senior management in the State Tax Administration in June. In the run-up to the presidential elections, the government approved an increase in the minimum monthly pension from Hrv 130 ($25) to Hrv 284.6 ($54), effective retroactively, September 1, 2004. This increase—which follows two earlier sizeable increases in the year—boosts the monthly pension bill by 36 percent for the remaining four months of the year, raising government expenditure by about 1¼ and three percent of GDP in 2004 and 2005, respectively. As a result, the draft 2005 budget, which was submitted to parliament in mid-September and targeted a consolidated budget deficit of 1.8 percent of GDP, is now obsolete. Provisional data show that this year fiscal deficit has increased to 1½ percent of GDP as of end-September.

In the context of a de facto peg to the dollar, strong money growth has until very recently been consistent with single-digit inflation, amid continued remonetization and a modest monetary policy tightening. In the first part of 2004, a large build-up of government deposits helped moderate base-money growth, despite the National Bank of Ukraine’s (NBU) pronounced interventions in the foreign exchange market that led to strong NIR accumulation. Starting in May, the NBU has tightened monetary policy, including by issuing Certificates of Deposit (CDs) (although in low volumes) and raising reserve requirements. The discount rate was raised again by 50 basis points to eight percent in early October.

Competitiveness remains strong. In the 12 months to June 2004, the real effective exchange rate depreciated by four percent, reflecting mainly Ukraine's low inflation vis-à-vis Russia, and the strengthening euro. Average wages remain less than half Russia’s wages.

Despite the NBU’s ongoing steps to strengthen prudential regulation and banking supervision, credit expansion and credit quality remain a concern. The credit-to-GDP ratio stands at 29.5 percent compared to 12.4 percent in 2000. While credit expansion has decelerated since early 2004, loans have increased to about two-thirds of bank assets. Nonperforming loans classified by past due criteria are estimated at eight percent of total loans.

There has been progress in the structural reform agenda, but tax administration should improve. Income taxes have been cut and the tax base broadened by eliminating some exemptions, the pension system reformed, and collection ratios in the energy sector have improved. However, several actions under program conditionality—concerning related-party lending, tax preferences and exemptions, and VAT refund arrears—have not been completed.

Executive Board Assessment

Directors noted that the impressive macroeconomic developments over the last few years—fast growth, declining inflation and strong external position—owed much to the prudent macroeconomic and structural reform policies followed until recently. They expressed concern, however, about the fiscal expansion underway in the context of an already rapidly growing economy, and stressed the need to return to a more prudent fiscal stance. Moreover, structural policies needed to be stepped up to raise sustainable growth over the medium term. In this context, Directors regretted that the review of the Stand-By Arrangement could not be completed as scheduled.

Directors welcomed several positive features of Ukraine's recent macroeconomic performance. Growth has been booming, the external current account surplus has reached record levels, market confidence has improved, and, accordingly, official international reserves have increased considerably. However, Directors noted that capacity bottlenecks were now emerging, strong foreign exchange inflows continued to fuel domestic liquidity, and fiscal discipline was increasingly being undermined, pushing inflation up to double digits.
They stressed that the overheating pressures and the fact that current activity was largely supported by the external sector, while banks' portfolios had expanded significantly, were reminders that the economy remained vulnerable to shocks.

In this context, Directors felt that the loosening of fiscal policy in 2004 increased the risks of overheating. They noted that, although the surge in the deficit this year was largely financed through higher-than-expected privatization proceeds, the significant increases in recurrent government spending, particularly pensions, compromised the 2005 budget and placed public finances on a less firm footing. Moreover, they emphasized that resources from the sale of public assets would be better used to retire existing debt so as to build room against future contingencies and for the sizable medium-term public spending needs, including in infrastructure.

Directors, noting that fiscal discipline had served Ukraine well in the past, urged the authorities to take prompt corrective measures to restore a sound fiscal outlook and to avoid a sizable slippage with respect to the original fiscal target for 2004—a consolidated budget deficit of 1¾ percent of GDP. A large correction was also needed to achieve the consolidated budget deficit envisaged in the draft 2005 budget of 1¾ percent of GDP.

Directors encouraged expenditure prioritization through further development of a medium-term budget framework, but cautioned against hasty tax rate reductions before the tax base was broadened and tax administration strengthened. While welcoming the recent sharp reduction in VAT refund arrears, Directors remained cautious on whether the good performance will be sustained, and saw significant scope for further improving VAT administration.

Directors noted that the real exchange rate would be subject to appreciation pressures in the medium term, and, given the choice between inflation and nominal appreciation in realizing this appreciation, they considered a move toward a more flexible exchange rate regime more beneficial to Ukraine. In this respect, Directors felt that the de facto peg to the U.S. dollar was now exacerbating the challenge for the NBU to achieve its inflation objective. It also contributed to a distorted saving-investment position and provided an implicit exchange rate guarantee, with attendant risks for the financial stability of the private sector as a whole. Many Directors referred to the vulnerability of the banking system, observed the need for appropriate sequencing, and suggested that the pace of movement toward flexibility should be left to the judgment of the authorities.

While welcoming the NBU's increasing efforts to drain liquidity, Directors noted that monetary conditions remained too loose to ensure attainment of the original inflation objective in 2004 and beyond. In the face of additional government spending, mounting inflationary pressures and absent greater exchange rate flexibility, Directors felt that the NBU should tighten monetary policy further to achieve its objective of bringing inflation back to single digits.

Directors commended the NBU on the continued progress in strengthening prudential banking regulation and supervision. The various actions taken to improve the monitoring of credit growth and of the adequacy of banks' capital and risk management practices were welcome. However, they regretted that the draft amendments to the Banking Act, which would allow identification of bank owners and tighten related-party lending, had not yet been adopted by parliament. While stressing the need to continue addressing the banking sector's vulnerabilities, Directors encouraged the authorities to raise the minimum capital adequacy ratio to 12 percent, to contain risk from foreign currency loans, and to adopt tighter accounting and reporting standards for corporations. They welcomed the inclusion of collective action clauses in Ukraine's 2004 Eurobond issues.

Directors agreed that sustaining high medium-term growth required a better investment climate. In this context, Directors noted that governance problems remained widespread, ranging from tax collection and public procurement to law enforcement and divestment of public assets. They regretted that, while privatization had recently accelerated, procedures remained nontransparent. Directors welcomed the recent fall in the energy sector quasi-fiscal deficit. They also advised prompt passage of important legislation, such as the energy debt restructuring law and the joint-stock company law; a reduction in the burden of licensing and inspection regimes; and a strengthening of the judiciary and of contract enforcement.

Directors noted that, while broadly adequate for surveillance, statistical data could be improved, particularly with regard to the national accounts and the balance of payments.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Ukraine is also available.

Ukraine: Selected Economic Indicators

	2000	2001	2002	2003 Est.	2004 Proj. 1/	2005 Proj. 2/
	(Percent change, unless indicated otherwise)					
Production and prices						
Nominal GDP (in billions of hryvnia)	170.1	204.2	225.8	264.2	332.0	387.1
Real GDP growth	5.9	9.2	5.2	9.4	12.5	6.0
Consumer price index (period average)	28.2	12.0	0.8	5.2	8.8	9.5
Consumer price index (end of period)	25.8	6.1	-0.6	8.2	11.0	7.0
	(In percent of GDP)					
Public finance						
Consolidated government budget balance, cash basis	-1.3	-1.6	0.5	-0.7	-4.6	-1.8
Primary balance	1.8	0.4	1.8	0.3	-3.6	-0.9
Revenue	33.4	33.5	36.0	37.0	35.6	35.7
Expenditure	34.7	35.1	35.5	37.7	40.2	37.5
Public debt and arrears (in percent of GDP)	47.0	38.6	35.7	30.3	26.9	21.8
	(Percent change, unless indicated otherwise)					
Money and credit						
Base money	40.1	37.4	33.6	30.1	50.5	21.4
Broad money	45.5	41.9	41.8	46.5	45.3	27.5
Credit to nongovernment	61.3	40.5	47.3	63.4	31.3	28.4
Velocity (annual GDP divided by end of period broad money)	5.3	4.5	3.5	2.8	2.4	2.2
External sector						
Current account balance (in percent of GDP)	4.7	3.7	7.5	5.8	10.2	4.1
External public debt (in percent of GDP)	33.1	26.6	24.0	21.9	19.0	15.1
Debt service (in percent of exports of goods and services)	10.4	8.7	5.7	6.3	4.8	5.2
Terms of trade (annual change in percent)	-8.2	1.3	1.6	8.6	13.0	-6.1
Gross reserves (end of period, in months of next year's imports of goods and services)	0.9	1.7	1.9	2.4	3.8	3.9

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

1/ Fiscal deficit assumes pension increase and execution of the amended budget.
2/ Assumes a fiscal deficit limited to that envisaged under the draft budget submitted to parliament in September.
Actual budget numbers for revenues and expenditures are 2 percent of GDP higher than reported in the table, reflecting offset transactions.