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2013 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR UKRAINE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV Consultation and First Post-Program Monitoring, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 16, 2013, following discussions that ended on October 29, 2013, 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 December 2, 2013
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of December 16, 2013 updating information on recent developments.
- **Press Release** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its December 16, 2013 consideration of the staff report on issues related to the Article IV Consultation and First Post-Program Monitoring.
- A **Statement by the Alternate Executive Director** for Ukraine.

The following document has been or will be separately released.

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INTERNATIONAL MONETARY FUND

UKRAINE

December 2, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING

KEY ISSUES

Context: Weak external demand and inconsistent macroeconomic policies have contributed to a prolonged economic recession. A combination of an effectively pegged exchange rate, loose fiscal policy, and sizable quasi-fiscal losses in the energy sector has pushed the fiscal and external current account deficits to very high levels. A gradual depletion of international reserves and other buffers is making the economy particularly vulnerable to external shocks.

Outlook and risks: A modest economic recovery should commence in late 2013. However, a difficult business climate and impaired external competitiveness are weighing on the medium-term outlook. The current policy mix is not sustainable as it generates large imbalances and depresses growth. The risk of a costly market-forced adjustment is high.

Main policy recommendations:

- Allow the exchange rate to adjust to its equilibrium level and increase its flexibility. Accelerate preparations for the introduction of inflation targeting.
- Strengthen the financial system's resilience to shocks, including by developing comprehensive contingency plans to cover potential capital and liquidity shortfalls under various scenarios.
- Curtail the fiscal deficit through a reform-based current expenditure consolidation and the cancelation of unaffordable tax cuts.
- Reduce the quasi-fiscal losses in the energy sector by increasing the very low household gas and heating tariffs in the context of a comprehensive energy sector reform plan, while protecting the most vulnerable households.
- Launch broad structural and governance reforms to improve the business climate and boost sustainable growth.

Approved By
Poul M. Thomsen and Mark Flanagan

Discussions were held in Kyiv during October 17–29, 2013. The mission met with Prime Minister Azarov; First Deputy Prime Minister Arbuzov; Minister of Finance Kolobov; Minister of Revenues and Duties Klymenko; Minister of Economic Development and Trade Prasolov; Minister of Energy Stavitskyi; Governor of the National Bank of Ukraine Sorkin; and other senior officials, ambassadors, and representatives of international financial institutions, research institutes, trade unions, and business community. The staff team comprised Mr. Gueorguiev (head); Mr. Gorbanyov, Ms. Kaltani, and Ms. Jajko (EUR); Messrs. Kazarian (MCM), Poghosyan (FAD), and Youssef (SPR). Mr. Vacher (Resident Representative) assisted the mission. The mission cooperated closely with World Bank staff. Mr. Petryk, Alternate Executive Director for Ukraine, attended many policy meetings.

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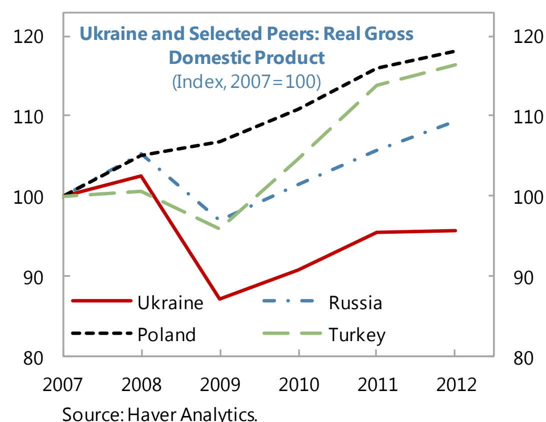
CONTEXT

1. Incomplete transition to a market economy holds back Ukraine's economy. While significant progress has been made in establishing basic markets and reducing poverty, extensive state presence in the economy—a large state budget, distorting price regulation, and pervasive governance deficiencies—weighs heavily on economic growth, deterring the best use of abundant natural and human resources. The recovery from the global crisis in 2008–09, which hit Ukraine particularly hard, has been lagging behind that of peers (Figure 1). Progress with structural reforms has been slow (Figure 7) and the business climate—although improved in some areas—is considered difficult by local and foreign businesses alike.



2. Inconsistent macroeconomic policies generate deep-seated vulnerabilities and recurrent crises. Ukraine has long relied on an effectively pegged exchange rate as a nominal anchor, accompanied by loose fiscal policy and sizable quasi-fiscal losses ultimately covered by the budget (and monetized by the NBU, which holds over 60 percent of domestic government debt). This policy mix results in an overvalued exchange rate, large twin deficits, a steady rise in indebtedness, recurrent difficulties with external financing, and low international reserves. Such vulnerabilities make the economy especially susceptible to external shocks and balance of payments crises, as in 1998 and 2008–09.

3. Political polarization, the upcoming presidential elections, and pressures from vested interests limit the authorities' policy space. The ruling coalition led by the Party of Regions remains in power after the parliamentary elections in October 2012. The majority and the opposition have cooperated in passing legislation necessary for concluding the association agreement with the EU. However, the unexpected government decision to suspend preparations for signing the agreement as planned on November 29 prompted large-scale mass protests not seen since 2004. Tensions remain high and may increase further in the run-up to the presidential elections in March 2015. Vested interests, notably in the energy sector, continue to act as a drag on needed reforms.

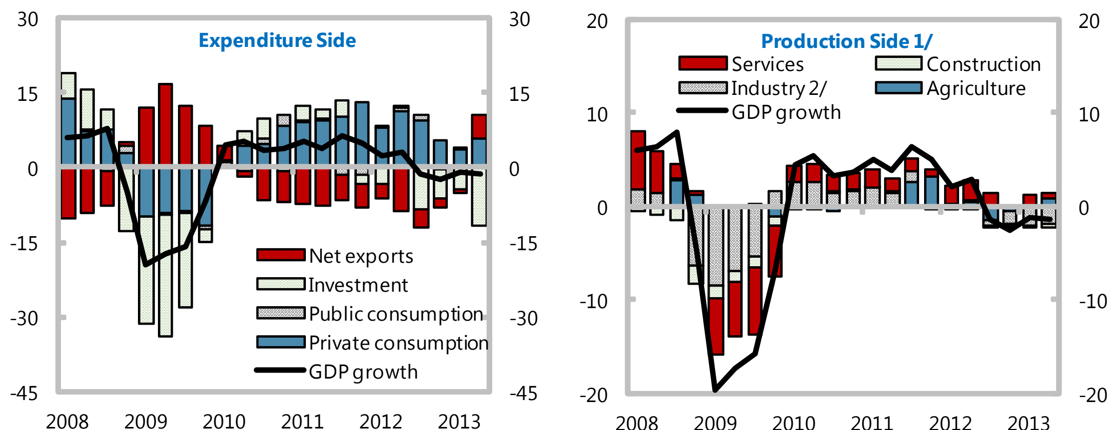
RECENT DEVELOPMENTS

4. The economy has been in recession since mid-2012. Although a 15 percent budget wage hike in 2012 boosted private consumption, weak external demand and falling investment dragged activity down after the positive effects of co-hosting the Euro 2012 Soccer Cup had dissipated (chart below). GDP contracted by 1.3 percent y-o-y in January–September 2013, but unemployment remains below its long-term average at 7.5 percent in mid-2013 (Figure 2). Consumer prices stayed

flat in 2013 (Figure 3), held down by falling food prices and tight monetary policy. The 12-month rolling current account deficit was 8 percent of GDP by end-September 2013, essentially unchanged from end-2012 despite the 22 percent reduction in natural gas imports in January–September 2013 (Figure 4).

Contribution to Real GDP Growth, 2008–13

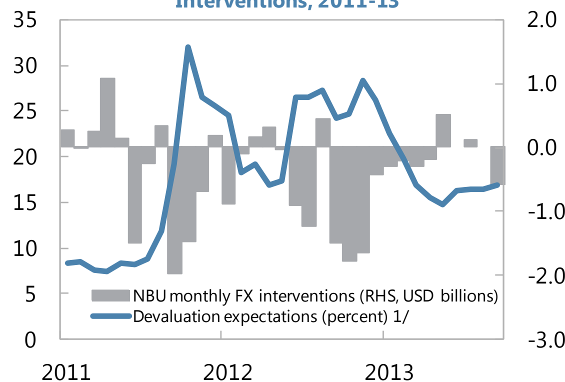
(Percent; year-on-year)



Sources: State Statistics Committee; and IMF staff calculations.
1/ Difference between GDP growth and sum of components accounted for by taxes minus subsidies.
2/ Industry includes mining, manufacturing, and energy.

5. Tight monetary policy has stemmed pressures on the foreign exchange market. In late 2012, devaluation expectations rose and demand for foreign currency spiked. Defending the exchange rate, the NBU intervened heavily, intensified foreign exchange controls, and squeezed bank liquidity. This prompted banks to raise deposit and lending rates and tighten credit conditions, exacerbating the recession. Persistent devaluation expectations and zero inflation kept real hryvnia interest rates in double digits (Annex III). The high rates prompted a 30 percent increase of hryvnia deposits in the year to September 2013. The banks used deposit inflows mainly to buy government securities and repay loans to the NBU, while credit to the economy expanded only by 7 percent y-o-y. Private balance sheets have maintained their moderate short foreign currency position since end-2012, with both loans and deposits in foreign exchange stagnating. In an attempt to relax monetary conditions while safeguarding reserves, the NBU lowered its main policy rate from 7.5 percent to 6.5 percent over the summer but raised the reserve requirements on foreign currency deposits by several percentage points.

Ukraine: Devaluation Expectations and NBU Interventions, 2011-13



Sources: NBU; Bloomberg; and staff estimates.
1/ Derived from 12-month NDF contracts on hryvnia.

6. Ukraine's market access has become much more difficult and international reserves are running low. In two Eurobond issues in early 2013, Ukraine raised US$2.25 billion at yields of about 7½ percent. Since late May, yields have hovered in the 8½–15 percent range. This led the

authorities to postpone further Eurobond issuance, while tapping domestic banks and NBU's international reserves for financing in foreign currencies. The recent downgrades of the sovereign by Moody's to Caa1 and S&P and Fitch to B- led to renewed spikes in the bond and CDS spreads (Figure 4); the bond yield curve inverted. By end-October, reserves fell to about 2.5 months of imports and 36 percent of debt service in 2014. Meanwhile, foreign banks have continued to reduce their exposure to Ukraine, but this has been more than offset in 2013 by asset repatriation by domestic banks to purchase government US$-denominated bonds.

7. The fiscal stance loosened in 2012, contributing to the buildup of vulnerabilities. Large pension and wage increases, generous energy subsidies, and soccer cup spending led to a widening of the general government deficit to 4½ percent of GDP in 2012, an expansion of 1½ percent of GDP in structural terms. The combined structural deficit of the government and the state-owned company Naftogaz, a perennial source of quasi-fiscal losses, rose to 6¾ percent.

8. To cope with fiscal pressures, the authorities have been increasingly resorting to off-balance sheet activity, non-cash settlements, and low quality measures. As rising wage and entitlement spending squeezes the budget, the authorities are trying to buoy public investment by extending large amounts of state guarantees. In 2012, the guarantees exceeded 5 percent of GDP, and could reach up to 3.5 percent of GDP in 2013 according to the budget law, although only about 0.7 percent of GDP has been allocated by end-October. In October, the parliament approved the use of the so-called promissory notes (government IOUs) for about 1¼ percent of GDP for repayment of overdue VAT refunds and expenditure arrears. The notes would be accepted as payments to Naftogaz. Finally, as budget revenue has been falling short of expectations, the central government has cut transfers to local governments and postponed low-priority budget spending.

9. Energy-related quasi-fiscal losses are mounting and large contingent liabilities may be looming. Despite lower gas imports, Naftogaz's losses in 2013:H1 more than doubled. The losses are generated by very low prices on sales to households and district heating companies and declining share of sales to the profitable commercial enterprise market. Naftogaz' shortage of funds has also led to delays in paying for gas imports despite restructuring of a US$2 billion loan from Russia's Gazprombank. As reduced imports defy the "take-or-pay" terms of its contract, Gazprom has announced an US$7 billion claim on Naftogaz for 2012, but has not taken legal steps to collect.

10. Ukraine's future trade and economic relations with the EU and Russia are unclear. In August–October 2013, the Ukrainian authorities intensified their efforts to meet the conditions for signing an association and free trade agreement with the EU. In this context, Russia's authorities announced that a free trade agreement with the EU would preclude Ukraine from participating in the regional Customs Union (including Russia, Belarus, and Kazakhstan). The Ukrainian authorities and businesses report that since August 2013, Russia's authorities have been tightening customs procedures and controls for Ukrainian exports. Moreover, Russian officials have stated that to prevent re-export of EU goods to the Customs Union, the current essentially free trade regime with Ukraine may revert to WTO's most favored nation status should Ukraine sign a free trade agreement with the EU. On November 21, the Ukrainian authorities unexpectedly suspended preparations for signing the agreement with the EU citing the need to sort out trade and economic relations with

Russia and the Customs Union first and calling for trilateral discussions between Ukraine, the EU, and Russia on the matter. As of the time of issuance of the staff report, the authorities' further intentions regarding economic relations with the EU and Russia remain unclear.

11. Meanwhile, the technical discussions on a possible new Fund-supported program continue. When the program supported by an SBA expired in December 2012 (Box 1), the authorities expressed their interest in a new arrangement with the Fund. Two missions visited Kyiv in early 2013, but the authorities were not able to commit to a set of policies that would adequately deal with Ukraine's deep-seated problems. In the context of the 2013 Article IV consultations, the authorities re-affirmed their interest in an arrangement with the Fund. Technical discussions with staff are ongoing to ensure that policy commitments are sufficient to address Ukraine's challenges.

Box 1. Ukraine: Stand-By Arrangements in 2008–12

In November 2008, the Executive Board approved a two-year, SDR 11 billion SBA with Ukraine (802 percent of quota). The primary objectives of the SBA-supported program were macroeconomic stabilization and adjustment amid the heavy impact of the global economic crisis of 2008–09. The program mitigated the effects of the steep currency devaluation in late 2008, while still allowing the exchange rate to find its market-driven equilibrium that dramatically improved the external position of the country. The program also helped stabilize the banking system and created preconditions for economic recovery. However, little ownership and insufficiently strong policy implementation amid political turmoil prevented tackling fundamental structural and institutional weaknesses of the country (IMF Country Report 11/325). Under that arrangement, two reviews were completed and SDR 7 billion disbursed before it went off track and was cancelled in mid-2010 upon the approval of the next arrangement.

In July 2010, the Executive Board approved a 29-month, SDR 10 billion (729 percent of quota) SBA. This SBA-supported program aimed to set public finances on a sustainable path, eliminate quasi-fiscal losses in the energy sector, facilitate transition to a flexible exchange rate regime, and further strengthen the financial sector. Its main achievements included a pension reform in 2011, initial energy tariff adjustments, and restoring international market access for Ukraine. Again, the authorities' program policy ownership waned, particularly in the key areas of energy tariff adjustment and exchange rate flexibility, and only one review was successfully completed. Two purchases totaling SDR 2.25 billion were made before the program went off track in 2011 and expired in December 2012.

EXTERNAL STABILITY ASSESSMENT

12. Competitiveness is weak and the REER overvalued (Annex I). High real wage growth amid slow productivity rise has eroded the gains from the 2009 devaluation, and the real exchange rate remains significantly misaligned (by 14–16 percent). Economy-wide unit labor costs and the ULC-based REER have exceeded their high 2008 levels. Staff estimates indicate that even if fiscal policy gaps were closed while maintaining the current exchange rate level, the need for a significant devaluation would persist.

13. Large gross financing needs pose substantial risks. Debt rollover risks are high with external debt above 75 percent of GDP and a gross external financing requirement of 37 percent of GDP in 2014 (Table 4). The rollover risks are mitigated to some extent by the fact that a large portion

of the debt represents significant inter-company lending and transfer pricing operations. The NBU's international reserves are low against several common metrics (Annex I).

OUTLOOK AND RISKS

14. A pick up in agriculture and rising external demand in partner countries should support a modest recovery from late 2013 on. The good agriculture performance will likely lead to an exit from the recession in 2013:Q4. However, GDP would still decline by ¼ percent in 2013 as weak industrial production and construction will outweigh the output boost from agriculture. Under currently planned policies, a modest growth of about 1 percent is expected in 2014, driven by improvements in external demand, strong grain exports, and continuing consumption expansion, while saving and investment would decline further. After hovering around zero in 2013, inflation would modestly rise to about 2 percent in 2014. The current account deficit would remain elevated above 8 percent of GDP in 2013–14, as the pick-up in demand would largely offset the export boost.

15. However, the current policy mix would sustain large imbalances and depress growth. An overvalued exchange rate and large fiscal and quasi-fiscal deficits would keep the current account deficit above 7 percent of GDP over the medium term, well above its estimated equilibrium level (Annex I). Even assuming that external financing remains at historical levels, which cannot be guaranteed, the depletion of the NBU's international reserves will continue unabated (Table 3). Remaining buffers and sporadic financing opportunities could allow maintaining stability for a while, but they would not be able to prevent an eventual market-forced adjustment if current policies remain in place. Meanwhile, the tight monetary policy in support of the exchange rate would keep constraining private investment, while public investment would be further displaced by high wage and pension spending. High labor costs relative to productivity would limit employment growth. Together with the difficult business climate, these factors would keep actual and potential growth depressed.

16. The risk of a costly market-forced adjustment is high. The decline in international reserves could trigger a run for foreign exchange, leading to a disruptive exchange rate shock that would compress demand, raise inflation, and hit banks. This risk could be exacerbated by (i) sustained loss of market access caused by the ongoing reappraisal of emerging market risk and Ukraine's deteriorating fundamentals; (ii) a more restrictive trade regime with Russia that could lead to sizable export losses; and/or (iii) loss of confidence in government policies as their focus alternates between integration with the EU and Russia.[1] Other global and local risks cloud the outlook as well (Annex II). On the upside, the possible—if postponed—signing of an association agreement with the EU could help exports and spur FDI over time, with potential gains magnified once competitiveness and the business climate are significantly improved.

[1] Russia accounts for about ¼ of Ukrainian exports, mainly base metals and machinery. Most of these exports are now exempt from customs duties under CIS and bilateral agreements.

REPORT ON DISCUSSIONS

A. The Policy Mix and Medium-Term Outlook

17. In discussion with authorities, staff highlighted the deep economic problems associated with the current policy mix and suggested an alternative. To maintain stability and revive growth, staff advised a decisive and comprehensive policy turnaround: (i) allow the exchange rate to adjust, eliminating overvaluation, and increase its flexibility; (ii) strengthen the financial system's resilience to shocks, including by developing comprehensive contingency plans to cover potential capital and liquidity shortfalls under various scenarios; (iii) launch fiscal consolidation to support the external adjustment and reduce financing risks; (iv) raise energy tariffs as part of a comprehensive plan to reduce quasi-fiscal losses, and (v) persevere with deep structural reforms to improve the business climate and raise growth. Several of these recommendations were already discussed during the 2012 Article IV consultation (Box 2).

18. The adjustment scenario outlined by staff would substantially reduce Ukraine's vulnerabilities and help revive growth (Table 7 and Figure 8). The exchange rate adjustment would significantly improve the external position of Ukraine and help rebuild international reserves. Energy tariff increases and fiscal restraint would help raise public savings—the key thrust of the package—and make space for public investment in infrastructure. Reduced vulnerabilities, regained access to international capital markets, structural reforms, and higher international competitiveness would promote higher private savings and investment, including FDI. Overall, after an initial dip caused by the need to tighten policies to support the external adjustment and contain inflation (¶21), growth should recover, led by exports and investment.

Ukraine: Baseline and Adjustment Scenarios, 2013–18

	2013	2014	2015	2016	2017	2018
	Projections					
Real GDP growth (percent)						
Baseline	-0.3	1.0	1.5	1.5	1.5	1.5
Adjustment	-0.3	0.5	3.5	4.0	4.5	4.5
CPI inflation (end of period)						
Baseline	0.2	2.3	3.8	4.0	4.0	4.0
Adjustment	0.2	12.9	5.9	5.2	5.0	5.0
Overall fiscal balance (including Naftogaz, percent of GDP)						
Baseline	-7.7	-6.6	-6.3	-8.0	-7.7	-7.6
Adjustment	-7.7	-4.0	-3.2	-2.8	-2.2	-2.0
Public and publicly guaranteed debt (end of period)						
Baseline	41.3	44.7	48.0	53.4	57.5	60.2
Adjustment	41.3	41.5	40.7	39.7	37.8	34.6
Current account balance (percent of GDP)						
Baseline	-8.3	-8.2	-7.7	-7.4	-7.1	-7.1
Adjustment	-8.3	-5.0	-4.1	-3.8	-3.8	-3.6
External debt (end of period)						
Baseline	76.7	75.3	74.7	75.1	75.2	75.2
Adjustment	76.7	84.6	80.8	79.9	78.6	77.8
Gross external financing requirements (USD billion)						
Baseline	72.5	67.6	71.2	78.0	85.1	88.9
Adjustment	72.5	61.8	64.5	71.0	78.9	84.6
Gross international reserves (percent of IMF composite measure)						
Baseline	38.6	21.3	16.5	14.1	11.8	10.2
Adjustment	38.6	50.5	62.1	81.2	105.9	137.5

Sources: Ukrainian authorities; and staff estimates.

Box 2. Ukraine: 2012 Article IV Consultation: Key Recommendations and Actions Taken

A year ago, Article IV discussion centered on policies to: (i) secure sound public finances; (ii) strengthen the finances of the energy sector; (iii) reduce financial vulnerabilities and revive lending; (iv) enhance the effectiveness of monetary policy; and (v) facilitate higher, sustainable medium-term growth. Progress in implementing staff's advice in most of these areas has been slow.

- *Fiscal recommendations.* Meeting the 1.8 percent of GDP deficit target in 2012 required immediate adoption of measures to (i) raise tax rates and eliminate exemptions; (ii) remove special tax treatment of offshore tax havens; (iii) cut current spending; and (iv) apply strict limits on state guarantees.

- *Progress:* Some progress has been achieved in closing transfer pricing tax loopholes, amending the tax treaty with Cyprus to raise some taxes, and automating VAT refunds. However, the general government deficit reached 4.5 percent of GDP in 2012, and government guarantees exceeded 5 percent of GDP.

- *Energy sector recommendations.* Raise household gas and heating tariffs (mitigated by better-targeted social assistance) and articulate a broader energy sector reform strategy.

- *Progress:* The tariffs remained essentially unchanged, and energy reforms have been very slow to progress.

- *Monetary/exchange rate recommendations.* Increase exchange rate flexibility. Gradually unwind crisis-era policies, including Resolution 109 that forced banks to hold negative open foreign exchange positions.

- *Progress:* NBU continued defending the effective exchange rate peg, and the official exchange rate UAH/US$ remained fixed. Unwinding Resolution 109 was limited to a pilot project that allowed several banks to include government foreign exchange-linked bonds in the calculation of the net open foreign exchange position.

- *Financial sector recommendations.* Staff urged a review of contingency plans, strengthened monitoring, and creation of a dedicated financial stability unit, as well as close supervision of banks to ensure compliance with prudential norms.

- *Progress:* Reported financial stability indicators point to gradual strengthening of the financial system. With the help of IMF technical assistance, financial stability unit in the NBU has been created and become operational.

- *Structural reform recommendations.* Reforms to promote growth, improve the business climate, and attract investment, including global integration, deregulation, stronger governance, and privatization.

- *Progress:* Reforms allowed Ukraine to advance in the World Bank's *Doing Business* international competitiveness ranking, but business people report that the business climate remains very challenging, as evidenced by declining domestic investments and FDI. Governance issues persist, particularly in public procurement and the opaque energy sector.

19. Authorities' views. The authorities recognized the risks and agreed in principle that corrections to current policies are needed. They are currently elaborating policy adjustments in several areas. However, their assessment of the degree and speed of the necessary changes in monetary, fiscal, and energy policies differed from staff's views. To minimize the reforms' adjustment costs, the authorities preferred a gradual approach in the context of a comprehensive macroeconomic adjustment program, preferably supported by a financial arrangement with the Fund. They also saw the economic outlook more positively, emphasizing the positive impact of the good grain harvest on output and exports.

B. Moving Towards a Sustainable Exchange Rate Regime and Monetary Framework

20. Allowing the exchange rate to adjust to its equilibrium level and increasing its flexibility thereafter is necessary for a sustainable correction of external imbalances. Staff considers it essential to allow the exchange rate to move to the level that would correct the estimated real overvaluation—taking into account the adjustment's own effect on inflation—and enable the NBU to replenish its international reserves through market purchases. This adjustment should be accompanied by the introduction of a wide band around the new parity, within which the exchange rate should be allowed to float freely. With confidence in the new regime and the NBU's ability to control inflation rising over time, the exchange rate band could be widened further and eventually abandoned with the formal introduction of inflation targeting (¶23).

21. The exchange rate adjustment should be accompanied by tight policies to contain inflation. As inflation is currently near zero, it would remain manageable after the adjustment. Tight monetary policy, conducted through strict limits on the NBU's NDA—while allowing adequate liquidity provision to banks early on—and positive policy interest rates in real terms will help contain the second round effects on private wages and inflation expectations. Tight fiscal policy (discussed below) will support monetary policy.

22. Staff advised against extensive use of administrative foreign exchange controls as a substitute for the needed policy adjustment. To prop the overvalued exchange rate, Ukraine already uses various administrative measures designed to limit demand for foreign exchange and increase its supply, and has tended to intensify such measures at times of market tensions.[2] However, they are costly for the economy and may be counterproductive if they thwart vital inter-company lending and diminish policy credibility. Staff advised the authorities not to intensify existing controls and begin to dismantle them gradually once a package of adjustment policies is in place. Staff also advised the NBU to eliminate the two remaining multiple currency practices described in the Informational Annex.

[2] Exporters are subject to a 50 percent surrender requirement on their earnings. Recently, the NBU extended the surrender requirement to a broader range of transactions. Conversion in hryvnia is required for all foreign exchange transfers from abroad to persons when the amount exceeds UAH 150,000 a month. A license is required for some foreign exchange transactions, including investment abroad.

23. Moving to a flexible exchange rate regime would require significant changes in the NBU monetary policy framework and eventual adoption of inflation targeting (IT). Staff has long recommended IT as the most suitable monetary policy framework for Ukraine given the NBU's mandate to focus on price stability and the need to have an anchor under a flexible exchange rate. The NBU has made good technical progress in preparations for switching to IT. They have narrowed the interest rate corridor between their deposit and lending facilities and introduced an automatic overnight deposit facility, as recommended by Fund staff. Alongside, the authorities have been building up capacities for macroeconomic modeling and inflation forecasting. Staff assesses that once the high-level commitment to adopt the new framework is made, it could become operational within 12–18 months. To facilitate the transition, staff recommended enhancing further the tools for managing short-term interest rates and allowing banks additional flexibility in managing their liquidity (Annex V). The new tools would strengthen the interest rate-based monetary policy transmission via the interbank money market in preparation for transitioning away from exchange rate and money anchors.

24. Authorities' views. The NBU was in favor of gradually increasing exchange rate flexibility. However, they expressed concern about possible market disruptions following the switch to the new regime, and preferred to do so as part of a comprehensive adjustment program. Moreover, the NBU considered that a modest exchange rate move would be sufficient to reduce the current account deficit to a sustainable level, which they viewed to be about 5–6 percent of GDP. At the same time, the NBU stressed the importance of foreign exchange controls for maintaining steady supply of foreign exchange to the market and discouraging speculative pressures on the exchange rate in the current difficult situation. Staff noted that a current account deficit of 5–6 percent of GDP would keep international reserves declining as external financing necessary to cover such a deficit has not been available to Ukraine since 2010 (Table 3). Even if such financing were to appear, the already high external liabilities would keep rising fast, and reserve coverage of debt would remain precariously low. The NBU agreed with the benefits of a monetary policy framework based on interest rate management, and with a gradual transition to IT in the medium term.

C. Maintaining Financial Stability

25. The banking system appears stable at present, but vulnerabilities persist. The authorities have steered the economy through domestic market tensions at the end of 2012, and confidence in the banking system has improved. A high average capital adequacy ratio of 18 percent provides some cushion against risks stemming from an elevated NPL ratio of 14 percent (Table 6).[3] The NPLs are relatively well provisioned, with specific provisions covering 81 percent of impaired loans and 45 percent of doubtful loans, but the market value and liquidity of posted collateral are difficult to verify, and regulatory and tax impediments keep NPL resolution slow. At the same time, the NBU's Resolution 109 continues to force the banking sector into a large negative foreign

[3] Including substandard loans in the definition of NPLs, in line with the best international practice, would raise the NPL ratio to over 25 percent.

exchange position of about 20 percent of capital by end-September 2013.[4] Though significantly reduced since end-2012, this exposure still keeps banks vulnerable to a large exchange rate move. Moreover, banks' uncertainty about the macroeconomic outlook and access to NBU liquidity facilities forces them to seek liquidity by maintaining high deposit rates, with the resulting high lending rates limiting demand for credit. This constrains economic growth and limits banks' ability to further build capital buffers out of their profits.

26. Staff proposed to unwind Resolution 109 in a balanced way that reduces bank vulnerabilities without destabilizing the foreign exchange market. Allowing the provisions against foreign currency loans back in the calculation of the foreign currency position over three years would generate only modest additional bank demand for foreign exchange and thus strike the right balance in this respect. To improve the banks' foreign exchange position while also reducing their exposure to foreign exchange risk during the transition, staff recommended allowing all banks to include government exchange rate-indexed securities in the calculation of foreign currency assets. Further limited issuance of such securities will help as well, as it would help mitigate the impact of exchange rate devaluation on the banks at the expense of only minor additional cost for the government. Alongside, staff advised removing the remaining tax, administrative, and legal obstacles that prevent NPL resolution and corporate debt restructuring, such as the need to pay VAT when selling NPLs and the lack of out-of-court procedure to settle insolvency between defaulting borrowers and the involved banks.

27. Authorities' views. The NBU agreed to repeal Resolution 109 and gradually phase out its restrictions in three years, but wanted to start the process as part of a comprehensive adjustment program. Meanwhile, the NBU envisaged expanding the pilot project allowing banks to count government exchange rate-indexed securities as foreign currency assets and including provisions in foreign currencies up to the amount of the indexed bonds in the calculation of the foreign exchange position. Staff cautioned that while such securities do cushion the effect of an exchange rate move on banks' balance sheets, this approach is not international best practice, as the indexed bonds cannot cover losses caused by possible write-offs of foreign currency loans. The NBU has set up a working group with representatives of relevant government agencies to identify impediments to NPL resolution and making recommendations for their removal.

28. Even as the banking system appears capable of withstanding significant shocks, staff advised developing contingency and recovery plans. Stress tests conducted by staff suggest that even in case of significant—but still orderly—exchange rate depreciation, banks' capital and liquidity needs will remain manageable.[5] Nevertheless, detailed contingency plans focused on keeping

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[4] NBU's Resolution 109 excludes provisions in foreign currencies from the calculation of banks' foreign exchange position. This artificially reduces banks' foreign currency liabilities and forces the banks to keep their foreign currency assets low in order to comply with the NBU regulation on open foreign exchange positions. However, this policy amounts to requiring the banks to run a structural negative (short) economic open position, as their foreign exchange assets fall well short of their foreign exchange liabilities inclusive of provisions in foreign currencies.

[5] For example, stress tests on groups of banks covering credit and foreign exchange risks based on data for September 2013 indicate that a significant but orderly devaluation and the concomitant rise in NPLs would reduce bank capital by 2¼–4 percent of GDP. This would not generate recapitalization needs for most banks given existing

(continued)

systemic banks sufficiently capitalized and the whole system liquid should help mitigate the impact of adverse shocks. The mission also recommended that systemically important banks be required to prepare recovery plans and the NBU, in coordination with the Deposit Guarantee Fund and the Ministry of Finance, develop specific resolution plans for the most vulnerable banks to be used in case of need. To dispel possible doubts about the strength of banks' balance sheets and their adherence to reporting standards, staff advised the NBU to launch independent diagnostic audits of vulnerable systemic banks, focusing on asset quality, loan classification, provisioning, adequacy of loan collateral, and related party lending.

29. Authorities' views. The NBU agreed that the banking system can withstand mild shocks, but argued—on the basis of stress tests with extremely strong assumptions—that exchange rate moves of the magnitude implied by staff's advice would generate very large capital needs. Staff acknowledged the need to be conservative when running stress tests, but noted that the NBU's assumptions appear extreme in view of the macroeconomic situation expected to prevail after adjustment policies are put in place (Table 7) and international best practice. The NBU shared the view that independent audits of vulnerable systemic private banks would be useful, and—in cooperation with Fund and World Bank staff—has developed terms of reference for such audits and made other preparatory steps. Staff pointed out that the audits should go ahead as soon as possible, as they could provide useful input in the contingency and recovery plans mentioned above.

30. Enhancing bank supervision and strengthening reporting standards should help reveal and address banking sector vulnerabilities. Despite improvement in banking supervision, significant weakness remain particularly regarding identification of true owners of banks, the sources of funding, and monitoring of connected lending and large exposures on consolidated basis. While the NBU appears to have the adequate authority and rules for consolidated supervision, its enforcement could be much more effective with more assertive supervisory regime. Staff encouraged the NBU to strengthen its financial stability and supervisory functions by prompt enforcement of consolidated bank supervision and improving their early warning system to ensure timely detection of problem banks and subject them to enhanced supervision. Staff also advised an acceleration of the process of resolving the three intervened banks in state possession, which is moving slowly.

31. Authorities' views. The NBU has adopted a new regulation for consolidation supervision and is working on making it fully operational. They pointed out the significant progress in transforming Rodovid (one of the three intervened banks) into a bad bank that would accept NPLs from the other two (Kiev bank and Ukrgaz bank). Currently they are in the process of selecting financial advisor to recommend how to dispose (through sale or merger) of Kiev bank and Ukrgaz bank.

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high capital buffers. Nevertheless, a few large banks would need to raise their capital somewhat in order to reach the minimum 10 percent capital adequacy ratio.

D. Launching Fiscal Consolidation to Support the Adjustment

32. Under current policies, the combined general government-Naftogaz deficit is projected to rise sharply in 2013 and remain elevated in 2014. Staff projects the budget deficit at 5¾ percent of GDP in 2013, including 1¼ percent of GDP in recognized tax refund and expenditure arrears to be covered by promissory notes (Table 2). The combined general government-Naftogaz deficit will expand to 7¾ percent of GDP in 2013. The large tax cuts currently envisaged in the tax code would have further raised the combined deficit to 8½ percent of GDP in 2014, had the authorities not decided to reconsider them (see below).[6]

33. While the current level of public debt is still moderate, it is projected to rise further and is subject to considerable risks. Under the baseline, public debt is projected to exceed 40 percent of GDP in 2013 and approach 60 percent of GDP in the medium term (Annex III). Substantial gross external financing requirements would expose Ukraine to significant rollover and exchange rate risks. Large contingent liabilities generated by generous use of government guarantees, promissory notes, and Naftogaz's actual and potential obligations present substantial risks as well.

34. Staff urged the authorities to embark on fiscal consolidation as part of the adjustment package. To support the external adjustment and stave off the acute financing risks (Annex VI), staff recommended a general government deficit target of 2¾ percent of GDP in 2014, falling to 1¾ percent of GDP in the medium term (text table). Including the effects of the energy sector

Fiscal Balances Under the Baseline and Adjustment Scenarios, 2011–18

(Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018
Baseline scenario								
General government balance 1/	-2.8	-4.5	-5.7	-4.6	-4.7	-6.5	-6.3	-6.3
Overall balance (including Naftogaz's deficit)	-4.3	-5.5	-7.7	-6.6	-6.3	-8.0	-7.7	-7.6
Structural general government balance	-3.0	-4.5	-4.1	-4.1	-4.5	-6.4	-6.3	-6.3
Structural general government and Naftogaz balance	-4.6	-6.8	-6.0	-6.1	-6.0	-7.9	-7.7	-7.6
Adjustment scenario								
General government balance 1/	-2.8	-4.5	-5.7	-2.7	-2.3	-2.2	-2.0	-1.7
Overall balance (including Naftogaz's deficit)	-4.3	-5.5	-7.7	-4.0	-3.2	-2.8	-2.2	-2.0
Structural general government balance	-3.0	-4.5	-4.1	-1.9	-1.9	-2.0	-2.0	-1.7
Structural general government and Naftogaz balance	-4.6	-6.8	-6.0	-3.2	-2.9	-2.6	-2.2	-2.0

Sources: Ukrainian Authorities; and IMF staff estimates.

1/ The general government includes the central and local governments and the social funds. In 2013, the general government deficit includes recognized arrears (1.3 percent of GDP).

reform, the combined budget-Naftogaz structural deficit would fall by 2¾ percent of GDP in 2014 and 4 percent by 2018. The frontloading of the fiscal adjustment is necessary to (i) support the external adjustment; (ii) contain inflation; and (iii) reduce the budget's acute financing needs, a key

[6] The tax code envisages cuts in the value-added tax (VAT) rate from 20 to 17 percent and corporate income tax (CIT) rate from 19 to 16 percent.

vulnerability. In the short term, the fiscal consolidation will exert an inevitable but moderate drag on domestic demand and growth, partly offset by the boost in net exports. In the medium term, the moderate deficit would stop crowding out bank lending to the economy, reduce pressures on the NBU balance sheet, and help stabilize public debt below the generally accepted for emerging markets benchmark of 40 percent of GDP, opening fiscal space for countercyclical policies.

35. The brunt of the fiscal consolidation should fall on reducing current expenditure. In 2014, high budget expenditure (about 50 percent of GDP) should be reduced by rationalizing public procurement, reducing subsidies, restraining public sector wages and hiring, and indexing pensions only with inflation, removing the recently introduced wage-linked indexation component. These policies will begin reversing the unaffordable wage and pension hikes of previous years. Over the medium term, staff recommended current expenditure cuts of some 6¾ percent of GDP through continuing wage and employment restraint, pension reforms with a focus on privileged pensions, and deeper subsidy cuts made feasible by the energy sector reform (Annex VII). This will return current expenditure just below its 2011 level and allow doubling capital outlays to 3 percent of GDP—the minimum necessary to maintain public infrastructure**.**

36. Staff strongly cautioned against unaffordable and untimely tax cuts and distortionary substitutions. The authorities were considering proposing to parliament to postpone the scheduled cuts in the VAT and CIT from 2014 to 2016. Staff argued that any tax cuts should be postponed until the needed adjustment in current expenditure was well under way and the budget deficit reduced to a sustainable level. Once this is done, tax cuts that best support growth should be given priority. On this basis, staff supported the intention to postpone the cut in the CIT rate to 2016, but advised abandoning altogether the plan to cut the VAT rate, as this is unlikely to be affordable given the need to reduce the budget deficit. Staff also advised against the contemplated re-introduction of a tax on non-cash foreign exchange purchases, abolished in 2011 due to its distortionary impact on financial intermediation. Instead, staff recommended phasing out existing VAT exemptions, especially in agriculture, and supported plans for a five-year schedule for raising excise taxes, starting in 2014. The recent revision of Ukraine's tax treaty with Cyprus and the introduction of a law on transfer pricing have some revenue-raising potential, although estimated gains seem optimistic.

37. Staff cautioned against the use of promissory notes to settle arrears. Staff welcomed recognition of existing arrears, but stressed that these should be settled through conventional methods such as cash payments and netting the due refunds against VAT liabilities. Staffs emphasized that the issuance of promissory notes to clear arrears would undermine future budget and Naftogaz revenue and impose deep haircuts on legitimate business receivables.

38. Authorities' views. The authorities broadly agreed with the need to frontload fiscal consolidation and reduce the general government deficit below 3 percent in 2014, but were yet in the process of shaping key policies to achieve that. They argued for a consolidation strategy based on a combination of expenditure and revenue measures. Given the large and highly rigid social component of total expenditures—which they found hard to change—the authorities considered the amount of proposed medium-term current expenditure consolidation difficult to implement. On tax issues, the authorities agreed that the scheduled cuts in VAT and CIT rates may adversely affect

macroeconomic stability in 2014, and committed to proposing to parliament their postponement until 2016. At the same time, they argued that the reduction in VAT rate may help reduce the shadow economy and should not be abandoned altogether. The authorities also acknowledged that reducing tax exemptions to the agricultural sector was long overdue and could generate large savings, but highlighted political difficulties associated with this reform. The authorities emphasized that the acceptance of promissory notes will be voluntary and agreed to settle obligations in cash should there be no demand for such notes.

39. Staff emphasized the importance of reforms to modernize the institutional framework of fiscal policy and limit accumulation of fiscal risks. These reforms would support macroeconomic stability following the adjustment and should include: (i) a fiscal rule to anchor the budget deficit consistent with medium-term macroeconomic stability; (ii) a medium-term budget framework with binding expenditure ceilings supporting the authorities' policy objectives; and (iii) a rigorous and transparent process for selecting public investment projects—both on-budget and state-guaranteed—with the highest economic rate of return. In this regard, staff recommended limiting state guarantees to 1 percent of GDP per year to stem the rapid buildup of contingent liabilities and consequent upward pressures on government borrowing costs.

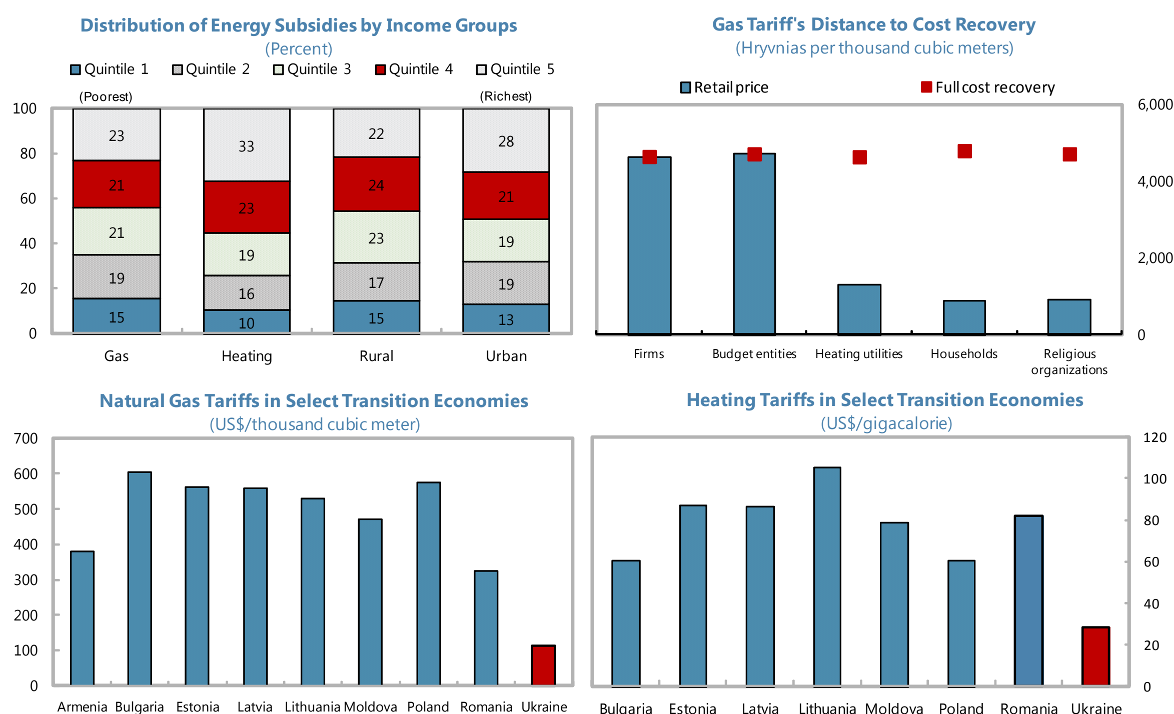
40. Authorities' views. The authorities felt that state guarantees were important to attract long-term investments to the economy. They explained that the recently created special committee to oversee investment projects seeking support through state guarantees has strengthened the project selection mechanism to minimize contingent liability risks. However, they noted practical difficulties associated with the adoption of a medium-term budget framework given large uncertainties about the macroeconomic outlook.

E. Reducing Quasi-Fiscal Losses and Raising Growth with Energy Sector Reforms

41. An inefficient and opaque energy sector is weighing on public finances and the economy. Overall energy subsidies in Ukraine, on- and off-budget, are estimated at 7½ percent of GDP in 2012 with relatively well-off households capturing the larger share of the benefits. The very low tariffs for residential gas and district heating (20–30 percent of economic costs)—the main factors behind the high subsidies—encourage one of the highest energy consumption levels in Europe and lead to large quasi-fiscal losses by Naftogaz. They also exacerbate balance of payment weaknesses, discourage investment in domestic production, and breed governance problems.

42. A large body of analytical work has prepared the ground for reform. Studies by Ukrainian and IFI (mainly World Bank) experts have brought clarity about the size and distribution of existing subsidies, developed proposals how to mitigate the impact of subsidy removal on the most vulnerable, and suggested means of effective communication of the need for reform to various

stakeholders. International experience suggests that these are the prerequisites for a successful reform.[7]



Source: Ukrainian authorities; WB and IMF staff estimates; www.energy.eu; www.euroheat.org.

43. An ambitious and comprehensive energy sector reform, focused on eliminating Naftogaz's operational losses, is an indispensable part of the macroeconomic adjustment package. Such a reform will reduce quasi-fiscal losses and budget subsidies, help in reining in the current account deficit, secure funds for domestic investment to achieve energy independence—a key medium-term objective of the authorities—and alleviate governance problems in the sector. Staff argued that the reform should aim at gradually eliminating Naftogaz's operational losses over the medium term, limiting its deficit to the interest paid on its debt. For 2014, staff supported the authorities' intention to cut Naftogaz's deficit to 1¼ percent of GDP and urged the adoption of credible policies to this end.

44. The reform should be based on a schedule of gradual, but upfront, meaningful, and broad-based tariff increases. Staff stressed that given the current very low tariffs, it would necessarily take a few years to reach full economic cost recovery. That said, the low initial position and the impact of the expected exchange rate adjustment on the cost of gas imports makes it imperative to start with meaningful gas and heating tariff increases for a broad household customer base in 2014 as also advised by the World Bank. This approach would strike the right balance between decisively moving toward cost recovery while minimizing collection problems along the

[7] IMF Policy Paper "Energy Subsidy Reform: Lessons and Implications," January 2013.

way. Moreover, such policy would help reduce Naftogaz's deficit and enable cuts of budget subsidies already in 2014, as well as strengthen incentives to save energy. Also, it would improve governance in the energy sector by reducing arbitrage opportunities for gas and heat sales—long exploited by vested interests—created by the existing tariff differentials across customer categories. To offset the effect of tariff adjustment on the most vulnerable and facilitate social acceptance of the reform, staff advised increasing targeted social assistance to the poorest 40 percent of households by expanding the existing means-tested programs (Annex VIII).

45. Tariff adjustment would work best as part of a comprehensive energy sector reform plan to reduce the use and cost of energy and raise domestic gas output. To this end, staff advised: (i) accelerating gas and heat metering and energy saving efforts, to complement the indispensable tariff hikes; (ii) diversifying gas imports toward cheaper sources; and (iii) create enabling environment—in terms of pricing and business climate—for attracting investment into domestic gas production.

46. Authorities' views. The authorities agreed that the energy sector is in need of reforms on multiple fronts, and announced their intention to cut Naftogaz's deficit to 1¼ percent of GDP in 2014. However, they are reluctant to raise current gas and heating tariffs, despite considering options to this effect. In the heating sector, the authorities are working on a program to increase energy efficiency and cost transparency of the housing, utilities, and public sectors. In parallel, plans are being designed to convert in-kind energy benefits in cash by distributing voucher-like electronic cards to eligible households. Meanwhile, the authorities are working on raising domestic gas production from both conventional and unconventional sources and diversifying import sources, but notable gains from both approaches are expected only in the medium term.

F. Boosting Sustainable Growth

47. Advancing structural reforms and improving the business climate is imperative for unlocking Ukraine's growth potential. Progress in this area has been mixed, with improvements in the area of starting a business, registering property, and paying taxes, but remaining inefficiencies in institutional capacity and business regulations. The mixed record is reflected in competitiveness ratings. On the one hand, Ukraine rapidly advanced in the 2014 Doing Business report (by 28 ranks to 112th place out of 189 countries); on the other hand, it lost ground in the 2013–14 Global Competitiveness Index. Staff welcomed the authorities' efforts to improve the legal framework for governance and business climate, but emphasized that the uneven implementation of laws and regulations remains a drag on business activity, private investment, and technology transfer. As a consequence, the productivity potential of the economy remains suppressed and competitiveness and FDI inflows compare unfavorably against regional peers. Overall, most domestic business persons and international observers agree that comprehensive and far-reaching improvements in business climate and governance are needed to attract investment and support economic growth.

48. Staff recommended a focus on structural reforms addressing the binding constraints to growth, which are generally in the areas where Ukraine lags behind its regional peers (Figure 7 and Annex IX). This includes strengthening the judicial system, simplifying or repealing

burdensome government regulations, and stepping up anti-corruption measures. The authorities are undertaking welcome measures to reduce excessive regulation, pass anti-corruption legislation, and address judicial weaknesses as part of the work on the association agreement with the EU. These efforts need to continue in a decisive and comprehensive manner, with equally strong emphasis put on implementation and execution of law and regulations. In this regard, staff recommended: (i) ensuring timely and fair resolution of commercial disputes by improving the efficiency and governance in the judicial system; (ii) establishing an independent business ombudsman, as recommended by a number of business organizations and IFIs, to respond to concerns about unfair business practices and advocate swift action to resolve such concerns; (iii) strengthening administrative, judicial and operational capacity to protect property rights; (iv) imposing clear and consistent rules in tax administration and continuing to address delays in VAT refunds through conventional measures; and (v) making the recently reformed corporate insolvency framework operational. Decisive progress in these areas should raise productivity and private investment, substantially lifting potential growth in the medium term.

49. Staff recommends further strengthening the regulatory and operational framework for anti-money laundering and combating financing of terrorism (AML/CFT). The assessment done in 2009 by Moneyval, the regional body assessing compliance with AML/CFT standards, revealed flaws in the Ukrainian legal framework, and the progress report submitted to Moneyval in December 2012 confirmed that some of those flaws remained in place. In particular, there are shortcomings in proper customer due diligence requirements on ultimate beneficial owners of legal persons, which are crucial to detect potentially illicit funds. Furthermore, there is no explicit requirement to check the source of wealth/funds of owners (including beneficial owners) of qualifying holdings of banks. In this context, staff advised the NBU to expedite the work on draft amendments to the AML/CFT law in line with FATF recommendations as well as ensure their prompt adoption and implementation. In addition, staff recommended to the NBU to set up more specific requirements to check the source of wealth/funds of the founders and owners of qualifying holdings of banks, including beneficial owners.

50. Authorities' views. The authorities agreed with the need to further improve the business climate and governance, and underscored that their reforms have significantly improved Ukraine's standing in the World Bank Doing Business report. They focus on an ambitious deregulation process, as well as tax and custom administration reforms to create more business-friendly environment, as provided for in the President's Reform Program for 2010–14 and the Program to Accelerate Economic Development for 2013–14. Regarding the AML/CFT agenda, the authorities are in the process of incorporating the latest FATF requirements in their legislation and operational regulations, and hope that their progress in this regard will be noted in the next assessment by Moneyval now scheduled for May 2014.

CAPACITY TO REPAY THE FUND

51. Ukraine's capacity to repay the Fund remains adequate, but risks are emerging. So far all repurchases have been made in full and on schedule. On the obligation basis, outstanding Fund credit to Ukraine would decline below 200 percent of quota by February 2014 and below 100 percent of quota by September 2014 (Table 9). However, declining reserves and difficulties in obtaining external financing pose risks for the large repurchases in 2014 (SDR 2.4 billion) and 2015 (SDR 1 billion). Staff emphasized that resolute and comprehensive policy adjustments to correct external imbalances and strengthen Ukraine's external position would uphold Ukraine's capacity to repay the Fund and service its other liabilities as scheduled.

52. The authorities have reaffirmed their commitment to repay the outstanding Fund credit. They underlined that Ukraine has already made large repurchases of SDR 2.2 billion in 2012 and SDR 3.7 billion in 2013 that exceed the remaining amounts. Looking forward, the authorities believed that their international reserves, prospective financing opportunities, and other available buffers are sufficient to ensure the scheduled repurchases in 2014–15 that would extinguish all outstanding Fund credit.

STAFF APPRAISAL

53. The Ukrainian authorities maintained macroeconomic stability in 2012–13 amid worsening external conditions and a recession. The authorities steered the economy through market tensions at the end of 2012, and households' precautionary demand for foreign exchange has considerably eased since then. Confidence in the banking system has improved, and high capital adequacy ratios provide a cushion against risks. Large negative foreign exchange positions have been reduced, although further progress is needed. Naftogaz managed to reduce expensive gas imports, which kept in check the external current account deficit despite the decline in exports. The authorities began to close some tax loopholes with the passage of the law on transfer pricing and amendments in the tax treaty with Cyprus.

54. However, stability was maintained at a high economic price. The authorities' policies to maintain the effective exchange rate peg and raise public wages and pensions in 2012 led to large twin deficits and depletion of international reserves. As access to external debt markets has become more difficult in 2013, the government has increasingly resorted to the NBU and state-controlled banks for financing the ballooning budget deficit. To calm the persistent devaluation expectations and sterilize excess bank liquidity, the NBU maintained tight monetary policy stance and intensified foreign exchange controls. This prompted banks to offer very high deposit rates, which moderated households' demand for foreign exchange, but also raised the cost of credit in the midst of the recession. Ultimately, this policy mix contributed to deepening the recession in 2012–13.

55. The current policy mix is not sustainable as it generates significant risks and depresses growth. An overvalued exchange rate, large fiscal deficit, and sizable quasi-fiscal losses keep the current account deficit well above equilibrium. Under unchanged policies, the NBU's international

reserves and other buffers will be further depleted during 2014, making the country particularly vulnerable to disruptive shocks and raising the risk to repayments to the Fund. Rising risk perception reflected in sovereign rating downgrades by all major rating agencies makes it much more difficult for the sovereign and corporates to obtain external market financing, while domestic sources of financing are limited. Tight monetary policy to support the exchange rate, low public investment, and tough business climate keep growth depressed.

56. To resolve macroeconomic imbalances and revive growth, the authorities would be well advised to undertake resolute and comprehensive policy adjustments in several critical areas. The needed adjustment package should aim to curtail the fiscal and external current account deficits, phase out unaffordable and distortive energy subsidies, strengthen the banking sector, and improve the external competitiveness of the economy. Staff presented its recommendations to the authorities on the policy design in all critical areas. The authorities are now developing their own set of policies aimed at achieving similar objectives.

57. Allowing the exchange rate to adjust and eliminate overvaluation and shifting to a new monetary policy framework is critical to correct external imbalances and avoid future policy traps. A more flexible exchange rate responding to market forces would boost Ukraine's export performance and economic growth, especially in the face of volatile export prices and partner country demand. It would also allow more room for independent monetary policy. In the medium term, inflation targeting is the appropriate monetary framework for Ukraine, and preparations for its introduction should be accelerated.

58. Alongside, strengthening the banking system to increase its resilience to shocks would widen the menu of policy options available to the authorities. Official data suggest that the banking system is able to withstand a wide range of shocks. However, the NBU remains concerned for its stability in case of a significant exchange rate move. The independent diagnostic audits proposed by IMF and World Bank staff should help clear potential doubts about asset quality and reporting standards in a number of systemic banks. Allowing all banks to reduce their negative foreign exposure and removing impediments to NPL resolution would strengthen their balance sheets. Alongside, contingency plans to keep systemic banks sufficiently capitalized and the whole system liquid should help mitigate the impact of adverse shocks.

59. A sizeable expenditure-reducing fiscal consolidation is needed to curtail the budget deficit and make room for public investment. High budget expenditure should be reduced by rationalizing public procurement, restraining public sector wages and employment, and limiting pension indexation to inflation. Over the medium term, these policies will return current expenditure broadly to its 2011 level and allow proper investment in public infrastructure. To anchor the fiscal adjustment, the authorities could adopt a rule-based approach to setting the budget deficit targets and spending limits over the medium term.

60. A comprehensive energy sector reform, centered on upfront, meaningful, and broad-based tariff increases, is indispensable for the needed macroeconomic adjustment. Upfront gas and heating tariff increases would strengthen incentives to save energy, reduce the budget transfers

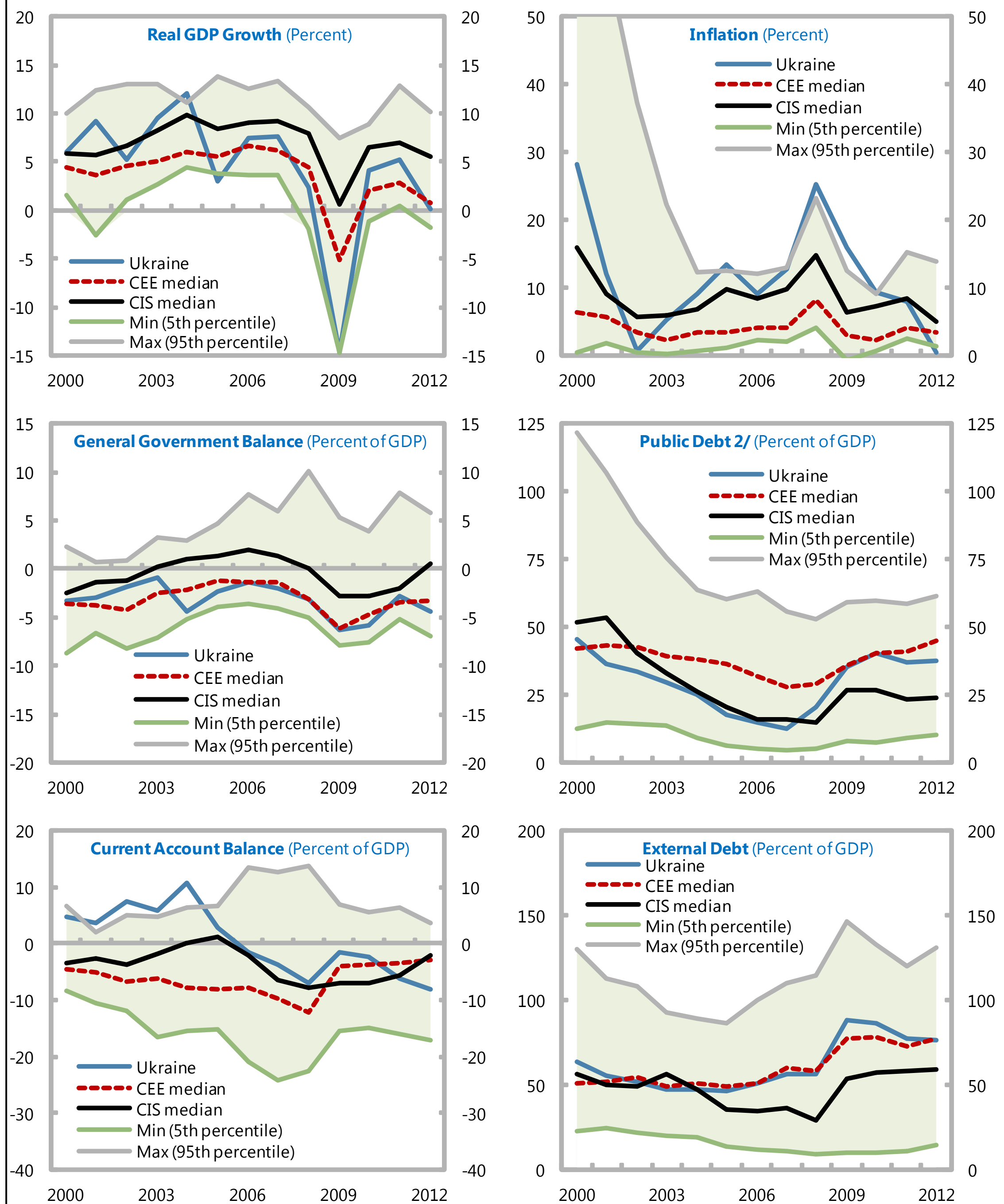
to Naftogaz, and enable cuts of budget subsidies. Also, they would incentivize domestic gas production and improve governance in the energy sector by reducing arbitrage opportunities for gas sales created by the existing tariff differentials. To offset the effect of tariff adjustment on the most vulnerable, staff advises increasing targeted social assistance to the poorest 40 percent of households. Welcome energy-saving reforms and import diversification toward cheaper sources should complement, but not substitute for the indispensable tariff hikes.

61. Improving the business climate is imperative for higher growth. Progress in this area has been mixed. Reforms in several areas allowed Ukraine to advance considerably in the World Bank's *Doing Business 2014* report. Still, the recorded progress did not always match the feedback that staff received from business representatives regarding their operational environment. To raise investment and promote growth, reforms should be accelerated to relax binding constraints on growth, in particular in areas where Ukraine lags behind its regional peers.

62. To fully realize its ample economic potential over the medium term, Ukraine needs comprehensive macroeconomic adjustment and ambitious structural reforms. The growth model based on public sector-driven expansion of domestic consumption has reached its limits. The current policy mix and difficult business climate deter investment. And impaired competitiveness weighs on exports. To remove these brakes on economic activity, the authorities will be well advised to undertake resolute macroeconomic adjustment and decisive structural reforms. Ukraine indeed has great potential. Agriculture has been developing well recently, but has much more room to grow as Ukraine has some of the best arable land in Europe. With the right prices and investment climate, production of natural gas could expand significantly over time. And Ukraine's well-educated labor force can substantially raise total factor productivity. Deeper integration with the EU could help exports and spur FDI, with potential gains significantly magnified once competitiveness and the business climate are improved. Sound policies can substantially raise actual and potential growth over the medium term, with the concomitant boost in population's living standards and general well-being.

63. It is proposed that the next Article IV Consultation with Ukraine be held on the standard 12-month cycle.

Figure 1. Ukraine: Performance Among Peers, 2000–12 1/

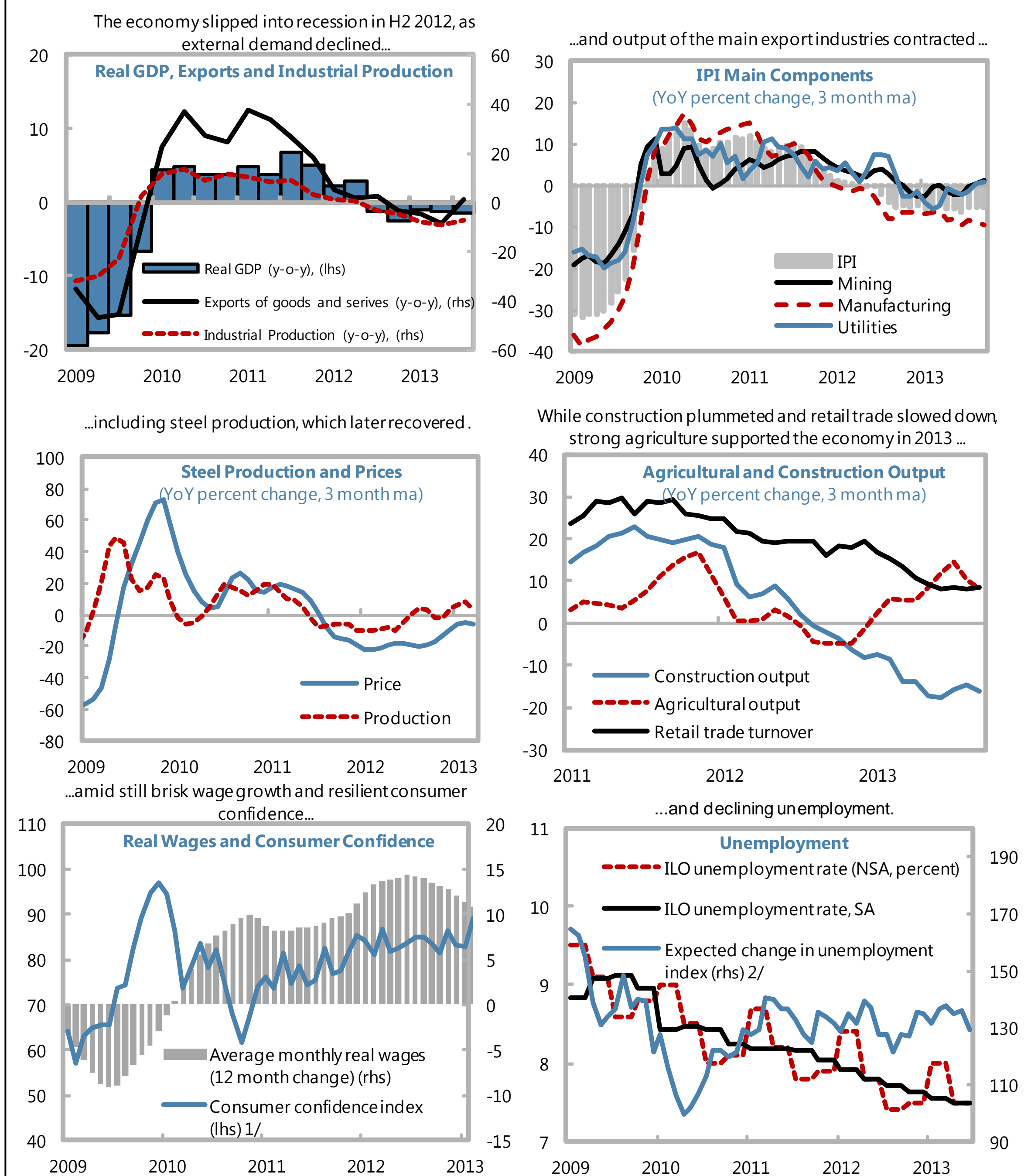


Sources: IMF, *World Economic Outlook;* and IMF staff calculations.

1/ CEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovak Rep., and Turkey . CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Rep., Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, and Uzbekistan. The 5th and 95th percentiles include the entire CEE and CIS samples excluding Ukraine.

2/ CIS, 5th, and 95th percentiles exclude Mongolia.

Figure 2. Ukraine: Real Sector Indicators, 2009–13



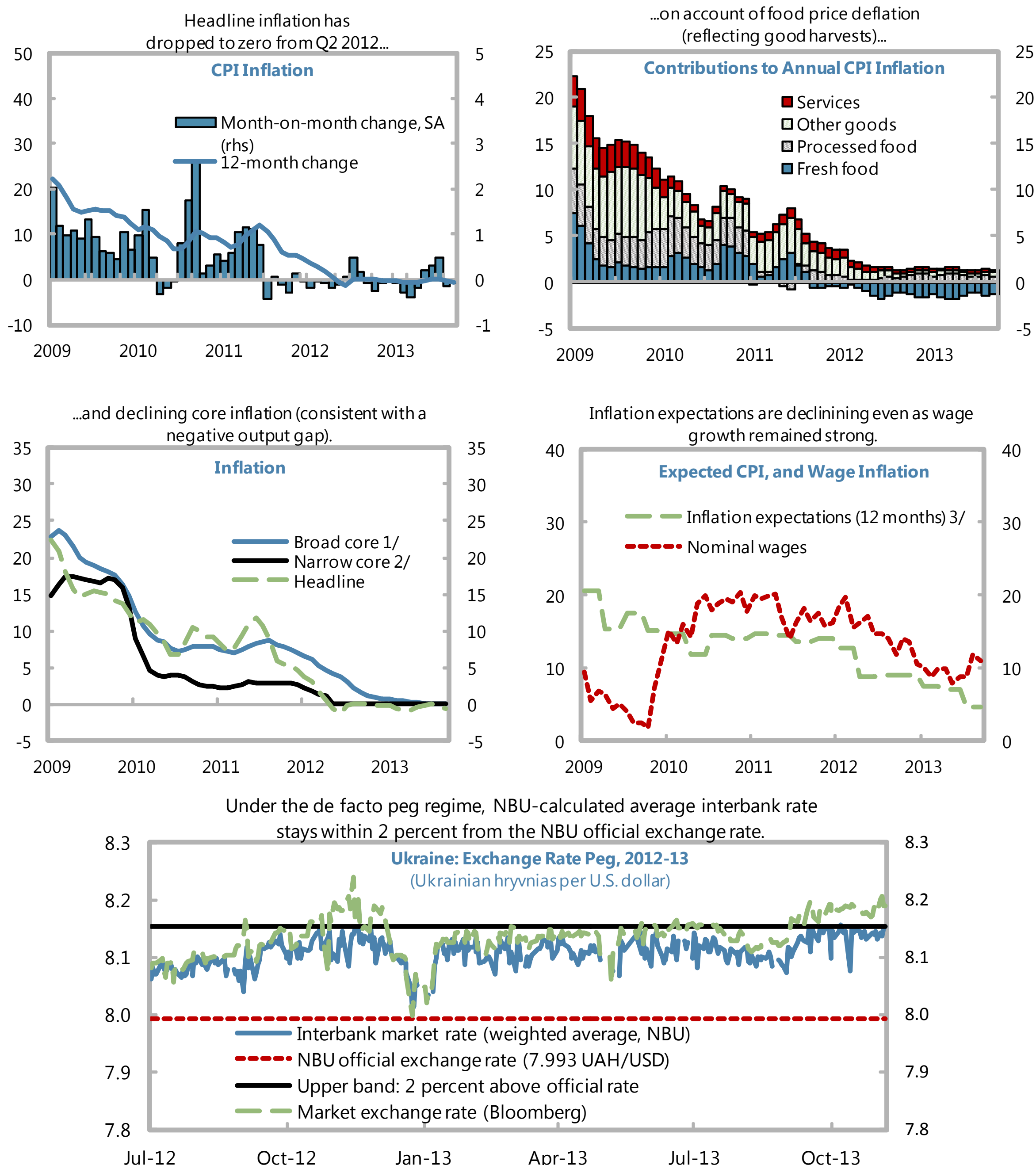
Sources: State Statistics Committee of Ukraine; Haver; Bloomberg; GFK Ukraine; International Centre for Policy Studies; and IMF staff calculations.

1/ Consumer confidence index is based on survey respondents' answers to questions that relate to personal financial standing, changes in personal financial standing, economic conditions over the next year, economic conditions over the next five years, and propensity to consume. Index values range from 0 to 200. The index equals 200 when all respondents positively assess the economic situation. It totals 100 when the shares of positive and negative assessments are equal. Indices of less than 100 indicate the prevalence of negative assessments.

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

Figure 3. Ukraine: Inflation, Monetary, and Exchange Rate Developments, 2009–13

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



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

1/ Broad core excludes unprocessed food, fuel, and administrative services.

2/ Narrow core excludes food, fuel, and all services.

3/ Inflation expectations are surveyed and compiled by the NBU.

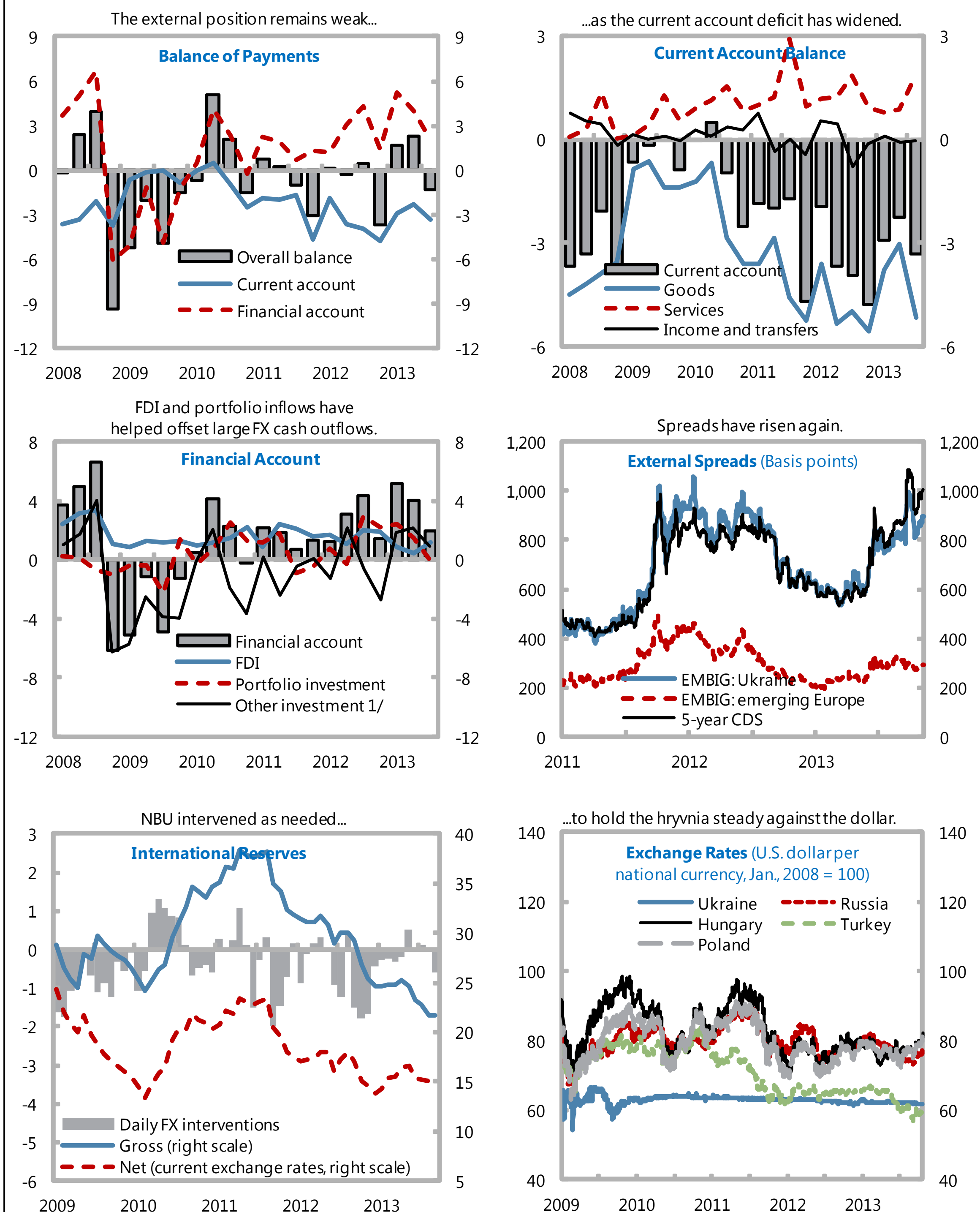


Figure 4. Ukraine: External Sector Developments, 2008–13
(Billions of U.S. dollars, unless otherwise indicated)
The external position remains weak...
Balance of Payments
Overall balance
Current account
Financial account
...as the current account deficit has widened.
Current Account Balance
Current account
Goods
Services
Income and transfers
FDI and portfolio inflows have helped offset large FX cash outflows.
Financial Account
Financial account
FDI
Portfolio investment
Other investment 1/
Spreads have risen again.
External Spreads (Basis points)
EMBIG: Ukraine
EMBIG: emerging Europe
5-year CDS
NBU intervened as needed...
International Reserves
Daily FX interventions
Gross (right scale)
Net (current exchange rates, right scale)
...to hold the hryvnia steady against the dollar.
Exchange Rates (U.S. dollar per national currency, Jan., 2008 = 100)
Ukraine
Russia
Hungary
Turkey
Poland
Sources: National Bank of Ukraine; State Committee of Statistics; Bloomberg; and IMF staff estimates and calculations.
1/ Includes residents' conversion of hryvnia cash to foreign currency held outside the banking system.

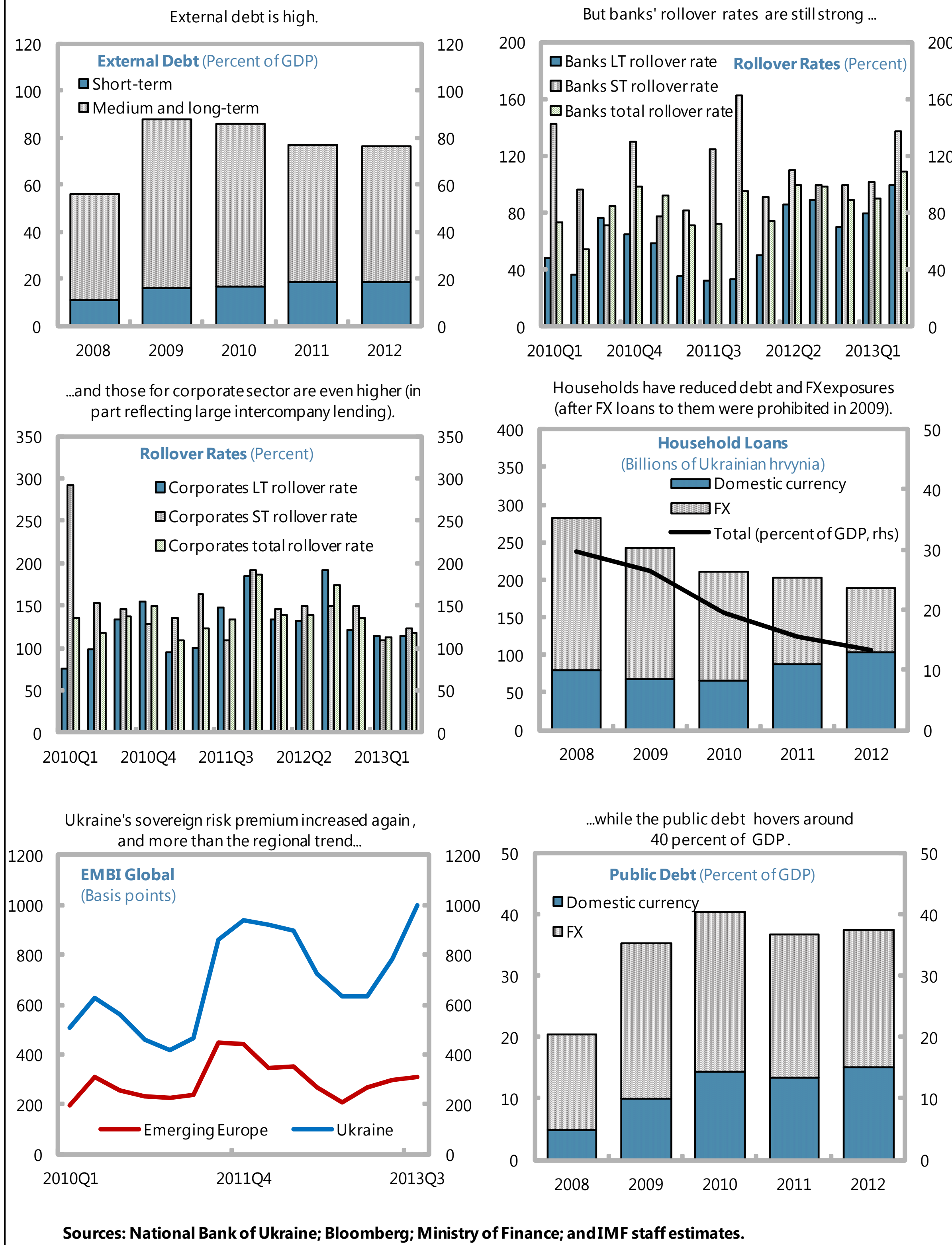
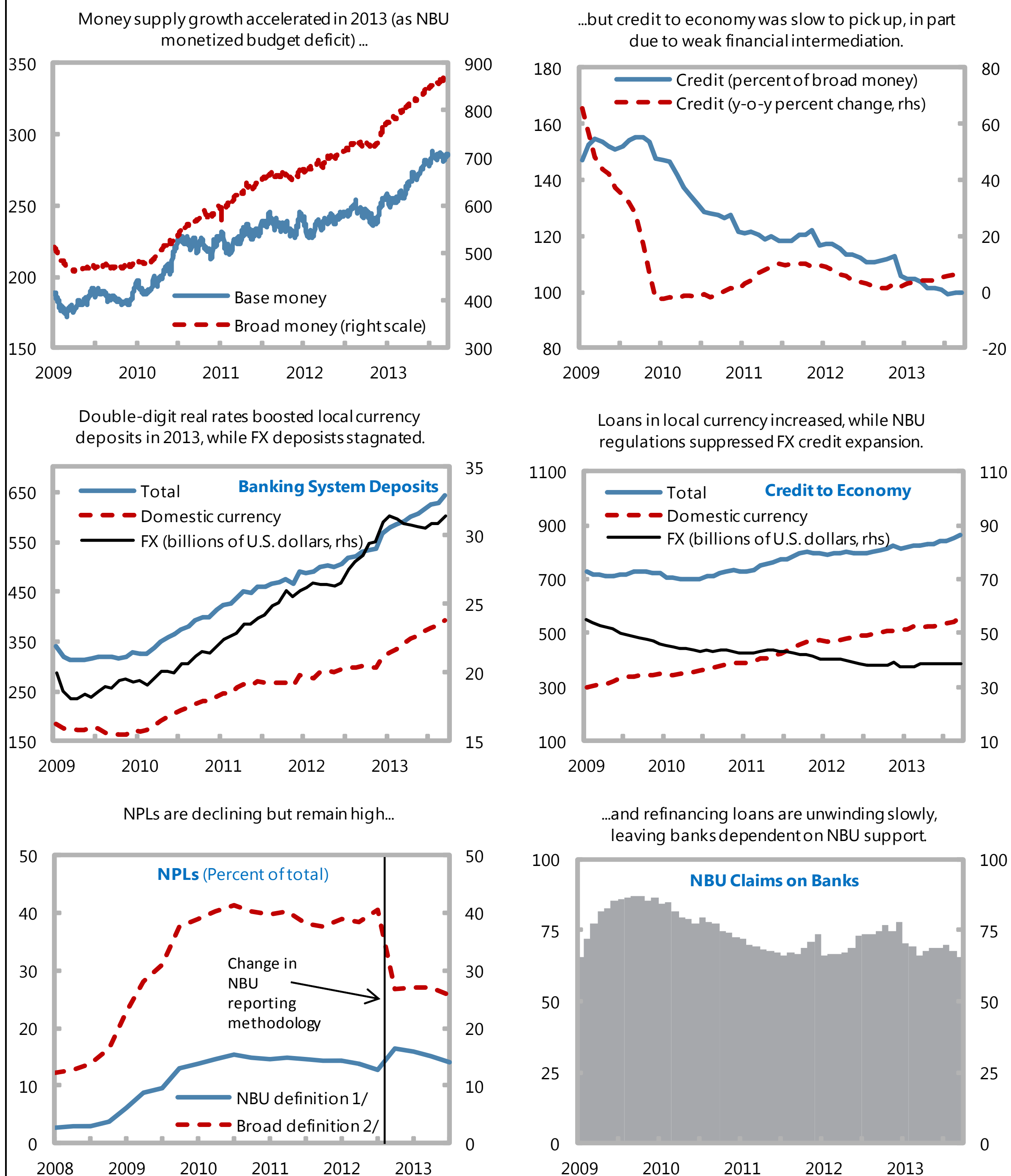


Figure 5. Ukraine: Debt and Rollover of Debt, 2008–13
External debt is high.
External Debt (Percent of GDP)
Short-term
Medium and long-term
But banks' rollover rates are still strong ...
Rollover Rates (Percent)
Banks LT rollover rate
Banks ST rollover rate
Banks total rollover rate
...and those for corporate sector are even higher (in part reflecting large intercompany lending).
Rollover Rates (Percent)
Corporates LT rollover rate
Corporates ST rollover rate
Corporates total rollover rate
Households have reduced debt and FX exposures (after FX loans to them were prohibited in 2009).
Household Loans
(Billions of Ukrainian hryvnia)
Domestic currency
FX
Total (percent of GDP, rhs)
Ukraine's sovereign risk premium increased again, and more than the regional trend...
EMBI Global
(Basis points)
Emerging Europe
Ukraine
...while the public debt hovers around 40 percent of GDP.
Public Debt (Percent of GDP)
Domestic currency
FX
Sources: National Bank of Ukraine; Bloomberg; Ministry of Finance; and IMF staff estimates.

Figure 6. Ukraine: Financial Sector Indicators, 2009–13

(Billions of Ukrainian hryvnias, unless otherwise indicated)

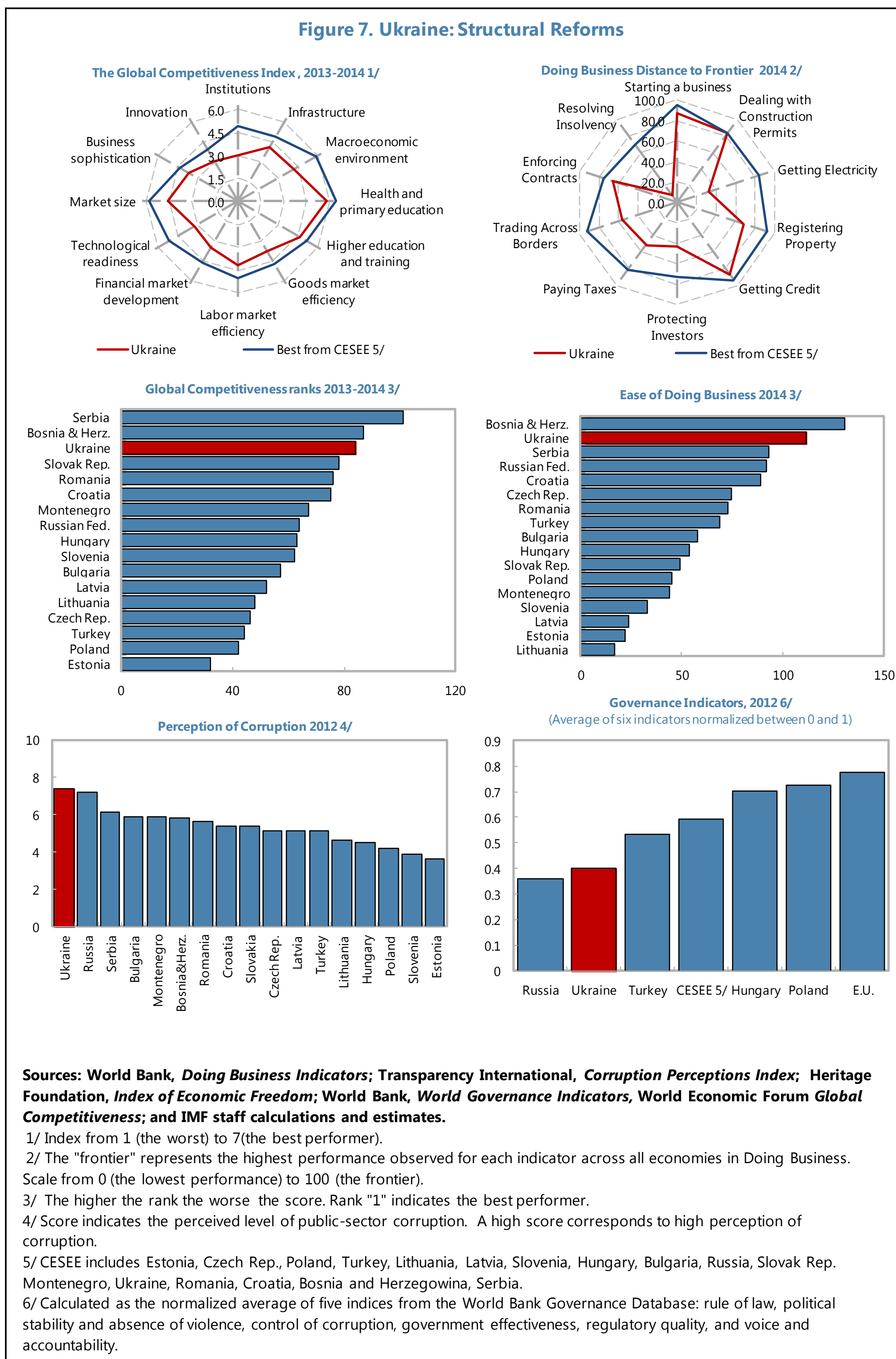


Sources: National Bank of Ukraine; and IMF staff calculations.

1/ Included NPLs that were classified as doubtful and loss until December 2012, when the NBU changed its classification of reported NPLs, which resulted in series break.

2/ Included NPLs that are classified as substandard, doubtful, and loss. From December 2012, estimated by staff using NPL data published by NBU according to new methodology, which resulted in series break.

Figure 7. Ukraine: Structural Reforms



Sources: World Bank, *Doing Business Indicators*; Transparency International, *Corruption Perceptions Index*; Heritage Foundation, *Index of Economic Freedom*; World Bank, *World Governance Indicators,* World Economic Forum *Global Competitiveness*; and IMF staff calculations and estimates.

1/ Index from 1 (the worst) to 7(the best performer).

2/ The "frontier" represents the highest performance observed for each indicator across all economies in Doing Business. Scale from 0 (the lowest performance) to 100 (the frontier).

3/ The higher the rank the worse the score. Rank "1" indicates the best performer.

4/ Score indicates the perceived level of public-sector corruption. A high score corresponds to high perception of corruption.

5/ CESEE includes Estonia, Czech Rep., Poland, Turkey, Lithuania, Latvia, Slovenia, Hungary, Bulgaria, Russia, Slovak Rep. Montenegro, Ukraine, Romania, Croatia, Bosnia and Herzegowina, Serbia.

6/ Calculated as the normalized average of five indices from the World Bank Governance Database: rule of law, political stability and absence of violence, control of corruption, government effectiveness, regulatory quality, and voice and accountability.

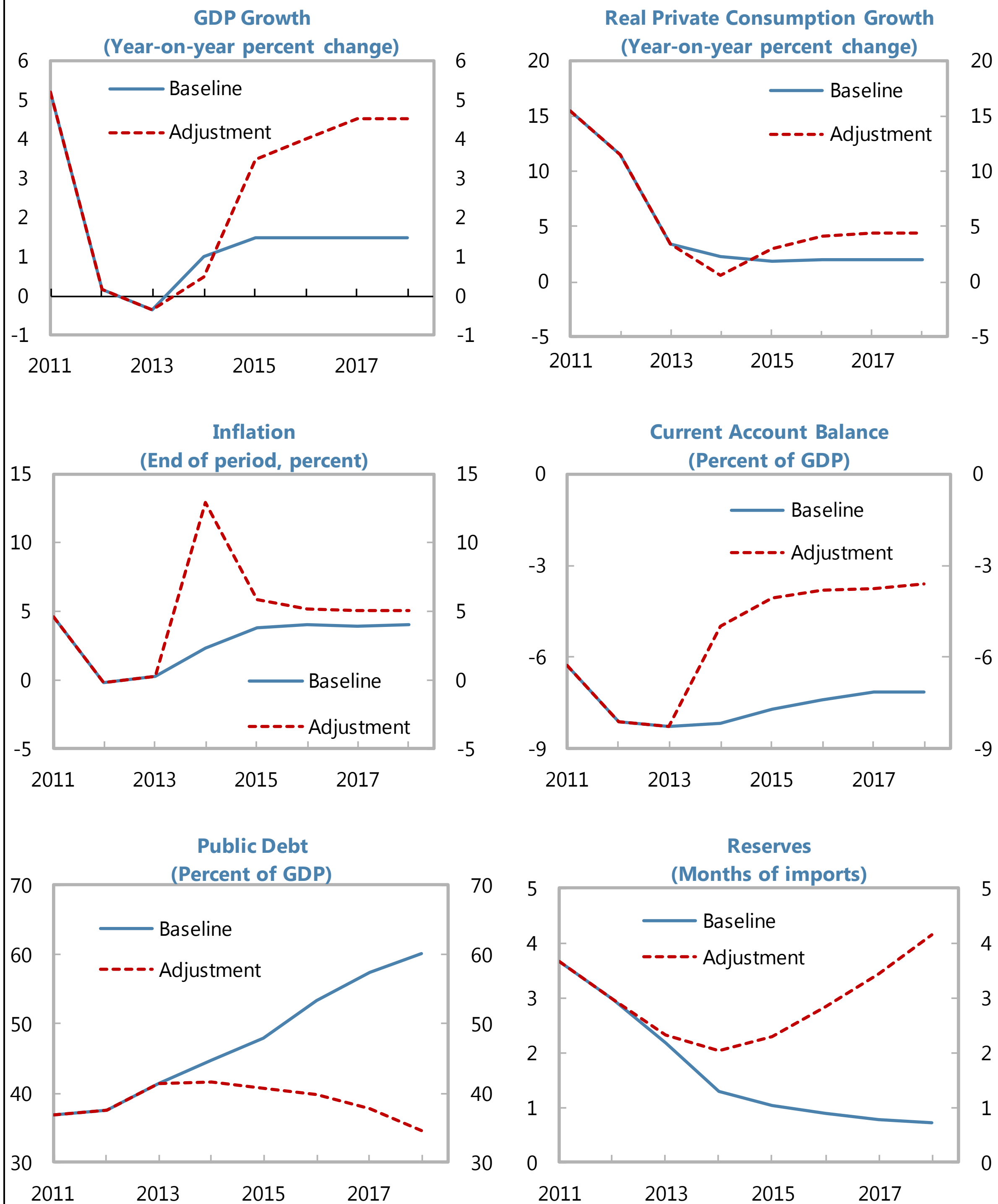


Figure 8. Ukraine: Baseline and Adjustment Scenarios, 2011–18
GDP Growth
(Year-on-year percent change)
Baseline
Adjustment
Real Private Consumption Growth
(Year-on-year percent change)
Inflation
(End of period, percent)
Current Account Balance
(Percent of GDP)
Public Debt
(Percent of GDP)
Reserves
(Months of imports)
2011
2013
2015
2017
Source: Ukrainian authorites; and IMF staff estimates and calculations.

Table 1. Ukraine: Baseline Selected Economic and Social Indicators, 2009–18

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
Real economy (percent change, unless otherwise indicated)										
Nominal GDP (billions of Ukrainian hryvnias)	913	1,083	1,302	1,409	1,432	1,503	1,611	1,724	1,846	1,977
Real GDP	-14.8	4.1	5.2	0.2	-0.3	1.0	1.5	1.5	1.5	1.5
Contributions:										
Domestic demand	-25.8	7.7	12.6	5.5	-0.6	0.9	1.7	1.7	1.9	1.9
Private consumption	-9.3	4.6	10.0	7.8	2.7	1.8	1.5	1.6	1.7	1.7
Public consumption	-0.4	0.8	-0.6	0.4	0.1	0.0	0.1	0.1	0.1	0.1
Investment	-16.0	2.3	3.2	-2.7	-3.5	-1.0	0.0	0.1	0.1	0.1
Net exports	11.0	-3.6	-7.4	-5.3	0.3	0.1	-0.1	-0.2	-0.4	-0.4
GDP deflator	13.0	13.8	14.3	8.0	2.0	4.0	5.5	5.5	5.5	5.5
Output gap (percent of potential GDP)	-8.5	-4.3	0.5	0.1	-1.2	-1.0	-0.6	-0.2	0.0	0.0
Unemployment rate (ILO definition; percent)	8.8	8.1	7.9	7.5	8.0	8.0	7.8	7.8	7.6	7.5
Consumer prices (period average)	15.9	9.4	8.0	0.6	-0.3	1.6	3.3	3.9	4.0	4.0
Consumer prices (end of period)	12.3	9.1	4.6	-0.2	0.2	2.3	3.8	4.0	4.0	4.0
Core inflation (period average) 1/	19.4	8.6	7.7	3.3	0.2	1.4	3.2	3.8	4.0	4.0
Core inflation (end of period) 1/	14.9	7.9	6.9	0.8	0.1	2.3	3.7	4.0	4.0	4.0
Nominal monthly wages (average)	5.5	17.7	17.5	14.9	9.0	5.6	7.0	7.0	7.1	7.1
Real monthly wages (average)	-8.9	7.6	8.8	14.2	9.3	3.9	3.6	3.0	3.0	3.0
Savings (percent of GDP)	15.6	16.3	14.5	10.1	6.3	5.3	5.4	5.5	5.5	5.5
Private	19.7	19.2	14.2	11.5	10.3	8.8	8.8	10.5	10.2	10.0
Public	-4.1	-2.9	0.3	-1.4	-4.0	-3.4	-3.4	-5.0	-4.7	-4.5
Investment (percent of GDP)	17.1	18.5	20.7	18.3	14.6	13.5	13.1	12.9	12.7	12.7
Private	14.9	15.6	17.7	15.2	12.9	12.5	12.1	11.9	11.7	11.7
Public	2.2	2.8	3.0	3.1	1.7	1.0	1.0	1.0	1.0	1.0
Public finance (percent of GDP)										
General government balance 2/	-6.3	-5.8	-2.8	-4.5	-5.7	-4.6	-4.7	-6.5	-6.3	-6.3
Overall balance (including Naftogaz operational deficit)	-8.7	-7.4	-4.3	-5.5	-7.7	-6.6	-6.3	-8.0	-7.7	-7.6
Structural general government balance	-2.1	-3.7	-3.0	-4.5	-4.1	-4.1	-4.5	-6.4	-6.3	-6.3
Structural general government and Naftogaz balance	…	…	-4.6	-6.8	-6.0	-6.1	-6.0	-7.9	-7.7	-7.6
Public debt (end of period) 3/	35.4	40.5	36.8	37.4	41.3	44.7	48.0	53.4	57.5	60.2
Money and credit (end of period, percent change)										
Base money	4.4	15.8	6.3	6.4	14.7	12.9	12.6	12.4	12.1	11.9
Broad money	-5.5	22.7	14.7	12.8	16.8	14.1	13.4	13.1	12.7	12.3
Credit to nongovernment	-2.2	1.1	9.5	2.2	7.8	8.2	8.3	8.4	8.5	8.6
Velocity	1.9	1.8	1.9	1.8	1.6	1.5	1.4	1.3	1.2	1.2
Interbank overnight rate (annual average, percent) 4/	11.5	2.0	5.8	10.8	3.3	…	…	…	…	…
Balance of payments (percent of GDP)										
Current account balance	-1.5	-2.2	-6.3	-8.1	-8.3	-8.2	-7.7	-7.4	-7.1	-7.1
Foreign direct investment	4.0	4.2	4.3	3.8	2.4	2.4	2.4	2.4	2.4	2.4
Gross reserves (end of period, billions of U.S. dollars)	26.5	34.6	31.8	24.5	18.5	11.2	9.2	8.3	7.4	7.1
Months of next year's imports of goods and services	4.3	4.2	3.7	3.0	2.2	1.3	1.0	0.9	0.8	0.7
Percent of short-term debt (remaining maturity)	67.4	73.3	55.4	40.0	32.3	18.8	14.6	11.5	10.0	8.3
Net reserves (end of period, billions of U.S. dollars)	15.5	21.3	18.5	13.8	8.8	5.0	4.5	3.5	2.7	2.3
External debt (percent of GDP)	88.2	86.0	77.2	76.6	76.7	75.3	74.7	75.1	75.2	75.2
Goods exports (annual volume change in percent)	-24.2	9.3	7.1	2.0	-7.4	3.9	3.6	4.1	4.1	4.1
Goods imports (annual volume change in percent)	-41.6	15.0	22.6	2.2	-5.5	2.6	2.4	3.6	4.0	4.4
Goods terms of trade (percent change)	-13.8	0.3	7.6	-3.2	2.2	0.2	1.7	1.5	1.4	1.3
Exchange rate										
Hryvnia per U.S. dollar (end of period)	8.0	8.0	8.0	8.0	…	…	…	…	…	…
Hryvnia per U.S. dollar (period average)	7.8	7.9	8.0	8.0	…	…	…	…	…	…

Memorandum items:

Per capita GDP / Population (2012): US$3,877 / 45.5 million

Literacy / Poverty rate: 100 percent / 2.9 percent

Quota (current): SDR 1,372 million (2,098 million U.S. dollars)

Sovereign credit ratings: B- (S&P, Fitch), Caa1 (Moody's)

Sources: Ukrainian Authorities; World Bank, *World Development Indicators*; and IMF staff estimates.

1/ Excludes unprocessed food, fuel, and administrative services.

2/ The general government includes the central and local governments and the social funds. In 2013, the general government deficit includes recognized arrears (1.3 percent of GDP).

3/ Government and government-guaranteed debt (includes debt to IMF).

4/ For 2013, average of rates for the first ten months.

Table 2. Ukraine: Baseline General Government Finances, 2010–18

(Billions of Ukrainian hryvnia)

	2010	2011	2012	2013		2014	2015	2016	2017	2018
				Budget (w/ amendments)	Proj.	Projection				
Revenue	468.3	558.2	627.3	666.2	651.2	680.8	722.1	738.7	789.8	844.8
Tax revenue	406.4	499.8	547.8	589.9	570.4	596.1	632.7	643.0	687.3	735.1
Tax on income, profits, and capital gains	91.4	115.3	123.9	135.2	131.7	132.9	142.3	145.3	155.8	166.9
Personal income tax	51.0	60.2	68.1	78.0	74.5	78.6	84.1	90.0	96.6	103.5
Corporate profit tax	40.4	55.1	55.8	57.2	57.2	54.3	58.2	55.3	59.2	63.4
Payroll tax	126.1	161.2	183.5	196.1	198.8	209.8	224.6	240.4	257.8	276.3
Property tax	9.5	10.7	12.6	13.1	13.1	13.5	13.9	14.9	15.9	17.0
Tax on goods and services	143.5	175.7	189.7	209.3	186.1	195.7	206.0	194.4	206.9	219.7
VAT	102.8	130.1	138.8	154.6	133.5	139.4	146.9	132.0	140.9	149.8
Excise	28.3	33.9	38.4	41.8	39.5	42.7	44.8	47.2	50.0	53.0
Other	12.4	11.7	12.5	12.9	13.1	13.6	14.3	15.2	16.0	16.9
Tax on international trade	9.1	11.8	13.2	15.3	13.1	13.6	13.9	14.3	14.9	15.5
Other tax	26.8	25.1	24.9	20.8	27.6	30.6	32.0	33.7	36.0	39.7
Nontax revenue	61.9	58.4	79.5	76.4	80.8	84.7	89.4	95.7	102.5	109.7
Expenditure	530.6	594.1	690.4	719.6	733.4	750.0	798.4	851.4	906.8	969.0
Current	498.2	550.1	643.2	692.7	688.1	732.0	779.4	829.8	884.2	945.3
Compensation of employees 1/	123.6	135.1	157.5	167.0	167.0	176.3	188.6	201.8	216.1	232.6
Goods and services	79.2	88.6	104.5	114.2	114.2	118.7	126.9	135.8	146.2	157.5
Interest	17.6	25.6	27.0	37.7	33.2	48.9	58.3	68.8	81.3	95.3
Subsidies to corporations and enterprises	26.5	24.6	43.2	33.3	33.3	33.3	34.9	34.9	34.9	34.9
Social benefits	251.1	275.9	310.4	340.1	340.1	354.4	370.4	388.2	405.4	424.7
Social programs (on budget)	36.4	42.3	54.5	56.8	56.8	55.8	60.5	66.2	70.6	76.7
Pensions	193.9	210.8	233.7	254.2	254.2	269.0	279.4	290.3	301.8	313.7
Unemployment, disability, and accident insurance	20.8	22.8	22.2	29.1	29.1	29.6	30.5	31.7	33.0	34.3
Other current expenditures	0.2	0.3	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital	30.7	39.2	43.3	24.1	24.1	14.7	15.4	17.9	18.9	19.9
Net lending	1.4	4.8	3.9	1.3	1.3	1.3	1.4	1.4	1.5	1.5
Discrepancy / reserve fund	0.3	0.0	0.0	1.5	1.5	2.0	2.3	2.3	2.3	2.3
Promissory Notes to settle pre-2013 arrears	...	...	...	...	18.4	0.0	0.0	0.0	0.0	0.0
Overall balance	-62.3	-35.9	-63.0	-53.4	-82.1	-69.2	-76.5	-112.8	-117.0	-124.0
General government financing	62.3	35.9	63.0	...	82.1	69.2	76.5	112.8	117.0	124.0
External	50.0	16.1	12.4	...	9.5	-2.1	-0.4	3.4	-8.0	16.7
Disbursements	57.7	29.7	42.8	...	42.0	32.8	28.6	26.7	26.7	26.7
Of which: IMF (includes SDR allocations)	16.1	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0	0.0
Amortizations	-7.7	-13.5	-30.4	...	-32.6	-34.9	-29.1	-23.3	-34.6	-10.0
Domestic (net)	12.3	30.6	50.6	...	72.6	71.4	76.9	109.4	125.0	107.3
Bond financing	20.2	16.3	41.0	...	73.0	49.7	72.9	105.4	121.0	103.3
Of which: Promissory Notes	...	...	...	...	18.4	0.0	0.0	0.0	0.0	0.0
Direct bank borrowing	2.7	-0.7	-3.0	...	-0.6	0.0	0.0	0.0	0.0	0.0
Deposit finance	-12.9	-8.1	-0.3	...	-6.1	4.7	0.0	0.0	0.0	0.0
Privatization	2.3	23.2	12.9	...	6.4	17.0	4.0	4.0	4.0	4.0
Naftogaz financing	18.2	20.4	15.2	...	28.3	30.2	25.5	25.0	25.6	27.0
General government and Naftogaz financing	80.5	56.3	78.2	...	110.4	99.5	102.0	137.8	142.6	151.0
Other financing	22.8	8.9	0.0	...	1.4	0.0	0.0	0.0	0.0	0.0
Bank recapitalization	6.4	8.9	0.0	...	1.4	0.0	0.0	0.0	0.0	0.0
VAT bonds	16.4	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0	0.0
Total financing	103.3	65.1	78.2	...	111.8	99.5	102.0	137.8	142.6	151.0

Table 2. Ukraine: Baseline General Government Finances, 2010–18 (Concluded)

(Percent of GDP)

	2010	2011	2012	2013		2014	2015	2016	2017	2018
				Budget (w/ amendments)	Proj.	Projection				
Revenue	43.3	42.9	44.5	46.5	45.5	45.3	44.8	42.8	42.8	42.7
Tax revenue	37.5	38.4	38.9	41.2	39.8	39.7	39.3	37.3	37.2	37.2
Tax on income, profits, and capital gains	8.4	8.9	8.8	9.4	9.2	8.8	8.8	8.4	8.4	8.4
Personal income tax	4.7	4.6	4.8	5.4	5.2	5.2	5.2	5.2	5.2	5.2
Corporate profit tax	3.7	4.2	4.0	4.0	4.0	3.6	3.6	3.2	3.2	3.2
Payroll tax	11.6	12.4	13.0	13.7	13.9	14.0	13.9	13.9	14.0	14.0
Property tax	0.9	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Tax on goods and services	13.3	13.5	13.5	14.6	13.0	13.0	12.8	11.3	11.2	11.1
VAT	9.5	10.0	9.9	10.8	9.3	9.3	9.1	7.7	7.6	7.6
Excise	2.6	2.6	2.7	2.9	2.8	2.8	2.8	2.7	2.7	2.7
Other	1.1	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Tax on international trade	0.8	0.9	0.9	1.1	0.9	0.9	0.9	0.8	0.8	0.8
Other tax	2.5	1.9	1.8	1.5	1.9	2.0	2.0	2.0	2.0	2.0
Nontax revenue	5.7	4.5	5.6	5.3	5.6	5.6	5.6	5.6	5.6	5.5
Expenditure	49.0	45.6	49.0	50.3	51.2	49.9	49.6	49.4	49.1	49.0
Current	46.0	42.2	45.7	48.4	48.1	48.7	48.4	48.1	47.9	47.8
Compensation of employees 1/	11.4	10.4	11.2	11.7	11.7	11.7	11.7	11.7	11.7	11.8
Goods and services	7.3	6.8	7.4	8.0	8.0	7.9	7.9	7.9	7.9	8.0
Interest	1.6	2.0	1.9	2.6	2.3	3.3	3.6	4.0	4.4	4.8
Subsidies to corporations and enterprises	2.4	1.9	3.1	2.3	2.3	2.2	2.2	2.0	1.9	1.8
Social benefits	23.2	21.2	22.0	23.8	23.8	23.6	23.0	22.5	22.0	21.5
Social programs (on budget)	3.4	3.2	3.9	4.0	4.0	3.7	3.8	3.8	3.8	3.9
Pensions	17.9	16.2	16.6	17.8	17.8	17.9	17.3	16.8	16.4	15.9
Unemployment, disability, and accident insurance	1.9	1.8	1.6	2.0	2.0	2.0	1.9	1.8	1.8	1.7
Other current expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital	2.8	3.0	3.1	1.7	1.7	1.0	1.0	1.0	1.0	1.0
Net lending	0.1	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Discrepancy / reserve fund	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Promissory Notes to settle pre-2013 arrears	...	...	...	...	1.3	0.0	0.0	0.0	0.0	0.0
Overall balance	-5.8	-2.8	-4.5	-3.7	-5.7	-4.6	-4.7	-6.5	-6.3	-6.3
General government financing	5.8	2.8	4.5	...	5.7	4.6	4.7	6.5	6.3	6.3
External	4.6	1.2	0.9	...	0.7	-0.1	0.0	0.2	-0.4	0.8
Disbursements	5.3	2.3	3.0	...	2.9	2.2	1.8	1.5	1.4	1.3
Of which: IMF (includes SDR allocations)	1.5	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0	0.0
Amortizations	-0.7	-1.0	-2.2	...	-2.3	-2.3	-1.8	-1.3	-1.9	-0.5
Domestic (net)	1.1	2.4	3.6	...	5.1	4.7	4.8	6.3	6.8	5.4
Bond financing	1.9	1.3	2.9	...	5.1	3.3	4.5	6.1	6.6	5.2
Of which: Promissory Notes	...	...	...	...	1.3	0.0	0.0	0.0	0.0	0.0
Direct bank borrowing	0.3	-0.1	-0.2	...	0.0	0.0	0.0	0.0	0.0	0.0
Deposit finance	-1.2	-0.6	0.0	...	-0.4	0.3	0.0	0.0	0.0	0.0
Privatization	0.2	1.8	0.9	...	0.4	1.1	0.2	0.2	0.2	0.2
Naftogaz financing	1.7	1.6	1.1	...	2.0	2.0	1.6	1.5	1.4	1.4
General government and Naftogaz financing	7.4	4.3	5.5	...	7.7	6.6	6.3	8.0	7.7	7.6
Other financing	2.1	0.7	0.0	...	0.1	0.0	0.0	0.0	0.0	0.0
Bank recapitalization	0.6	0.7	0.0	...	0.1	0.0	0.0	0.0	0.0	0.0
Total financing	9.5	5.0	5.5	...	7.8	6.6	6.3	8.0	7.7	7.6
Memorandum items:										
Cyclically-adjusted general government balance 2/	-3.7	-3.0	-4.5	...	-5.1	-4.1	-4.5	-6.4	-6.3	-6.3
Structural general government balance	-3.7	-3.0	-4.5	...	-4.1	-4.1	-4.5	-6.4	-6.3	-6.3
Government deposits at NBU	2.3	0.9	0.8	...	0.8	0.8	0.7	0.7	0.6	0.6
Public sector debt 3/	40.5	36.8	37.4	...	41.3	44.7	48.0	53.4	57.5	60.2
Nominal GDP (billions of Ukrainian hryvnia)	1,083	1,302	1,409	1,432	1,432	1,503	1,611	1,724	1,846	1,977

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

1/ Numbers are based on actual local governments' budgets.

2/ Preferred to cyclically-adjusted primary balance, as two-thirds of the interest bill relates to domestic debt.

3/ Government and government-guaranteed debt (includes debt to IMF).

Table 3. Ukraine: Baseline Balance of Payments, 2010–18

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

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projection					
Current account balance	-3.0	-10.2	-14.3	-14.5	-14.9	-15.2	-15.6	-16.1	-17.2
Goods and services trade balance	-4.0	-10.2	-14.3	-13.5	-13.4	-11.6	-10.8	-10.3	-10.4
Merchandise trade balance	-8.4	-16.3	-19.5	-18.1	-17.7	-16.0	-15.1	-14.5	-14.4
Exports, f.o.b.	52.2	69.4	70.2	65.6	68.7	71.8	75.5	79.5	83.8
Imports, f.o.b. 1/	-60.6	-85.7	-89.7	-83.6	-86.4	-87.7	-90.6	-94.0	-98.2
Of which: gas	-9.4	-12.4	-14.2	-10.9	-11.4	-10.9	-10.6	-10.4	-10.4
Services (net)	4.4	6.1	5.2	4.5	4.2	4.3	4.3	4.2	4.0
Receipts	17.1	19.4	19.8	20.2	20.1	19.8	19.6	19.5	19.4
Payments	-12.7	-13.3	-14.6	-15.6	-15.8	-15.5	-15.3	-15.3	-15.4
Income (net)	-2.0	-3.8	-3.0	-3.2	-4.8	-6.9	-8.0	-9.1	-10.1
Current transfers (net)	3.0	3.7	3.0	2.2	3.3	3.4	3.3	3.3	3.2
Capital and financial account balance	6.3	6.6	8.4	11.9	10.9	14.2	14.2	14.8	16.4
Capital account	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	6.1	6.5	8.4	11.9	10.9	14.2	14.2	14.8	16.4
Direct investment (net)	5.8	7.0	6.6	4.3	4.5	4.8	5.1	5.5	5.9
Portfolio investment (net)	4.3	1.6	5.7	4.6	5.5	3.2	3.9	4.1	5.2
Of which: general government	3.3	1.0	3.5	2.4	4.1	1.7	1.9	0.9	4.3
Other investment (net)	-3.9	-2.1	-4.0	3.0	0.9	6.2	5.2	5.2	5.4
Medium and long-term loans	1.7	-1.1	1.9	0.4	-0.9	2.2	2.1	1.6	1.5
Official	1.5	-0.5	-2.5	-0.5	-1.4	-0.6	-0.6	-1.0	-0.6
Disbursements 2/	1.9	…	…	…	…	…	…	…	…
Repayments	-0.5	-0.5	-2.5	-0.5	-1.4	-0.6	-0.6	-1.0	-0.6
Banks	-1.8	-3.4	-1.7	-0.5	-0.6	1.5	1.3	1.5	1.1
Other sectors	2.1	2.8	6.0	1.4	1.2	1.3	1.5	1.1	1.0
Short-term loans	3.3	10.7	5.3	2.8	3.2	6.5	5.8	6.5	6.8
Banks	0.4	1.8	-0.9	-0.1	0.6	0.3	0.3	0.0	0.0
Other sectors 3/	2.9	8.9	6.2	2.9	2.6	6.1	5.6	6.5	6.8
Currency and deposits	-9.0	-11.7	-11.2	-0.2	-1.5	-2.5	-2.7	-2.8	-2.9
Banks	-2.8	-0.4	-2.5	2.3	1.0	0.5	0.3	0.2	0.1
Other sectors 4/	-6.1	-11.3	-8.6	-2.5	-2.5	-3.0	-3.0	-3.0	-3.0
Errors and omissions	1.4	0.2	0.6	-0.1	0.0	0.0	0.0	0.0	0.0
Overall balance	4.7	-3.4	-5.3	-2.8	-4.1	-1.0	-1.3	-1.3	-0.8
Official financing	0.4	0.3	1.5	2.3	0.4	0.4	0.4	0.4	0.4
World Bank	0.2	0.2	0.9	0.3	0.3	0.3	0.3	0.3	0.3
EU	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
EBRD/EIB/Others	0.1	0.0	0.5	2.0	0.1	0.1	0.1	0.1	0.1
Financing	-5.0	3.1	3.8	0.5	3.7	0.5	0.9	0.8	0.4
Gross official reserves (increase: -)	-8.5	3.1	7.2	6.0	7.3	2.0	0.9	0.8	0.4
Net use of IMF resources	3.4	0.0	-3.4	-5.6	-3.7	-1.5	0.0	0.0	0.0
Memorandum items:									
Total external debt	117.3	126.2	135.0	134.8	138.1	146.8	157.9	169.3	181.3
Total external debt (percent of GDP)	86.0	77.2	76.6	76.7	75.3	74.7	75.1	75.2	75.2
Current account balance (percent of GDP)	-2.2	-6.3	-8.1	-8.3	-8.2	-7.7	-7.4	-7.1	-7.1
Goods and services trade balance (percent of GDP)	-2.9	-6.2	-8.1	-7.7	-7.3	-5.9	-5.1	-4.6	-4.3
Gross international reserves	34.6	31.8	24.5	18.5	11.2	9.2	8.3	7.4	7.1
Months of next year's imports of goods and services	4.2	3.7	3.0	2.2	1.3	1.0	0.9	0.8	0.7
Percent of short-term debt (remaining maturity)	73.3	55.4	40.0	32.3	18.8	14.6	11.5	10.0	8.3
Percent of the IMF composite measure (fixed) 5/	92.2	75.1	52.7	38.6	21.3	16.5	14.1	11.8	10.2
Merchandise export value (percent change)	29.2	33.0	1.2	-6.6	4.8	4.5	5.1	5.4	5.4
Merchandise import value (percent change)	35.5	41.4	4.7	-6.8	3.3	1.6	3.2	3.8	4.4
Merchandise export volume (percent change)	9.3	7.1	2.0	-7.4	3.9	3.6	4.1	4.1	4.1
Merchandise import volume (percent change)	15.0	22.6	2.2	-5.5	2.6	2.4	3.6	4.0	4.4
Goods terms of trade (percent change)	0.3	7.6	-3.2	2.2	0.2	1.7	1.5	1.4	1.3
Gross domestic product (current prices)	136.4	163.4	176.2	175.6	183.3	196.4	210.3	225.1	241.1

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

1/ Assumes gas import price of US$405 per tcm in 2013 and in line with global oil price developments beyond.
2/ Financing from World Bank, EU, and EBRD is recorded below the line.
3/ Includes trade credit and arrears, including those related to RUE settlement (2010 and 2011).
4/ Mainly reflects residents' conversion of hryvnia cash to foreign currency held outside the banking system.
5/ The IMF composite measure is calculated as a weighted sum of short-term debt, other portfolio liabilities, broad money, and exports in percent of GDP, with different weights for "fixed" and "floating" exchange rate regime. Official reserves are recommended to be in the range of 100-150 percent of the appropriate measure.

Table 4. Ukraine: Baseline Gross External Financing Requirements, 2010–18

(Billions of U.S. dollars)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Projection			
Total financing requirements	48.8	71.1	84.8	72.5	67.6	71.2	78.0	85.1	88.9
Current account deficit	3.0	10.2	14.3	14.5	14.9	15.2	15.6	16.1	17.2
Portfolio investment	4.3	6.7	9.2	9.6	1.2	3.4	3.6	4.7	1.5
Private	1.5	2.1	3.7	7.6	1.2	1.2	1.2	1.2	1.5
Public	2.8	4.6	5.4	2.0	0.0	2.2	2.4	3.5	0.0
Medium and long-term debt	14.6	16.2	19.0	15.9	13.4	11.6	11.6	11.5	11.1
Private	14.2	15.7	16.5	15.4	12.0	11.0	11.0	10.5	10.5
Banks	4.7	5.9	6.2	5.0	5.0	5.0	5.0	5.0	5.0
Corporates	9.5	9.8	10.3	10.5	7.0	6.0	6.0	5.5	5.5
Public	0.5	0.5	2.5	0.5	1.4	0.6	0.6	1.0	0.6
Short-term debt (including deposits)	9.7	12.2	14.2	12.8	14.4	15.8	17.5	19.4	21.4
Other net capital outflows 1/	6.2	12.0	10.6	-1.4	2.5	3.0	3.0	3.0	3.0
Trade credit	11.0	13.9	17.5	21.1	21.1	22.2	26.7	30.4	34.7
Total financing sources	52.2	67.4	79.0	69.7	63.5	70.3	76.7	83.8	88.1
Capital transfers	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	5.8	7.0	6.6	4.3	4.5	4.8	5.1	5.5	5.9
Portfolio investment	8.7	8.2	14.9	14.2	6.7	6.6	7.5	8.9	6.7
Private	2.6	2.6	6.0	9.8	2.6	2.7	3.2	4.4	2.4
Public	6.1	5.6	8.9	4.4	4.1	3.9	4.3	4.5	4.3
Medium and long-term debt	16.3	15.9	20.5	16.4	12.6	13.8	13.8	13.1	12.6
Private	14.4	15.7	19.8	16.4	12.6	13.8	13.8	13.1	12.6
Banks	2.8	2.4	4.6	4.5	4.4	6.5	6.3	6.5	6.1
Corporates	11.6	13.2	15.2	11.9	8.2	7.3	7.5	6.6	6.5
Public 2/	1.9	0.3	0.7	…	…	…	…	…	…
Short-term debt (including deposits)	12.1	16.5	18.7	13.8	17.5	18.4	19.9	21.8	23.4
Trade credit	9.1	19.7	18.2	21.1	22.2	26.7	30.4	34.7	39.5
Increase in gross reserves	8.5	-3.1	-7.2	-6.0	-7.3	-2.0	-0.9	-0.8	-0.4
Errors and omissions	1.4	0.2	0.5	-0.1	0.0	0.0	0.0	0.0	0.0
Total financing needs	3.8	0.3	-1.9	-3.2	-3.2	-1.1	0.4	0.4	0.4
Official financing	3.8	0.3	-1.9	-3.2	-3.2	-1.1	0.4	0.4	0.4
IMF	3.4	0.0	-3.4	-5.6	-3.7	-1.5	0.0	0.0	0.0
Official creditors	0.4	0.3	1.5	2.3	0.4	0.4	0.4	0.4	0.4
World Bank	0.2	0.2	0.9	0.3	0.3	0.3	0.3	0.3	0.3
EU	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
EBRD/EIB/Others	0.1	0.0	0.5	2.0	0.1	0.1	0.1	0.1	0.1
Memorandum items:									
Gross international reserves	34.6	31.8	24.5	18.5	11.2	9.2	8.3	7.4	7.1
Percent of short-term debt (remaining maturity)	73.3	55.4	40.0	32.3	18.8	14.6	11.5	10.0	8.3
Months of next year's imports of goods and services	4.2	3.7	3.0	2.2	1.3	1.0	0.9	0.8	0.7
Loan rollover rate (percent)									
Banks	78.7	72.2	82.9	90.8	99.9	123.6	119.7	118.7	114.6
Corporates	137.6	140.3	148.7	116.6	116.7	118.2	118.3	117.1	113.5
Total	110.4	114.4	125.1	107.0	114.1	119.9	117.9	116.6	112.8

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

1/ Mainly reflects residents' conversion of hryvnia cash to foreign currency held outside of the banking system.

2/ For the projection period (2013–18), financing from official sources is recorded below the line.

Table 5. Ukraine: Baseline Monetary Accounts, 2010–18

	2010	2011	2012	2013				2014	2015	2016	2017	2018
				Mar.	Jun.	Sep.	Dec.					
							Proj.	Projection				
	(Billions of Ukrainian hryvnias)											
Monetary survey												
Net foreign assets	62	61	67	64	59	61	50	11	-13	-36	-57	-72
Foreign assets	373	365	328	318	299	300	...	...	...	...	...	...
Foreign liabilities	311	304	261	254	240	239	...	...	...	...	...	...
Net domestic assets	536	625	706	737	777	811	853	1,020	1,182	1,357	1,546	1,743
Domestic credit	859	965	1,031	1,063	1,095	1,132	1,150	1,297	1,464	1,668	1,895	2,117
Net claims on government	115	147	188	207	222	232	242	314	399	514	643	757
Credit to the economy	728	798	815	827	839	865	879	951	1,030	1,116	1,211	1,315
Domestic currency	390	474	515	520	532	557	570	634	706	787	877	977
Foreign currency	339	324	300	307	308	308	309	317	323	329	334	337
Other items, net	-323	-340	-325	-327	-318	-321	-297	-278	-283	-311	-349	-373
Broad money	598	686	773	801	836	872	903	1,031	1,169	1,321	1,489	1,671
Currency in circulation	183	193	203	206	220	224	227	256	289	326	367	412
Total deposits	414	489	568	592	614	644	673	772	876	991	1,117	1,255
Domestic currency deposits	240	281	320	346	370	393	413	480	551	630	717	814
Of which: Time deposits	133	163	200	214	230	245	...	...	...	...	...	...
Foreign currency deposits	174	208	248	247	244	252	261	292	326	362	400	441
Of which: Time deposits	133	156	191	190	190	196	...	...	...	...	...	...
Accounts of the NBU												
Net foreign assets	168	145	113	125	124	121	113	83	78	69	61	56
Net international reserves	152	137	106	118	117	112	105	75	72	66	58	54
Reserve assets	265	250	192	193	181	167	...	...	...	...	...	...
Reserve liabilities	113	113	86	75	65	55	...	...	...	...	...	...
Net domestic assets	58	94	142	131	152	164	180	248	295	349	408	469
Net domestic credit	112	144	191	173	181	197	214	283	331	385	445	507
Net claims on government	50	77	116	113	121	136	153	238	303	363	428	495
Claims on government	72	90	117	125	130	143	162	247	312	372	437	504
Liabilities to government	22	12	1	12	10	7	8	8	8	8	8	8
Net claims on banks	61	66	75	59	60	61	61	45	27	22	16	11
Other items, net	-54	-49	-48	-42	-29	-33	-34	-35	-36	-36	-37	-38
Base money	226	240	255	256	276	285	293	331	372	419	469	525
Currency in circulation	183	193	203	206	220	224	227	256	289	326	367	412
Banks' reserves	43	47	52	50	56	60	65	75	83	92	102	113
Cash in vault	17	17	20	19	22	22	23	27	30	34	38	43
Required reserves	12	15	20	19	19	25	26	29	32	34	36	39
Excess reserves	13	15	13	12	15	13	17	19	22	24	27	31
Deposit money banks												
Net foreign assets	-106	-85	-46	-61	-65	-60	-63	-71	-91	-105	-119	-128
Foreign assets	92	106	129	118	111	124	...	...	...	...	...	...
Foreign liabilities	198	190	174	179	175	184	...	...	...	...	...	...
Net domestic assets	518	572	612	652	677	703	736	844	967	1,096	1,236	1,383
Domestic credit	789	867	890	939	968	993	1,006	1,092	1,217	1,372	1,547	1,715
Net claims on government	65	69	72	93	101	96	88	76	96	151	215	262
Credit to the economy	728	797	814	826	839	865	878	950	1,030	1,116	1,210	1,314
Other claims on the economy	15	20	28	30	34	35	35	35	36	36	36	37
Net claims on NBU	-20	-20	-24	-11	-6	-3	5	30	56	70	85	102
Of which: Refinancing loans	73	74	78	66	69	66	65	49	32	26	21	15
Other items, net	-270	-295	-278	-287	-290	-290	-270	-248	-250	-276	-311	-332
Banks' liabilities	413	488	566	591	613	643	673	772	876	991	1,117	1,255
Demand deposits	147	169	175	187	193	202	...	...	...	...	...	...
Time deposits	265	319	391	404	420	441	...	...	...	...	...	...
Memorandum items:	(Year-on-year percent change, unless otherwise indicated)											
Base money	15.8	6.3	6.4	9.9	13.4	14.8	14.7	12.9	12.6	12.4	12.1	11.9
Broad money	22.7	14.7	12.8	15.9	17.8	19.1	16.8	14.1	13.4	13.1	12.7	12.3
Credit to the economy	1.1	9.5	2.2	3.9	5.1	7.0	7.8	8.2	8.3	8.4	8.5	8.6
Velocity of broad money, ratio	1.81	1.90	1.82	1.77	1.71	1.68	1.59	1.46	1.38	1.31	1.24	1.18
Money multiplier, ratio	2.65	2.86	3.03	3.13	3.03	3.06	3.08	3.12	3.14	3.16	3.17	3.18
Hryvnia per U.S. dollar, end-of-period	7.96	7.99	7.99	8.13	8.15	8.18	...	...	...	...	...	...

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

Table 6. Ukraine: Financial Soundness Indicators for the Banking Sector, 2009–13

(Percent, unless otherwise indicated)

	2009	2010	2011	2012				2013		
				Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.
Ownership										
Number of banks	182	176	176	176	176	175	176	175	176	181
Private	180	174	174	174	173	172	171	170	171	175
Domestic	129	119	121	121	118	117	118	117	120	124
Foreign	51	55	53	53	55	55	53	53	51	51
Of which: 100% foreign-owned	18	20	22	22	23	23	22	22	21	21
State-owned	2	2	2	2	2	2	2	2	2	3
Foreign-owned banks' share in statutory capital	35.8	40.6	41.9	41.8	41.2	39.3	39.5	38.3	34.2	34.2
Concentration										
Share of assets of largest 10 banks	52.8	53.9	52.8	51.8	52.3	52.5	52.7	52.7	53.7	53.6
Share of assets of largest 25 banks	76.5	75.9	74.6	74.4	74.4	74.1	74.7	74.8	75.2	74.9
Number of bank with assets less than $150 million	107.0	92.0	81.0	77.0	77.0	72.0	75.0	73.0	74.0	75.0
Capital Adequacy										
Regulatory capital to risk-weighted assets	18.1	20.8	18.9	17.9	18.0	18.2	18.1	18.2	18.0	17.9
Capital to total assets	13.1	14.6	14.8	14.6	14.7	14.7	15.0	14.1	14.0	13.9
Asset Quality										
Credit growth (year-over-year percent change) 1/	-2.3	1.1	9.5	6.3	3.6	1.4	2.2	3.8	5.1	7.0
Credit to GDP ratio 1/	78.9	67.3	61.2	59.5	58.0	58.0	57.8	58.4	58.8	60.9
NPLs to total loans (NBU definition) 2/	13.1	14.9	14.3	14.3	13.7	12.8	16.5	15.9	15.2	14.0
NPLs to total loans (broad definition) 3/	37.6	40.3	37.7	39.1	38.4	40.5	26.7	27.1	27.2	25.6
NPLs net of provisions to capital 2/	32.0	29.2	25.8	26.9	25.9	25.1	36.0	35.7	35.7	31.8
Specific provisions (percent of NPLs, NBU definition)	65.1	66.6	68.3	66.8	65.6	65.2	63.9	77.6	77.9	81.0
Specific provisions (percent of total loans)	8.9	10.2	10.1	9.9	9.2	9.0	12.7	12.4	11.8	14.9
Foreign Exchange Rate Risk										
Loans in foreign currency to total loans 1/	51.2	46.5	40.6	40.3	38.5	37.7	36.9	37.2	36.7	35.7
Deposits in foreign currency to total deposits	47.2	42.1	42.6	42.3	42.0	43.3	43.8	41.7	39.9	39.1
Foreign currency loans to foreign currency deposits 1/	239.2	194.8	155.7	152.1	144.8	133.4	121.1	124.6	125.9	122.6
Net open FX position to regulatory capital (NBU definition) 4/	28.5	21.6	8.4	9.1	6.5	0.6	2.5	7.1	9.6	9.0
Net open FX position to regulatory capital (staff estimate) 4/	-23.6	-36.9	-40.0	-35.3	-33.8	-37.1	-29.4	-24.1	-19.6	-18.2
Liquidity Risk										
Liquid assets to total assets	11.5	18.8	18.7	19.4	19.1	21.3	22.2	24.7	22.7	22.8
Customer deposits to total loans to the economy 1/	45.3	56.7	61.2	62.7	63.4	65.3	69.6	71.5	73.1	74.4
Earnings and Profitability										
Return on assets (after tax; end-of-period)	-4.4	-1.5	-0.8	0.7	0.3	0.3	0.5	1.1	0.2	0.2
Return on equity (after tax; end-of-period)	-32.5	-10.2	-5.3	4.4	2.0	2.3	3.0	7.3	1.4	1.3
Net interest margin to total assets	6.2	5.8	5.3	4.7	4.7	4.6	4.5	4.0	4.0	4.1
Interest rate spreads (percentage points; end-of-period)										
Between loans and deposits in domestic currency	5.6	7.6	6.6	6.1	6.2	5.6	4.3	6.4	5.9	5.4
Between loans and deposits in foreign currency	0.7	4.7	2.8	2.7	3.3	2.1	4.5	4.4	4.3	3.7
Between loans in domestic and foreign currency	9.4	5.3	9.4	8.3	9.4	11.0	9.1	7.4	6.1	6.3
Between deposits in domestic and foreign currency	4.5	2.4	5.6	4.8	6.6	7.5	9.4	5.4	4.5	4.5
Number of banks not complying with banking regulations										
Not meeting capital adequacy requirements for Tier I capital	12	3	2	0	1	0	2	0	0	0
Not meeting prudential regulations	22	8	11	9	6	4	6	6	3	5
Not meeting reserve requirements	15	5	5	4	4	5	9	7	3	3

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

1/ Monetary statistics data.

2/ From December 2012, NBU changed loan classification, which resulted in the NPL series break. Up to September 2012, share of loans classified as doubtful and loss in the total loans. From December 2012, share of loans of IV and V category of quality in the total loans.

3/ Included NPLs that are classified as substandard, doubtful, and loss. From December 2012, estimated by staff using NPL data published by NBU according to new methodology, which resulted in series break.

4/ NBU definition does not take into account the effects of NBU Resolution 109, which forced banks into holding large negative open foreign exchange (FX) positions.

Table 7. Ukraine: Adjustment Scenario: Selected Economic and Social Indicators, 2012–18

	2012	2013	2014	2015	2016	2017	2018
		Projections					
Real economy (percent change, unless otherwise indicated)							
Nominal GDP (billions of Ukrainian hryvnias)	1,409	1,432	1,626	1,834	2,059	2,314	2,596
Real GDP	0.2	-0.3	0.5	3.5	4.0	4.5	4.5
Contributions:							
Domestic demand	5.5	-0.6	-3.0	3.9	5.1	5.7	5.9
Private consumption	7.8	2.7	0.4	2.5	3.3	3.6	3.6
Public consumption	0.4	0.1	-2.3	0.5	0.5	0.4	0.5
Investment	-2.7	-3.5	-1.1	0.9	1.4	1.6	1.8
Net exports	-5.3	0.3	3.4	-0.4	-1.1	-1.1	-1.4
GDP deflator	8.0	2.0	13.0	9.0	8.0	7.5	7.3
Output gap (percent of potential GDP)	0.1	-1.2	-1.5	-0.7	-0.5	0.0	0.0
Unemployment rate (ILO definition; percent)	7.5	8.0	8.3	7.8	7.3	7.0	6.6
Consumer prices (period average)	0.6	-0.3	9.7	6.6	5.8	5.0	5.0
Consumer prices (end of period)	-0.2	0.2	12.9	5.9	5.2	5.0	5.0
Core inflation (period average) 1/	3.3	0.2	6.2	6.3	5.1	5.0	5.0
Core inflation (end of period) 1/	0.8	0.1	9.6	5.1	5.0	5.0	5.0
Nominal monthly wages (average)	14.9	9.0	8.5	9.8	10.1	9.7	9.7
Real monthly wages (average)	14.2	9.3	-1.0	3.0	4.1	4.5	4.5
Savings (percent of GDP)	10.1	6.3	8.1	9.6	10.9	12.0	13.6
Private	11.5	10.3	8.9	9.8	10.7	11.2	12.0
Public	-1.4	-4.0	-0.8	-0.2	0.2	0.9	1.6
Investment (percent of GDP)	18.3	14.6	13.1	13.5	14.7	15.8	17.2
Private	15.2	12.9	11.4	11.8	12.6	13.3	14.2
Public	3.1	1.7	1.7	1.7	2.1	2.5	3.0
Public finance (percent of GDP)							
General government balance 2/	-4.5	-5.7	-2.7	-2.3	-2.2	-2.0	-1.7
Overall balance (including Naftogaz operational deficit)	-5.5	-7.7	-4.0	-3.2	-2.8	-2.2	-2.0
Structural general government balance	-4.5	-4.1	-1.9	-1.9	-2.0	-2.0	-1.7
Structural general government and Naftogaz balance	-6.8	-6.0	-3.2	-2.9	-2.6	-2.2	-2.0
Public debt (end of period) 3/	37.4	41.3	41.5	40.7	39.7	37.8	34.6
Money and credit (end of period, percent change)							
Base money	6.4	14.7	14.0	13.3	14.0	14.6	15.0
Broad money	12.8	16.8	13.0	13.9	14.6	15.3	15.7
Credit to nongovernment	2.2	7.8	8.6	9.1	10.2	11.5	12.0
Velocity	1.8	1.6	1.6	1.6	1.5	1.5	1.5
Interbank overnight rate (annual average, percent) 4/	10.8	3.3	...	...	...	...	...
Balance of payments (percent of GDP)							
Current account balance	-8.1	-8.3	-5.0	-4.1	-3.8	-3.8	-3.6
Foreign direct investment	3.8	2.4	3.0	3.0	3.0	3.0	3.0
Gross reserves (end of period, billions of U.S. dollars)	24.5	18.5	17.1	20.7	27.9	36.8	48.6
Months of next year's imports of goods and services	3.0	2.3	2.0	2.3	2.8	3.4	4.1
Percent of short-term debt (remaining maturity)	40.0	32.3	29.2	33.9	39.1	47.9	53.7
Net reserves (end of period, billions of U.S. dollars)	13.8	13.4	15.6	20.7	27.9	36.8	48.5
External debt (percent of GDP)	76.6	76.7	84.6	80.8	79.9	78.6	77.8
Goods exports (annual volume change in percent)	2.0	-7.4	7.3	6.9	7.0	7.5	7.5
Goods imports (annual volume change in percent)	2.2	-5.5	-4.0	6.3	8.7	9.8	9.9
Goods terms of trade (percent change)	-3.2	2.2	0.2	1.9	1.6	1.5	1.4
Exchange rate							
Hryvnia per U.S. dollar (end of period)	8.0	...	...	...	...	...	...
Hryvnia per U.S. dollar (period average)	8.0	...	...	...	...	...	...

Sources: Ukrainian Authorities; World Bank, *World Development Indicators*; and IMF staff estimates.

1/ Excludes unprocessed food, fuel, and administrative services.
2/ The general government includes the central and local governments and the social funds. In 2013, the general government deficit includes recognized arrears (1.3 percent of GDP).
3/ Government and government-guaranteed debt (includes debt to IMF).
4/ For 2013, average of rates for the first ten months.

Table 8. Ukraine: Baseline General Government Finances, GFSM 2001 Presentation, 2010–18

(Millions of UAH)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Statement of operations									
Revenues	**466,250**	**556,358**	**625,152**	**647,333**	**676,700**	**717,800**	**734,200**	**784,700**	**839,700**
Taxes	283,028	339,611	365,137	372,134	387,200	409,000	403,600	430,500	460,100
Personal income tax	51,029	60,225	68,092	74,456	78,600	84,100	90,000	96,600	103,500
Corporate income tax	40,359	55,097	55,793	57,200	54,300	58,200	55,300	59,200	63,400
Property tax	19,465	28,505	27,111	27,698	28,300	28,900	30,500	32,500	36,000
VAT	102,752	130,094	138,800	133,544	139,400	146,900	132,000	140,900	149,800
Excise	40,715	45,592	50,966	52,617	56,300	59,200	62,400	66,000	70,000
Other taxes on goods and services	16,881	7,280	10,363	13,031	15,800	16,900	18,100	19,400	20,800
Taxes on international trade	9,054	11,790	13,187	13,139	13,600	13,900	14,300	14,900	15,500
Earmarked taxes	2,773	1,029	826	447	900	900	1,000	1,000	1,100
Social contributions	126,093	161,179	183,540	198,807	209,800	224,700	240,400	257,800	276,300
Pension fund	106,565	139,179	157,995	171,137	180,600	193,400	206,900	221,900	237,800
Other social funds	19,528	22,000	25,545	27,670	29,200	31,300	33,500	35,900	38,500
Grants	180	481	223	1,048	1,100	1,100	1,200	1,300	1,400
Other revenue	56,949	55,086	76,251	75,345	78,600	83,000	89,000	95,100	101,900
o/w Budget insitutions´ own reserves	28,719	31,279	34,100	33,181	34,800	36,800	39,400	42,100	45,100
Expenditures	**527,193**	**587,550**	**684,267**	**709,786**	**744,514**	**792,828**	**845,413**	**900,346**	**962,151**
Expense	**513,508**	**571,199**	**662,200**	**696,720**	**741,000**	**788,800**	**839,200**	**893,600**	**954,700**
Compensation of employees 1/	123,637	135,075	157,500	166,966	176,300	188,600	201,800	216,100	232,600
Purchases of goods and services	79,163	88,586	104,500	114,233	118,700	126,900	135,800	146,200	157,500
Interest payments	17,557	25,631	27,000	33,200	48,900	58,300	68,800	81,300	95,300
Subsidies	26,480	24,645	43,200	33,316	33,300	34,900	34,900	34,900	34,900
Grants	210	342	600	316	300	300	300	300	300
Social benefits	214,760	233,606	255,900	283,346	298,600	309,900	322,000	334,800	348,000
Pension expenditure	193,934	210,806	233,700	254,249	269,000	279,400	290,300	301,800	313,700
Non-pension Social Fund Expenditure	20,826	22,800	22,200	29,097	29,600	30,500	31,700	33,000	34,300
Other expense	51,701	63,315	73,500	65,342	64,900	69,900	75,600	80,000	86,100
Budget transfers to households	36,398	42,260	54,500	56,772	55,800	60,500	66,200	70,600	76,700
Capital transfers	15,022	21,055	19,000	7,070	7,100	7,100	7,100	7,100	7,100
Unallocated spending	282	0	0	1,500	2,000	2,300	2,300	2,300	2,300
Net acquistion of nonfinancial assets	13,685	16,351	22,067	13,066	3,514	4,028	6,213	6,746	7,451
Investment	15,642	18,148	24,300	17,024	7,614	8,328	10,813	11,746	12,751
Sale of physical assets	-1,957	-1,797	-2,233	-3,958	-4,100	-4,300	-4,600	-5,000	-5,300
Gross operating balance	**-47,258**	**-14,841**	**-37,048**	**-49,387**	**-64,300**	**-71,000**	**-105,000**	**-108,900**	**-115,000**
Promissory Notes to settle pre-2013 arrears				18,400	0	0	0	0	0
Net lending/borrowing (overall balance)	**-60,943**	**-31,192**	**-59,115**	**-80,853**	**-67,814**	**-75,028**	**-111,213**	**-115,646**	**-122,451**
Net financial transactions	**-60,943**	**-42,015**	**-59,144**	**-80,798**	**-67,948**	**-75,070**	**-111,400**	**-115,500**	**-122,500**
Net acquistion of financial assets	**11,970**	**-10,306**	**-8,780**	**1,051**	**-20,350**	**-2,600**	**-2,600**	**-2,500**	**-2,500**
Currency and deposits	12,896	8,136	266	6,120	-4,650	0	0	0	0
Loans	1,354	4,755	3,856	1,302	1,300	1,400	1,400	1,500	1,500
Equity and other shares	-2,279	-23,197	-12,902	-6,370	-17,000	-4,000	-4,000	-4,000	-4,000
Net incurrence of liabilities	**72,914**	**31,709**	**50,364**	**81,849**	**47,598**	**72,470**	**108,800**	**113,000**	**120,000**
Domestic	22,899	15,566	37,997	72,398	49,745	72,892	105,410	120,974	103,313
Debt securities	20,151	16,299	41,025	72,973	49,745	72,892	105,410	120,974	103,313
Loans	2,748	-733	-3,028	-574	0	0	0	0	0
Foreign	50,015	16,144	12,367	9,451	-2,147	-422	3,390	-7,974	16,687
Loans	50,015	16,144	12,367	9,451	-2,147	-422	3,390	-7,974	16,687
Statistical discrepancy/financing gap	*0*	*10,823*	*29*	*-54*	*134*	*42*	*187*	*-146*	*49*
Financial balance sheet									
Financial assets	155,792	147,310	138,531	139,581	119,231	116,631	114,031	111,531	109,031
Currency and deposits	26,031	16,801	17,067	23,186	18,536	18,536	18,536	18,536	18,536
Loans	54,192	33,583	37,439	38,741	40,041	41,441	42,841	44,341	45,841
Equity and other shares	75,569	96,926	84,025	77,654	60,654	56,654	52,654	48,654	44,654
Financial liabilities	334,578	370,468	420,832	502,682	550,280	622,749	731,549	844,549	964,549
Currency and deposits (stocks of liabilities)	0	0	0	0	0	0	0	0	0
Securities other than shares (stocks of liabilities)	195,484	228,751	269,776	342,749	392,494	465,386	570,796	691,770	795,083
Loans (stocks of liabilities)	139,094	141,718	138,689	138,115	138,115	138,115	138,115	138,115	138,115
Other liabilities (stocks of liabilities)	0	0	12,367	21,818	19,671	19,249	22,639	14,664	31,352
Net financial worth	-178,786	-223,158	-282,302	-363,100	-431,048	-506,118	-617,518	-733,018	-855,518

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

Table 8. Ukraine: Baseline General Government Finances, GFSM 2001 Presentation, 2010–18 (Concluded)

(Percent of GDP)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Statement of operations									
Revenues	**43.1**	**42.7**	**44.4**	**45.2**	**45.0**	**44.6**	**42.6**	**42.5**	**42.5**
Taxes	26.1	26.1	25.9	26.0	25.8	25.4	23.4	23.3	23.3
Personal income tax	4.7	4.6	4.8	5.2	5.2	5.2	5.2	5.2	5.2
Corporate income tax	3.7	4.2	4.0	4.0	3.6	3.6	3.2	3.2	3.2
Property tax	1.8	2.2	1.9	1.9	1.9	1.8	1.8	1.8	1.8
VAT	9.5	10.0	9.9	9.3	9.3	9.1	7.7	7.6	7.6
Excise	3.8	3.5	3.6	3.7	3.7	3.7	3.6	3.6	3.5
Other taxes on goods and services	1.6	0.6	0.7	0.9	1.1	1.0	1.0	1.1	1.1
Taxes on international trade	0.8	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.8
Earmarked taxes	0.3	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Social contributions	11.6	12.4	13.0	13.9	14.0	14.0	13.9	14.0	14.0
Pension fund	9.8	10.7	11.2	12.0	12.0	12.0	12.0	12.0	12.0
Other social funds	1.8	1.7	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Grants	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	5.3	4.2	5.4	5.3	5.2	5.2	5.2	5.2	5.2
o/w Budget insitutions´ own reserves	2.7	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3
Expenditures	**48.7**	**45.1**	**48.6**	**49.6**	**49.5**	**49.2**	**49.0**	**48.8**	**48.7**
Expense	**47.4**	**43.9**	**47.0**	**48.7**	**49.3**	**49.0**	**48.7**	**48.4**	**48.3**
Compensation of employees 1/	11.4	10.4	11.2	11.7	11.7	11.7	11.7	11.7	11.8
Purchases of goods and services	7.3	6.8	7.4	8.0	7.9	7.9	7.9	7.9	8.0
Interest payments	1.6	2.0	1.9	2.3	3.3	3.6	4.0	4.4	4.8
Subsidies	2.4	1.9	3.1	2.3	2.2	2.2	2.0	1.9	1.8
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social benefits	19.8	17.9	18.2	19.8	19.9	19.2	18.7	18.1	17.6
Pension expenditure	17.9	16.2	16.6	17.8	17.9	17.3	16.8	16.4	15.9
Non-pension Social Fund Expenditure	1.9	1.8	1.6	2.0	2.0	1.9	1.8	1.8	1.7
Other expense	4.8	4.9	5.2	4.6	4.3	4.3	4.4	4.3	4.4
Budget transfers to households	3.4	3.2	3.9	4.0	3.7	3.8	3.8	3.8	3.9
Capital transfers	1.4	1.6	1.3	0.5	0.5	0.4	0.4	0.4	0.4
Unallocated spending	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Net acquistion of nonfinancial assets	**1.3**	**1.3**	**1.6**	**0.9**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Investment	1.4	1.4	1.7	1.2	0.5	0.5	0.6	0.6	0.6
Sale of physical assets	-0.2	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Gross operating balance	**-4.4**	**-1.1**	**-2.6**	**-3.4**	**-4.3**	**-4.4**	**-6.1**	**-5.9**	**-5.8**
Promissory Notes to settle pre-2013 arrears				1.3	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing (overall balance)	**-5.6**	**-2.4**	**-4.2**	**-5.6**	**-4.5**	**-4.7**	**-6.4**	**-6.3**	**-6.2**
Net financial transactions	**-5.6**	**-3.2**	**-4.2**	**-5.6**	**-4.5**	**-4.7**	**-6.5**	**-6.3**	**-6.2**
Net acquistion of financial assets	**1.1**	**-0.8**	**-0.6**	**0.1**	**-1.4**	**-0.2**	**-0.2**	**-0.1**	**-0.1**
Currency and deposits	1.2	0.6	0.0	0.4	-0.3	0.0	0.0	0.0	0.0
Loans	0.1	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Equity and other shares	-0.2	-1.8	-0.9	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2
Net incurrence of liabilities	**6.7**	**2.4**	**3.6**	**5.7**	**3.2**	**4.5**	**6.3**	**6.1**	**6.1**
Domestic	2.1	1.2	2.7	5.1	3.3	4.5	6.1	6.6	5.2
Debt securities	1.9	1.3	2.9	5.1	3.3	4.5	6.1	6.6	5.2
Loans	0.3	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	4.6	1.2	0.9	0.7	-0.1	0.0	0.2	-0.4	0.8
Loans	4.6	1.2	0.9	0.7	-0.1	0.0	0.2	-0.4	0.8
Statistical discrepancy/financing gap	0.0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial balance sheet									
Financial assets	14.4	11.3	9.8	9.7	7.9	7.2	6.6	6.0	5.5
Currency and deposits	2.4	1.3	1.2	1.6	1.2	1.2	1.1	1.0	0.9
Loans	5.0	2.6	2.7	2.7	2.7	2.6	2.5	2.4	2.3
Equity and other shares	7.0	7.4	6.0	5.4	4.0	3.5	3.1	2.6	2.3
Financial liabilities	30.9	28.5	29.9	35.1	36.6	38.7	42.4	45.8	48.8
Currency and deposits (stocks of liabilities)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares (stocks of liabilities)	18.1	17.6	19.1	23.9	26.1	28.9	33.1	37.5	40.2
Loans (stocks of liabilities)	12.8	10.9	9.8	9.6	9.2	8.6	8.0	7.5	7.0
Other liabilities (stocks of liabilities)	0.0	0.0	0.9	1.5	1.3	1.2	1.3	0.8	1.6
Net financial worth	-16.5	-17.1	-20.0	-25.4	-28.7	-31.4	-35.8	-39.7	-43.3
Memorandum item:									
Cyclically-adjusted general government balance 2/	-3.7	-3.0	-4.7	-5.2	-4.1	-4.5	-6.4	-6.3	-6.3
Government deposits at NBU	2.3	0.9	0.8	0.8	0.8	0.7	0.7	0.6	0.6
Public sector debt 3/	40.5	36.8	37.4	41.3	44.7	48.0	53.4	57.5	60.2
Nominal GDP (UAH billion)	1082.6	1302.1	1408.9	1431.8	1503.3	1610.5	1724.4	1845.9	1976.8

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

1/ Numbers are based on actual local governments' budgets.

2/ Preferred to cyclically-adjusted primary balance, as two-thirds of the interest bill relates to domestic debt.

3/ Government and government-guaranteed debt (includes debt to IMF).

Table 9. Ukraine: Indicators of Fund Credit, 2009–18

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
Stock of existing Fund credit 1/ 2/										
In millions of SDRs	7,000	9,250	9,250	7,016	3,359	969	0	0	0	0
In percent of quota	510	674	674	511	245	71	0	0	0	0
In percent of GDP	9	10	9	6	3	1	0	0	0	0
In percent of exports of goods and services	20	21	16	12	6	2	0	0	0	0
In percent of public sector external debt	46	44	43	34	18	5	0	0	0	0
In percent of gross reserves	42	41	45	44	28	13	0	0	0	0
Obligations to the Fund from existing drawings 2/										
In millions of SDRs	145	161	236	2,434	3,788	2,416	975	0	0	0
In percent of quota	11	12	17	177	276	176	71	0	0	0
In percent of GDP	0	0	0	2	3	2	1	0	0	0
In percent of exports of goods and services	0	0	0	4	7	4	2	0	0	0
In percent of public sector external debt service	6	5	5	29	59	52	23	0	0	0
In percent of gross reserves 3/	1	1	1	12	23	20	13	0	0	0

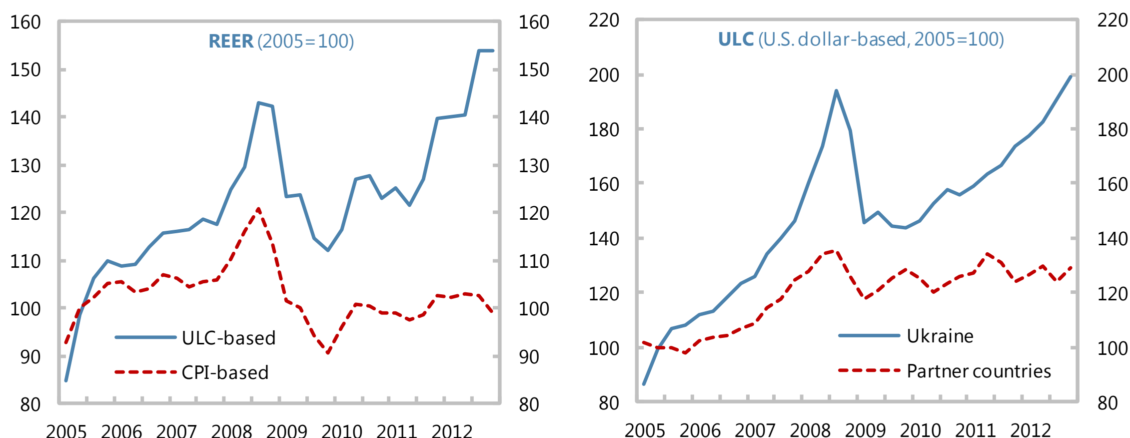
Source: IMF staff estimates.

1/ End of period.
2/ Repayment schedule based on repurchase obligations and charges.
3/ Reserves at the end of the previous year.

Annex I. Ukraine: Competitiveness, Exchange Rate Assessment, and Reserve Adequacy

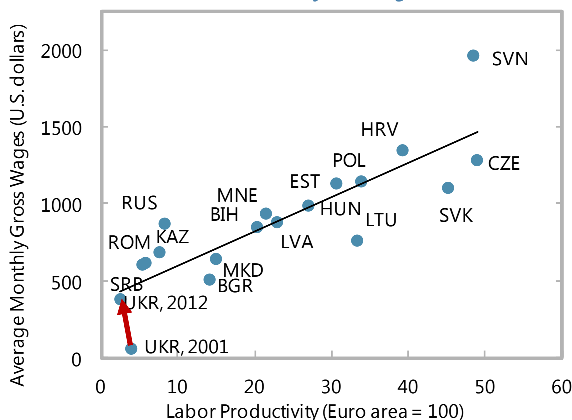
Ukraine's competitiveness has eroded, while cyclical and structural factors have led to significant vulnerabilities. After a period of overvaluation (2004–08), which was mainly driven by large inflation differentials vis-à-vis main trading partners, a forced nominal devaluation boosted Ukraine's competitiveness in 2009. Since then, unabated wage pressures—despite low inflation—have led to high real wage growth. Meanwhile, productivity continued to grow at a much slower pace relative to other CESEE countries, partly on account of poor quality capital stock and slower technological advances. As a result, the ULC-based competitiveness indicator points to a large deviation from trading partners, already exceeding the 2008 levels, while the CPI-based indicator is far more muted on account of the large weight of administered prices in the CPI. On balance, with persistent erosion in competitiveness under the pegged exchange rate, the current account deficit has become unsustainable and reserves continue to fall.

Price Competitiveness Indicators, 2005–12



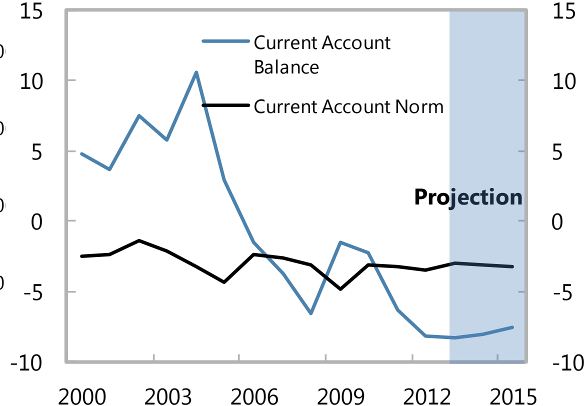
Sources: State Statistics Committee of Ukraine; OECD; Haver; IMF, *International Financial Statistics*; and IMF staff estimates.

Labor Productivity and Wages, 2012



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

Current Account Balance and Norm, 2000-15



Sources: Ukrainian authorities; and IMF staff estimates

Under the baseline of unchanged policies, quantitative estimates of real exchange rate misalignment suggest hryvnia overvaluation by 14–16 percent. The assessment of the real effective exchange rate is based on standard CGER-type methodologies, October 2013 WEO assumptions, and a projected current account deficit of more than 7 percent of GDP over the medium term. The macroeconomic balance method identifies a gap of about 4 percentage points between the current account balance and the norm over the medium term. To close this gap, the REER would need to depreciate by about 14 percent. Similarly, the external sustainability method indicates a need for REER depreciation of about 16.3 percent to reach the current account balance that would stabilize Ukraine's NFA position. The reduced-form equilibrium real exchange rate method estimates a small undervaluation of about 1.8 percent, mainly on account of non-structural and highly volatile variables such as terms of trade, relative productivity, relative government consumption, and initial net foreign assets. However, historical structural breaks in the data (which could also be expected to recur in the event of policy reversal) undermine the robustness of the results. Moreover, underlying fundamentals and market expectations are consistent with sizable overvaluation.

Exchange Rate Assessment 1/

(Percent deviation from equilibrium REER)

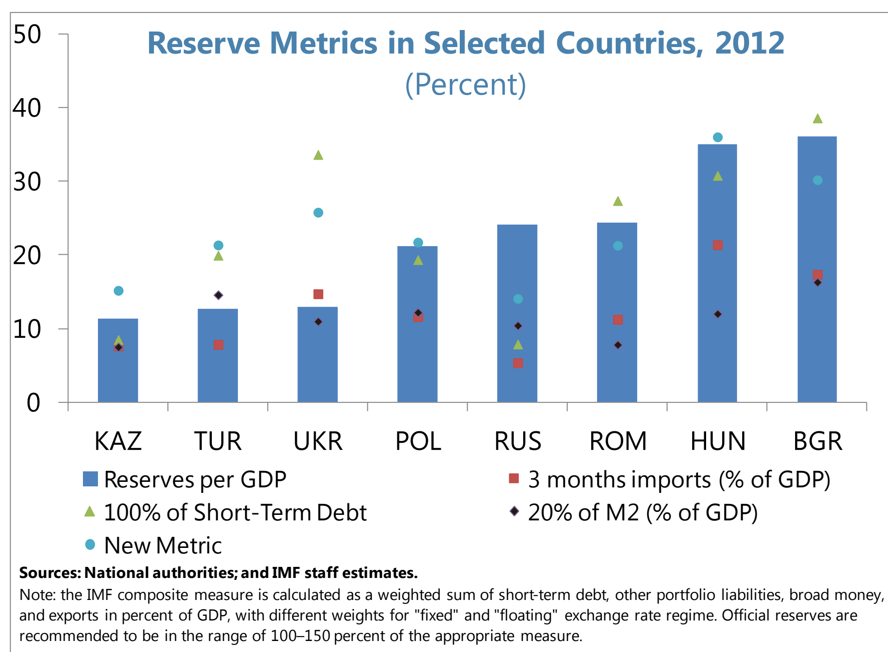
	Sep-11	Dec-12	Nov-13
Macroeconomic balance 2/	8.5	13.5	14.0
External sustainability 3/	5.5	14.4	16.3
Equilibrium real exchange rate	-9.3	-3.8	-1.8

Source: IMF Exchange Rate Assessment Toolkit.

1/ Based on WEO Projections

2/ REER adjustment needed to bring underlying current account to the level of the norm.

3/ REER adjustment needed to stabilize NFA



Sources: National authorities; and IMF staff estimates.

Note: the IMF composite measure is calculated as a weighted sum of short-term debt, other portfolio liabilities, broad money, and exports in percent of GDP, with different weights for "fixed" and "floating" exchange rate regime. Official reserves are recommended to be in the range of 100–150 percent of the appropriate measure.

With limited policy buffers, Ukraine's vulnerability to external shocks has risen. Gross reserves fell to US$20.7 billion by end-October 2013 (36 percent of short-term debt) from a peak of $38 billion in May 2011. The decline was driven by the large current account deficit and initially by bank deleveraging and additional household foreign exchange withdrawals, and more recently by large repayments on outstanding foreign debts (including Fund repurchases). Ukraine scores poorly in cross-country comparisons of reserve adequacy per the new composite IMF metric—assessing liquid reserve needs based on a combined measure of a country's external liabilities, export

earnings, and risks of potential capital flight (broad money)—and has particularly poor coverage of short-term debt.

Ukraine: Reserve Adequacy Metrics, 2010-15

	2010	2011	2012	2013	2014	2015
Gross official reserves (billions of US dollars)	34.6	31.8	24.5	18.5	11.2	9.1
Months of imports of goods and services	4.2	3.7	3.0	2.2	1.3	1.0
Percent of short term debt at remaining maturity	73.3	55.4	40.0	32.3	18.8	14.5
Percent of short term debt at remaining maturity plus current account deficit	68.9	47.0	32.4	25.8	15.0	11.7
Percent of IMF composite measure 1/	92.6	75.7	52.8	38.6	21.3	16.5

Source: NBU and Staff Calculations.

1/ The IMF composite measure is calculated as a weighted sum of short-term debt, other portfolio liabilities, broad money, and exports in percent of GDP, with different weights for "fixed" and "floating" exchange rate regime. Official reserves are recommended to be in the range of 100-150 percent of the appropriate measure.

Further analysis suggests that closing fiscal and quasi-fiscal policy gaps alone without devaluation would boost Ukraine's external sustainability only marginally, while leaving major vulnerabilities unaddressed. Fiscal consolidation starting in 2014 and targeting a combined fiscal and quasi-fiscal deficit of 1.9 percent of GDP over the medium term—while keeping the exchange rate pegged at its current level—would squeeze domestic demand and reduce the medium term current account deficit to around 6 percent of GDP vs. more than 7 percent under the baseline. Under this scenario, a double-digit real hryvnia devaluation would still be needed, however. The positive effects of a smaller fiscal balance on the current account would be broadly offset by a smaller current account deficit norm driven by the sharp and persistent deterioration in growth brought by the fiscal consolidation without competitiveness gains. Moreover, such a policy package would not achieve external sustainability as international reserves would still fall sharply in 2014—and remain below two months of imports, while short-term debt coverage would remain below 30 percent throughout the medium term.

Annex II. Ukraine: Risk Assessment Matrix[1]

Source of Risk	**Relative Likelihood – Time Horizon**	**Impact if Realized**	**Policy Response**
Global oil shock triggered by geopolitical events *(driving oil prices to $150 per barrel)*	**Low** **Short-Term**	**High** A significant deterioration in the current account (driven by price of imported gas from Russia), followed by ballooning operational deficit of the state-owned Naftogaz.	• Diversify energy import sources and boost domestic energy production including alternative energy sources; raise energy efficiency • Reduce quasi-fiscal deficit resulting from below-market prices and excessive subsidies
Protracted economic and financial volatility, especially for emerging markets, *triggered by prospective exit from unconventional monetary policy*	**High** **Short-Term**	**High** Sovereign and corporate / banks could lose market access.	Adjust the policy mix: • Allow increased exchange rate flexibility to reduce the current account deficit • Tighten monetary policy to keep inflation under control but ensure adequate bank liquidity • Tighten fiscal policy to reduce funding needs • Seek official financing in support of adjustment efforts
Exchange rate pressures *(a surge of devaluation expectations can lead to higher demand for foreign exchange)*	**High** **Short / Medium term**	**High** Sharp decline in international reserves and possible exchange rate depreciation.	
Financial stress in the euro area re-emerges *(triggered by stalled or incomplete delivery of national and euro area policy commitments)*	**Medium** **Short-term**	**Medium** A lasting shock on exports, FDI, and portfolio investment would depress growth.	Unlock domestic growth sources by: • Restarting structural reforms to foster private sector development • Improving business climate • Diversifying export markets • Developing domestic financial markets.
Protracted period of slower European growth *(larger than expected deleveraging or negative surprise on potential growth)*	**High** **Medium-term**	**High** A lasting shock on exports, FDI, and portfolio investment would depress growth.	
Lower than anticipated emerging market growth potential *(earlier maturing of the cycle and incomplete structural reforms)*	**Medium** **Short / Medium term**		

[1] The Risk Assessment Matrix shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of staff). The relative likelihood of the risks is staff's subjective assessment of the risks surrounding this baseline.

<table>
<tr>
<td>Bank stress (sudden exchange rate depreciation can impair bank balance sheets and cause a deposit run)</td>
<td>High</td>
<td>High

Decline in capital and liquidity in several large banks, with a risk for systemic crisis.</td>
<td>Prepare contingency plans to:
• Ensure full capitalization of systemic banks
• Provide adequate liquidity to solvent banks
• Allow banks to close large open negative foreign exchange position</td>
</tr>
<tr>
<td>Trade tensions with Russia (which can revoke free trade agreements or introduce customs restrictions if Ukraine signs an FTA with the EU)</td>
<td>Medium

Short / Medium term</td>
<td>Medium

Russia accounts for about a quarter of Ukrainian exports, and these exports could be affected.</td>
<td rowspan="2">• Diversify export and product markets
• Allow additional exchange rate flexibility to facilitate adjustment to terms-of-trade shocks</td>
</tr>
<tr>
<td>Sharp slowdown in growth in China (buildup of excess capacity eventually resulting in large financial and fiscal losses)</td>
<td>Medium

Medium-term</td>
<td>High

Significantly lower global prices and demand for steel and other commodities exported by Ukraine.</td>
</tr>
</table>

Annex III. Public and External Debt Sustainability Analysis

Public debt sustainability risks are significant and public debt is rising rapidly. Under the baseline scenario, public debt is projected to rise continuously to 60.2 percent of GDP in 2018 as the fiscal deficit is projected to remain elevated and economic performance depressed. The baseline public debt profile is subject to considerable risks particularly from lower growth and contingent liabilities. Gross financing needs are forecast to average 26 percent of GDP over the medium term, pointing to substantial rollover risks. External debt sustainability is subject to significant vulnerabilities over the medium term and, the debt is projected to remain elevated at around 75 percent of GDP. Growth or current account shocks would produce material risks to external debt sustainability.

Macroeconomic and fiscal assumptions: The assumptions underpinning the DSA are those of the baseline scenario of the staff report. Real GDP growth is projected at -0.3 percent in 2013 rising gradually to 1.5 percent in the medium term. Inflation is projected to be close to zero in 2013 and rise to 4 percent in the medium term as growth crosses into positive territory. The overall fiscal deficit, including Naftogaz's deficit, is projected to increase dramatically in 2013 (7.7 percent of GDP) and remain elevated over the medium term. The DSA tool that assesses the realism of the main assumptions on growth, primary balance, and inflation does not reveal systematic forecast errors.

The definition of public debt in this DSA includes: (i) central government debt as reported by the authorities; (ii) government guarantees issued for loans extended to state enterprises (including Naftogaz); and (iii) debt of local governments.

The DSA framework suggests that Ukraine's public debt is currently below the high-risk benchmark but is rising rapidly. The DSA suggests that although debt was still moderate at 37 percent of GDP at end-2012, it is projected to rise by about 20 percentage points in the medium term under a scenario of unchanged policies, reaching 60 percent in 2018. Nevertheless, the debt-to-GDP ratio would remain below 70 percent, the indicative threshold used in the DSA framework to highlight high risk debt levels (red in the standardized heat map on page 4).[1]

Under a number of individual shock scenarios the debt-to-GDP ratio remains below the corresponding high-risk benchmark of 70 percent, with the exception of a GDP growth shock.[2] These shocks pertain to an unchanged primary balance or a historical scenario where key variables remain at their 10-year historical average. Under a growth shock the debt-to-GDP ratio reaches 74 percent, thus increases by about 14 percentage points and breaches the 70 percent

[1] The 70 percent of GDP debt benchmark is based on a cross-country early-warning exercise of emerging market countries that have experienced episodes of debt distress.

[2] The following customization has been made to the various shocks by the team: the growth shock is equal to a half a standard deviation of the historical growth given that the GDP contraction of 2009 (14.8 percent) was deemed in staff's view as extreme; the assumed fiscal multiplier is 0.5 to better reflect country idiosyncrasies; the interest rate on new debt in the historical scenario is assumed to be equal to the average historical effective interest rate.

indicative threshold (yellow in the heat map on page 4). Other one-time shocks to the primary balance, the real interest rate and the real exchange rate lead to moderate increases in the debt profile in the medium term.

A combined macro-fiscal shock and a contingent liability shock would send the debt-to-GDP ratio above the critical value of 70 percent. The combined macro-fiscal shock is an aggregation of the shocks to real growth as well as the interest rate, the primary balance and the exchange rate while taking care not to double-count the effects of individual shocks. This shock produces the largest effect of all the various individual shocks. The contingent liabilities shock is essentially designed to highlight risks from implicit guarantees to banks and the state-owned gas importer Naftogaz. This shock includes an associated shock to growth (this was made consistent with the real GDP growth shock at 0.5 times the historical standard deviation) and resulting deterioration in the primary balance together with an increase in interest rates and decrease in inflation.

The baseline scenario and the numerous shocks produced by the DSA template highlight that Ukraine is exposed to considerable risks related to its large gross budget financing needs. Under the baseline, gross financing needs are close to 13 percent in 2013 (already above the indicative threshold for high risk of 10 percent) and approach 44 percent of GDP by 2018. These shares are magnified under the various shocks, especially under the combined macro-fiscal shock or the contingent liability shock. The exposure of gross financing needs under the baseline to various shocks reinforces staff's argument that continuing large fiscal and quasi-fiscal deficits and an overvalued exchange rate could not be sustained over the medium term.

A heat map, which is a standard output of the DSA, highlights that Ukraine faces high risks due to its high gross financing needs and deteriorating debt profile. Risks from the debt level are deemed low or medium given that the relevant threshold to which Ukraine's values are compared is 70 percent and only under the growth shock such a threshold is breached. In terms of the gross financing needs all relevant cells are red pointing to high risk given that the relevant threshold is 10 percent and Ukraine breaches this even under the baseline. In addition, risks to the debt profile are also generally high as captured by Ukraine's EMBIG spreads, its overall economy-wide gross external financing requirements, debt held by non-residents and debt held in foreign currency.

Gross external debt stood at 76.6 percent of GDP at end-2012, and is expected to remain around 75 percent of GDP over the medium term. A combination of significant repayments of maturing external debt during 2012 and 2013 (partly out of international reserves) and easy international market conditions during 2012:H2 and 2013:H1 for the sovereign and corporates have kept the external debt stock virtually unchanged over the last three years. Moreover, under current policies, projected large external financing needs and subdued growth over the medium term imply a persistently elevated level of external debt as a share of GDP. As a result, external debt is now projected to be 10 percentage points higher at 2018 relative to the DSA projections in the Ukraine 2012 Article IV report (IMF Country Report No. 12/315). Moreover, the deterioration in domestic fundamentals, and lower demand for Ukrainian exports are expected to keep the ratio of external

debt to exports fairly elevated and rising to 175.8 at 2018 (relative to a declining path to 125 expected last year).

Risks to debt outlook are substantial, if current policies remain unchanged. A permanent ½ standard deviation shock to growth, implying a contraction of around 3.1 percent in 2014 (about 4.1 percentage points below the baseline) and subsequent contractions of 2.6 percent annually thereafter, would raise the debt-to-GDP ratio to around 94 percent of GDP at 2018 (18.6 percentage points above the baseline), while the ratio of external debt to exports would reach around 219 percent at 2018 (43.5 percentage points above the baseline). A permanent ½ standard deviation shock to the current account (excluding interest payments) would [increase external debt to GDP to 85.3 percent at 208 (10 percentage points above the baseline), while the ratio of external debt to exports would reach around 207 percent at 2018 (31.5 percentage points above the baseline). Finally, a 30 percent depreciation of the domestic currency with no change in current policies would raise the debt-to-GDP ratio to 108.2 percent at 2018 (33 percentage points above the baseline).

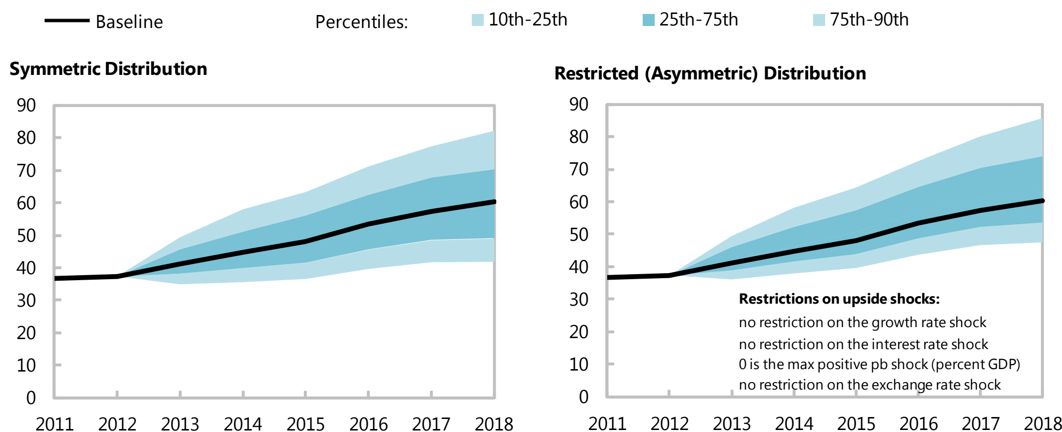
Ukraine Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

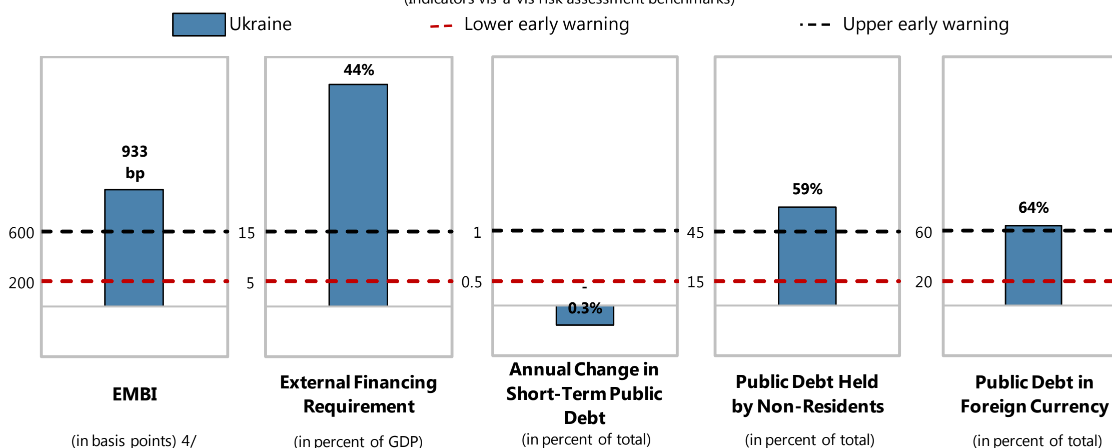
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

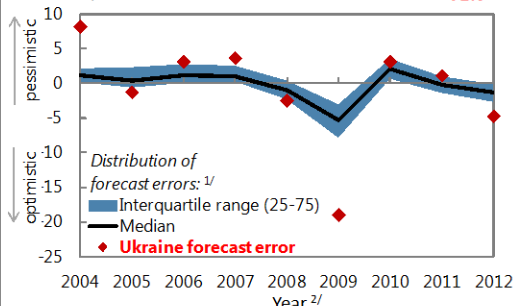
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ An average over the last 3 months, 14-Aug-13 through 12-Nov-13.

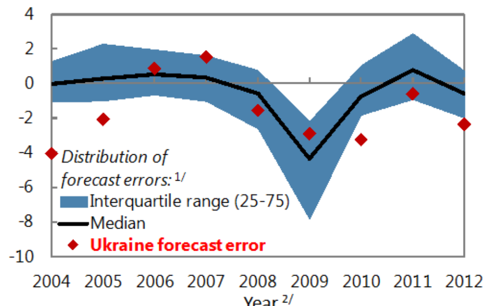
Ukraine Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

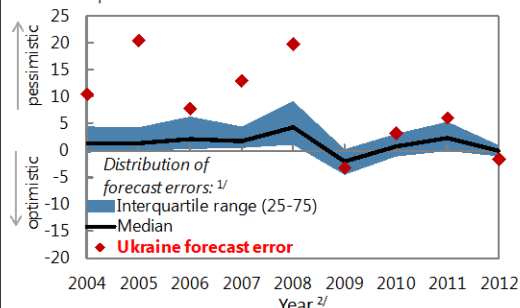
Real GDP Growth
(in percent, actual-projection)
Ukraine median forecast error, 2004-2012: **1.09**
Has a percentile rank of: **71%**



Primary Balance
(in percent of GDP, actual-projection)
Ukraine median forecast error, 2004-2012: **-2.06**
Has a percentile rank of: **12%**

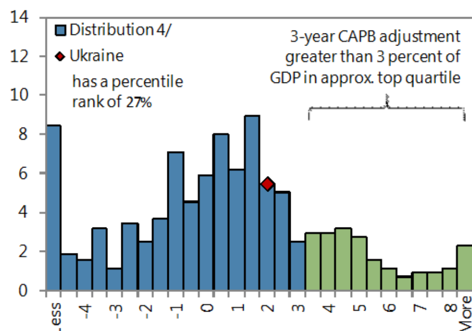


Inflation (Deflator)
(in percent, actual-projection)
Ukraine median forecast error, 2004-2012: **7.75**
Has a percentile rank of: **87%**

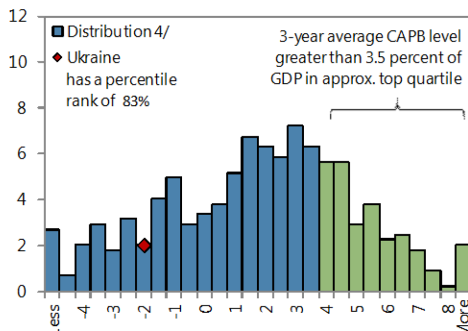


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Ukraine.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Ukraine Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

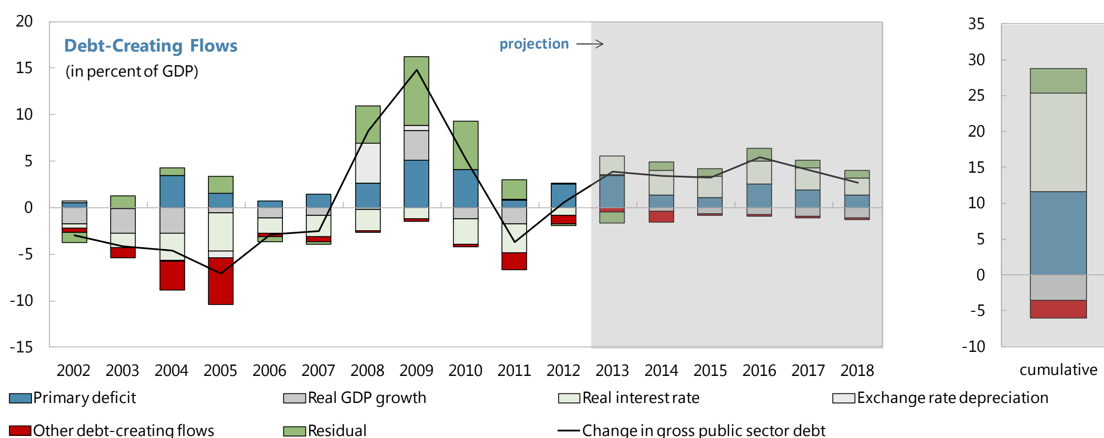
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	25.4	36.8	37.4	41.3	44.7	48.0	53.4	57.5	60.2
Public gross financing needs	5.0	7.4	10.6	13.5	19.7	21.4	25.3	32.0	44.0
Real GDP growth (in percent)	4.1	5.2	0.2	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation (GDP deflator, in percent)	16.2	14.3	8.0	2.0	4.0	5.5	5.5	5.5	5.5
Nominal GDP growth (in percent)	20.9	20.3	8.2	1.6	5.0	7.1	7.2	7.3	7.6
Effective interest rate (in percent) [4/]	4.5	5.8	5.6	7.5	10.8	11.1	11.1	10.4	9.1

As of November 12, 2013		
Sovereign Spreads		
EMBI (bp) 3/		876
CDS (bp)		946
Ratings	Foreign	Local
Moody's	Caa1	B3
S&Ps	B-	B-
Fitch	B-	B-

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.4	-3.7	0.6	3.9	3.4	3.3	5.5	4.0	2.7	22.7	
Identified debt-creating flows	-1.6	-5.8	0.8	5.8	2.5	2.5	4.1	3.2	2.0	20.0	
Primary deficit	2.2	0.8	2.6	3.4	1.3	1.1	2.5	1.9	1.4	11.7	0.6
Primary (noninterest) revenue and grants	40.9	42.9	44.5	45.5	45.3	44.9	42.8	42.7	42.5	263.7	
Primary (noninterest) expenditure	43.0	43.7	47.1	48.9	46.6	46.0	45.4	44.6	43.9	275.3	
Automatic debt dynamics [5/]	-2.5	-4.8	-0.9	2.8	2.3	1.7	1.8	1.5	0.8	10.8	
Interest rate/growth differential [6/]	-3.0	-4.9	-0.9	2.2	2.3	1.7	1.8	1.5	0.8	10.2	
Of which: real interest rate	-2.1	-3.1	-0.8	2.0	2.7	2.3	2.5	2.4	1.9	13.7	
Of which: real GDP growth	-0.9	-1.7	-0.1	0.1	-0.4	-0.6	-0.7	-0.9	-1.1	-3.6	
Exchange rate depreciation [7/]	0.5	0.1	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.2	-1.8	-0.9	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2	-2.5	
General Government: Net Privatization Proceeds	-1.2	-1.8	-0.9	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2	-2.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
(Specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	2.1	2.1	-0.2	-1.3	0.9	0.7	1.4	0.8	0.8	3.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBI.

4/ Defined as interest payments divided by debt stock at the end of previous year.

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

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

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

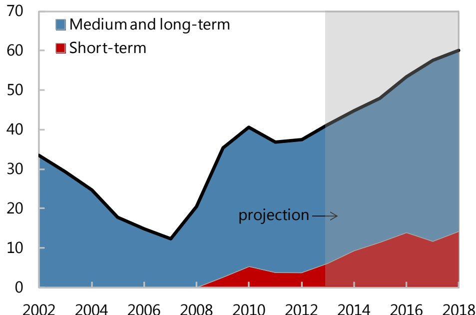
8/ For projections, this line includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

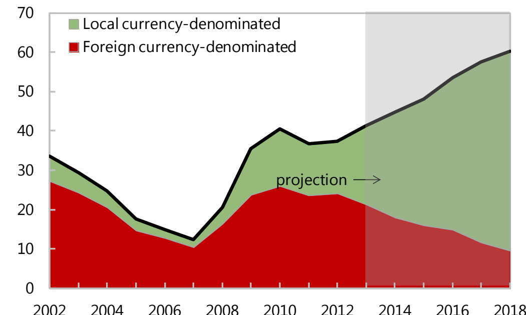
Ukraine Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



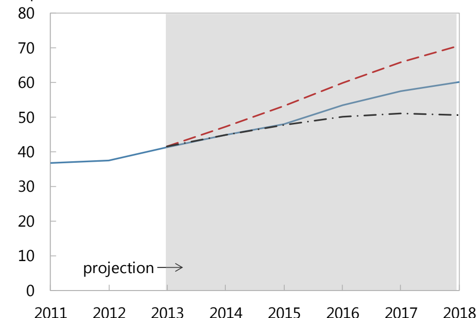
By Currency
(in percent of GDP)



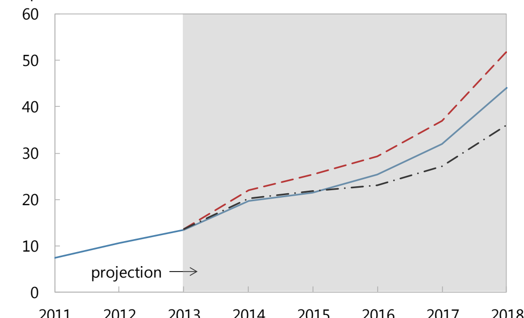
Alternative Scenarios

Baseline — Historical — Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

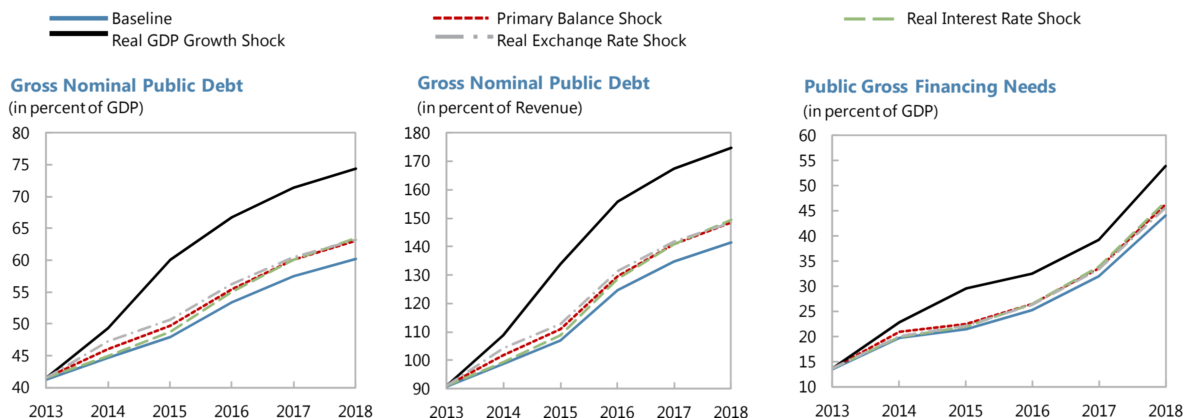
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation	2.0	4.0	5.5	5.5	5.5	5.5
Primary Balance	-3.4	-1.3	-1.1	-2.5	-1.9	-1.4
Effective interest rate	7.5	10.8	11.1	11.1	10.4	9.1
Constant Primary Balance Scenario						
Real GDP growth	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation	2.0	4.0	5.5	5.5	5.5	5.5
Primary Balance	-3.4	-3.4	-3.4	-3.4	-3.4	-3.4
Effective interest rate	7.5	10.9	11.3	11.1	10.5	8.7

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-0.3	3.7	3.7	3.7	3.7	3.7
Inflation	2.0	4.0	5.5	5.5	5.5	5.5
Primary Balance	-3.4	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	7.5	10.9	9.9	7.3	5.0	2.8

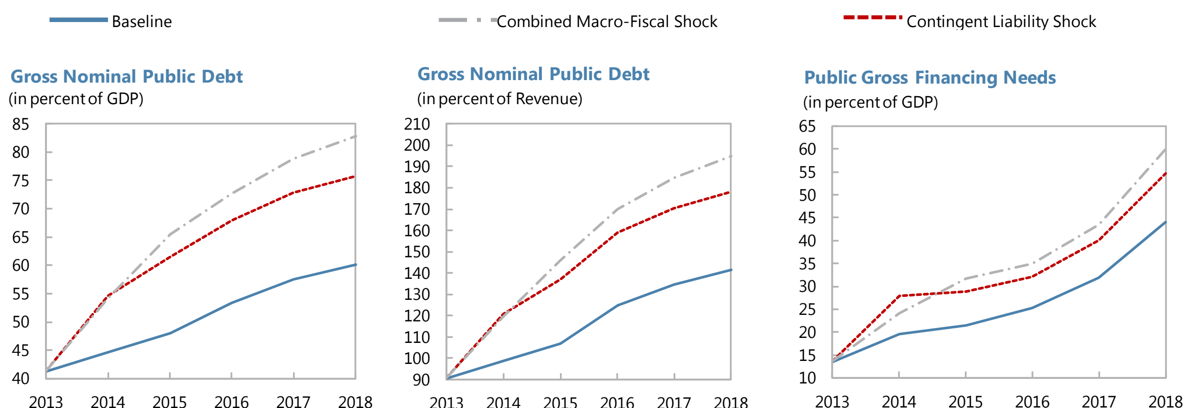
Source: IMF staff.

Ukraine Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

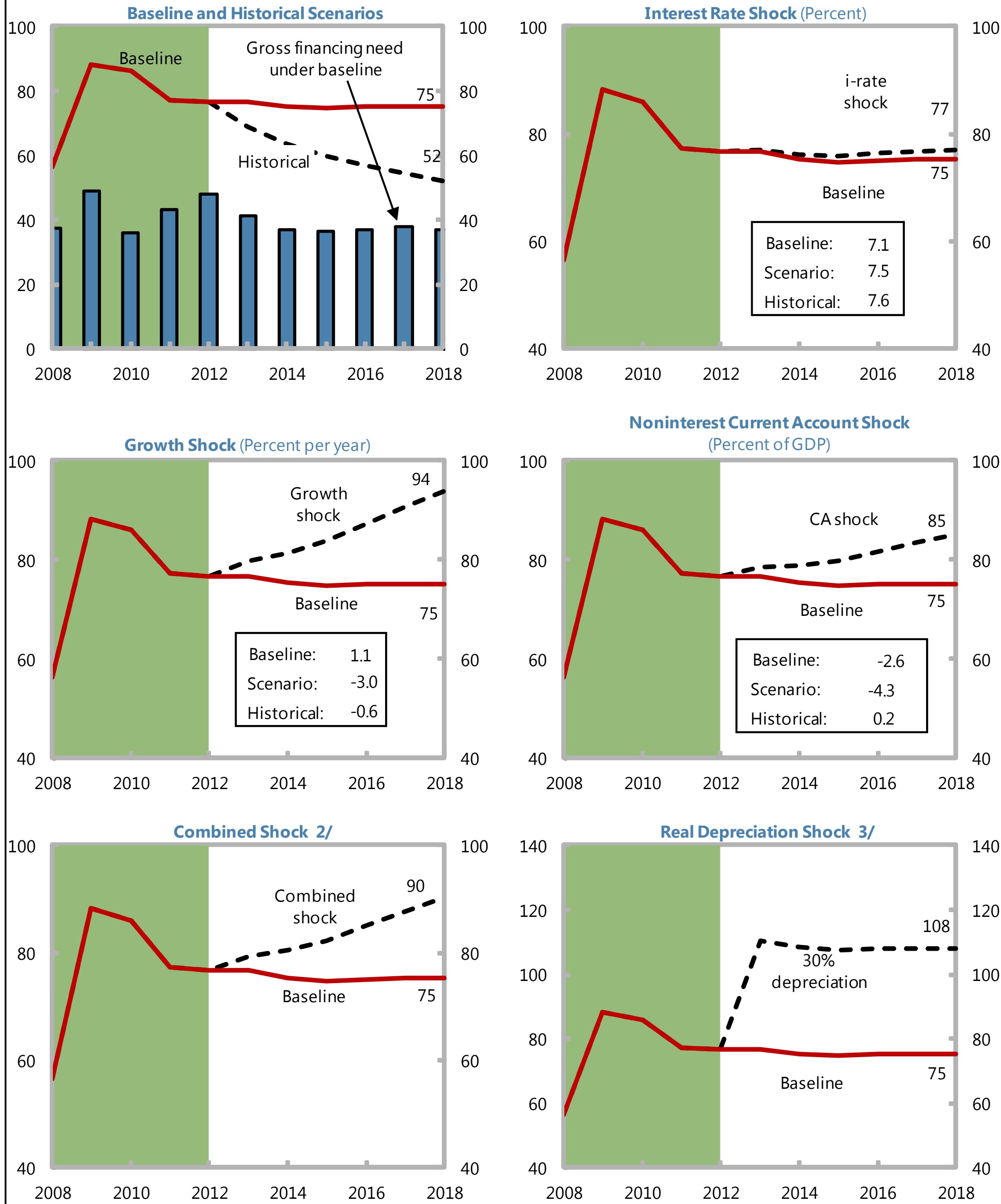
Primary Balance Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation	2.0	4.0	5.5	5.5	5.5	5.5
Primary balance	-3.4	-2.4	-1.2	-2.5	-2.2	-1.6
Effective interest rate	7.5	10.9	11.5	11.4	10.7	9.0
Real Interest Rate Shock						
Real GDP growth	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation	2.0	4.0	5.5	5.5	5.5	5.5
Primary balance	-3.4	-1.3	-1.1	-2.5	-1.9	-1.4
Effective interest rate	7.5	10.9	12.3	12.6	12.1	10.3
Combined Shock						
Real GDP growth	-0.3	-2.7	-2.2	1.6	1.8	2.0
Inflation	2.0	3.0	4.6	5.5	5.5	5.5
Primary balance	-3.4	-3.5	-5.5	-2.5	-2.2	-1.6
Effective interest rate	7.5	11.7	11.8	12.0	11.7	9.9

Real GDP Growth Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	-0.3	-2.7	-2.2	1.6	1.8	2.0
Inflation	2.0	3.0	4.6	5.5	5.5	5.5
Primary balance	-3.4	-3.5	-5.5	-2.5	-1.9	-1.4
Effective interest rate	7.5	10.9	11.6	11.6	10.7	8.9
Real Exchange Rate Shock						
Real GDP growth	-0.3	1.0	1.5	1.6	1.8	2.0
Inflation	2.0	9.2	5.5	5.5	5.5	5.5
Primary balance	-3.4	-1.3	-1.1	-2.5	-1.9	-1.4
Effective interest rate	7.5	11.7	11.1	11.2	10.5	8.8
Contingent Liability Shock						
Real GDP growth	-0.3	-2.7	-2.2	1.6	1.8	2.0
Inflation	2.0	3.0	4.6	5.5	5.5	5.5
Primary balance	-3.4	-8.0	-1.1	-2.5	-1.9	-1.4
Effective interest rate	7.5	12.2	11.8	11.4	10.6	8.9

Source: IMF staff. Real GDP growth shock scenario is customized to half the historical standard deviation. This is also reflected in the combined shock and the contingent liability shock.

Ukraine: Baseline External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Source: IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ In line with standard IMF stress tests, the shock simulates the impact of a one-time real depreciation of 30 percent in 2013.

Ukraine: Baseline External Debt Sustainability Framework, 2010–18

(Percent of GDP, unless otherwise indicated)

	Actual			Projections					
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Baseline: external debt	86.0	77.2	76.6	76.7	75.3	74.7	75.1	75.2	75.2
Change in external debt	-2.2	-8.8	-0.6	0.1	-1.4	-0.6	0.4	0.1	0.0
Identified external debt-creating flows (4+8+9)	-17.5	-13.2	1.0	3.5	2.0	2.6	2.1	1.9	1.6
Current account deficit, excluding interest payments	-2.7	0.6	2.4	2.9	2.9	2.7	2.5	2.2	2.2
Deficit in balance of goods and services	2.9	6.2	8.1	7.7	7.3	5.9	5.1	4.6	4.3
Exports	50.8	54.4	51.1	48.8	48.4	46.6	45.2	44.0	42.8
Imports	53.7	60.6	59.2	56.5	55.8	52.5	50.4	48.6	47.1
Net non-debt creating capital inflows (negative) 1/	-7.4	-5.2	-7.0	-5.1	-5.4	-4.0	-4.2	-4.2	-4.5
Automatic debt dynamics 2/	-7.4	-8.5	5.6	5.7	4.5	3.9	3.9	3.9	3.9
Contribution from nominal interest rate	4.9	5.7	5.7	5.4	5.2	5.0	4.9	5.0	5.0
Contribution from real GDP growth	-3.1	-3.7	-0.1	0.3	-0.7	-1.1	-1.0	-1.1	-1.1
Contribution from price and exchange rate changes 3/	-9.3	-10.5	0.0	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 4/	15.4	4.4	-1.6	-3.4	-3.4	-3.2	-1.8	-1.8	-1.6
External debt-to-exports ratio (percent)	169.4	142.1	150.0	157.2	155.6	160.3	166.1	171.0	175.8
Gross external financing need (billions of U.S. dollars) 5/	48.8	70.8	84.8	72.4	67.6	71.2	78.0	85.1	88.9
Percent of GDP	35.8	43.3	48.1	41.2	36.9	36.2	37.1	37.8	36.9
Scenario with key variables at their historical averages 6/			76.6	69.0	63.7	59.7	57.1	54.4	51.8
Key macroeconomic assumptions underlying baseline									
Real GDP growth (percent)	4.1	5.2	0.2	-0.3	1.0	1.5	1.5	1.5	1.5
GDP deflator in U.S. dollars (change in percent)	11.7	13.9	7.7	0.0	3.4	5.5	5.5	5.5	5.5
Nominal external interest rate (percent)	6.5	7.9	8.0	7.0	7.1	7.1	7.1	7.1	7.1
Growth of exports (U.S. dollar terms, percent)	27.7	28.3	1.3	-4.8	3.5	3.2	3.9	4.1	4.2
Growth of imports (U.S. dollar terms, percent)	30.3	35.2	5.4	-4.9	3.0	1.0	2.6	3.2	3.9
Current account balance, excluding interest payments	2.7	-0.6	-2.4	-2.9	-2.9	-2.7	-2.5	-2.2	-2.2
Net non-debt creating capital inflows	7.4	5.2	7.0	5.1	5.4	4.0	4.2	4.2	4.5

1/ Includes debt securities due to data limitations on the composition of FDI and portfolio flows.

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

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

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

5/ Defined as the sum of current account deficit, amortization on medium- and long-term debt, short-term debt at end of previous period, and other net capital outflows (mainly reflecting residents' conversion of hryvnia cash to foreign currency held outside the banking system). Excludes IMF transactions.

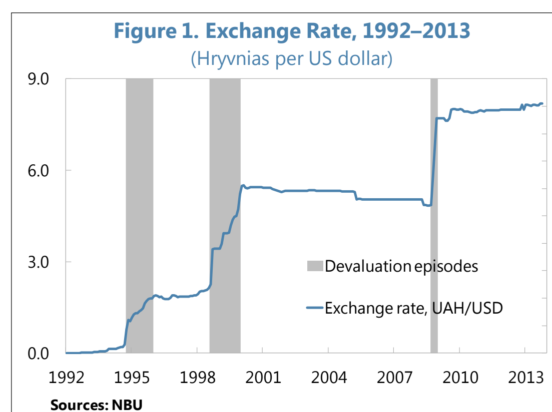
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP. Five year historical averages were used to exclude the distortionary effects of the pre-crisis boom years.

Annex IV. The Role of Devaluation Expectations in Determining the Spread Between Local and Foreign Currency Interest Rates in Ukraine[1]

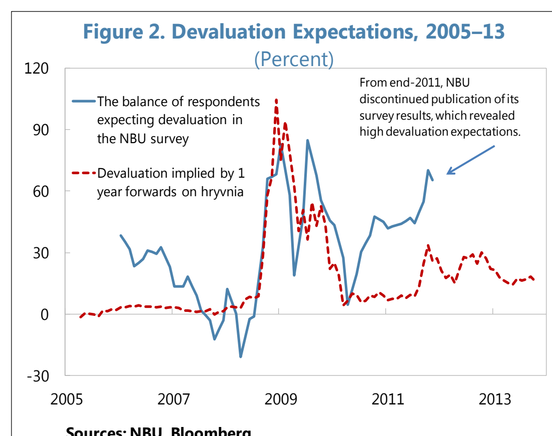
This note estimates the impact of devaluation expectations on the spread between deposit interest rates in the national currency and foreign exchange. It confirms that the devaluation expectations is the most important factor shaping the deposit spread and thus sustaining high interest rates on hryvnia deposits and credits to economy.

Background

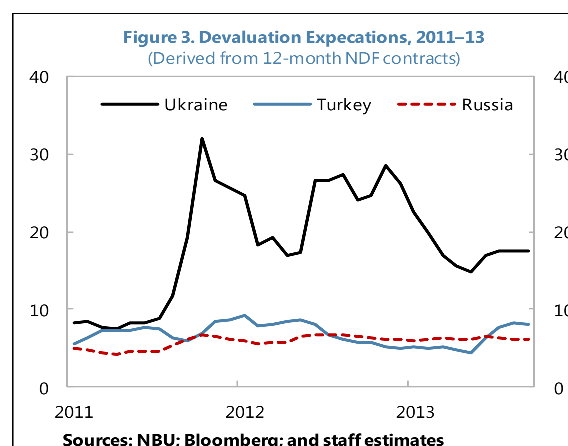
In Ukraine, long periods of exchange rate stability intertwined with episodes of steep adjustment. In the 22 years since its introduction, Ukrainian currency went through three episodes of sharp devaluation: in 1994–95, 1998–99, and in 2008. Between them, the currency was relatively stable, at around 2 UAH/USD in 1996–98, 5 UAH/USD in 2000–08, and, most recently, at about 8 UAH/USD since 2009 (Figure 1).



Past adjustments and concerns about new shocks gave rise to persistent devaluation expectations. Over the last seven years (for which the data is available), economic agents nearly always expected some devaluation in the months ahead. And they almost never projected hryvnia appreciation (Figure 2).

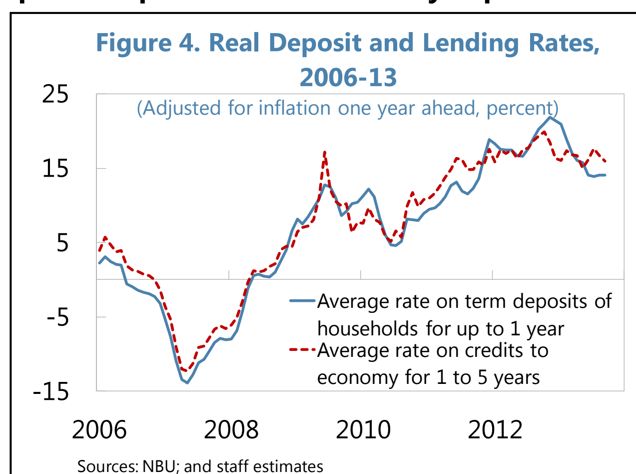


Even though modest devaluation expectations are quite common for emerging market currencies, their magnitude in Ukraine is a source of concern. Sometimes, presence of the devaluation expectations embedded in the forward contracts is referred to as "peso problem" (by the name of Mexican currency). It is largely attributed to the non-zero possibility of acute shocks that would destabilize the economy and cause sudden and significant depreciation. Still, it is not common to see implied devaluation expectations of 20–30 percent for more than two years, as it was in Ukraine from mid-2011 (Figure 3).

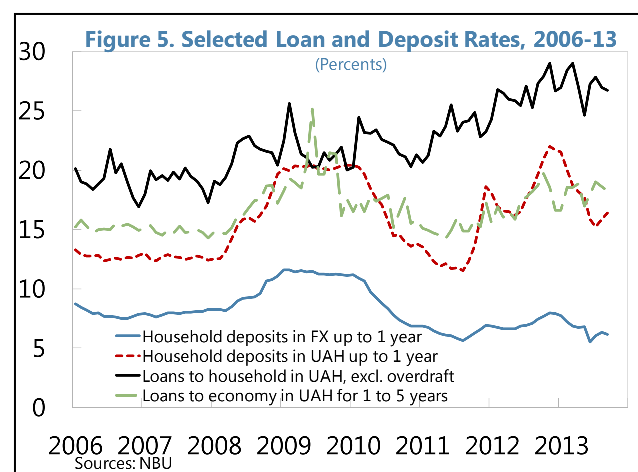


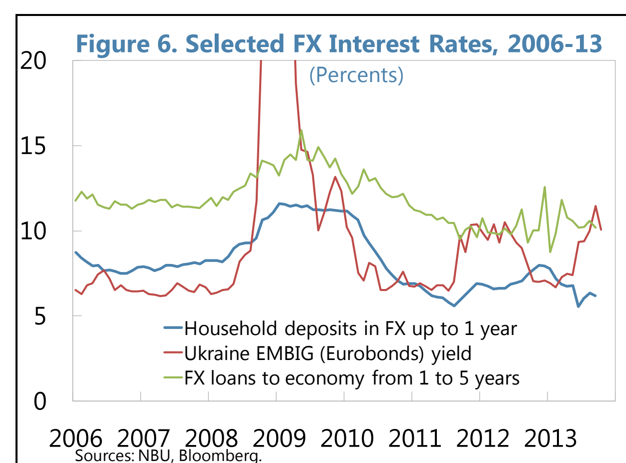
[1] Prepared by Michael Gorbanyov.

In 2011–13, elevated devaluation expectations pushed up the national currency deposit and lending rates. In late 2012, when the pegged exchange rate came under pressure, the average rates on term deposits and medium-term credits in the national currency reached 20 percent. And given the consumer price deflation that lasted for more than a year, this translated into real interest rates of around 20 percent (Figure 4). These were the highest real rates on local currency over the last seven years (for which detailed monthly data is available). But what was the exact contribution of the devaluation expectations to this spike?



Given the structure of interest rates in Ukraine, the influence of the devaluation expectations can be most directly linked to the spread between local deposit rates in national and foreign currency (Figures 5–6). The rates on FX deposits are mostly determined by factors independent of the currency risks, such as bank failure risk and costs of alternative FX funding for banks (e.g., the yield on Eurobonds). For households, the interest on FX deposits very much reflects the risk of trusting their money to the banking system as opposed to keeping them safe "under the mattress", which earns no interest at all (and can be subject to petty theft or currency notes decay). And the rates on the same-term hryvnia deposits reflect all the same risks as for FX deposits, plus the risk of currency devaluation. This confirms that the spread between deposit rates in the national and foreign currency could be attributed to the devaluation expectations (and can be even considered as a proxy for the devaluation expectations of local banks and depositors). More specifically, we prefer to use the spreads between the rates for comparable household deposits. These are characterized by multitude of relatively small individual transactions and broad conformity of deposit terms and conditions for operations both in FX and hryvnia.

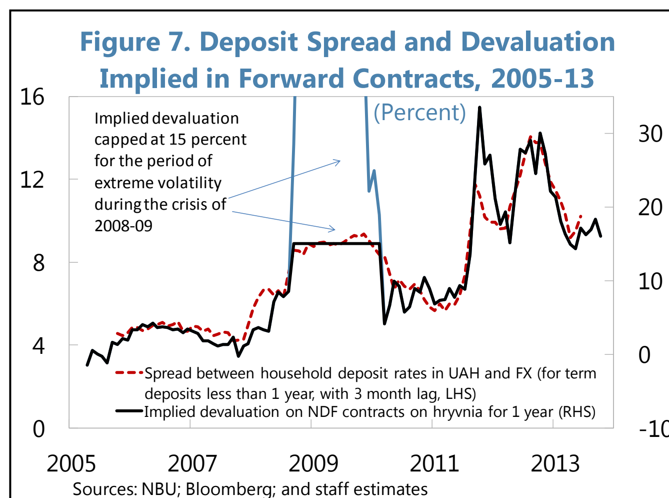




Model estimates

Except for the crisis years of 2008–09, deposit spreads very much followed the dynamics of the devaluation expectations. The evolution of non-deliverable forward contracts (NDF) on hryvnia preceded deposit spread changes by about three months. This correlation was broken only in 2008–09, when currency went through the sharp 60 percent devaluation in late 2008 and stabilized thereafter, but the forwards kept pointing to further 20–70 percent expected devaluation through most of 2009. Our preferred way of accounting for the abnormal crisis nature of these disturbances is simply to cap the value of the NDF implied devaluation series at 15 percent for this period. After the adjustment for the crisis of 2008–09 and with lag of three months for spread series, the adjusted curve for NDF implied devaluation nearly overlapped with the spread curve in the chart (Figure 7). The correlation between these two series was as high as **0.95**.

Figure 7. Deposit Spread and Devaluation Implied in Forward Contracts, 2005-13



Sources: NBU; Bloomberg; and staff estimates

Also, we considered alternative approaches for measuring devaluation expectations or accounting for the abnormal deviations of 2008–09. The devaluation expectations derived from the NBU quarterly surveys (Figure 2) also has high correlation of **0.74** with the deposit rates spread (with the lag of two months). However, we considered that the quality and representativeness of this survey-based data—published by the NBU on the quarterly basis until end-2011, and available but unpublished for 2012–13-is not as robust as that of the series for the NDF contracts. For the episode of 2008–09, another way to treat the deviation between the NDF quotes and deposits spreads is to introduce a dummy variable for this period, or estimate regression on the post-crisis data only. Yet another alternative approach would be to identify macroeconomic or financial variables that could explain that stark divergence of the expected devaluation and deposit spreads (see below).

To quantify the impact of devaluation expectations on deposit spreads, we estimated several regressions (Table 1). Predictably, coefficient for the devaluation implied by the NDF forward contracts came out highly significant. It ranged mostly from **0.26 to 0.30** whether we used the adjusted variable, or a dummy for the crisis, or estimated the regression only on the post-crisis data (regressions 1–3 and 6–8). This indicates that every additional 1 percent of expected devaluation added up to **0.30** percent to the interest rate spread. Moreover, when we forced the constant to zero, thus attributing all variation in the deposit spread to implied devaluation, the coefficient for it reached **0.55** (regressions 4). In the presence of this variable, other macroeconomic and financial variables that one would normally expect to influence the deposit rates (or explain the abnormal

deviations of 2008–09) became insignificant, or had very low coefficient, or unexpected sign (regressions 5–8).

Table 1. Determinants of Deposit Interest Rates Spread in Ukraine, 2006–13

	1	2	3 1/	4	5	6	7	8
Implied devaluation on NDF contracts on hryvnia for 1 year, adjusted for 2008-09 crisis period (with 3 months lag)	0.30 *** (0.01)			0.55 *** (0.02)			0.29 *** (0.02)	0.26 *** (0.02)
Implied devaluation on NDF contracts on hryvnia for 1 year (with 3 months lag)		0.28 *** (0.01)	0.27 *** (0.02)		0.21 *** (0.02)	0.27 *** (0.02)		
Dummy for NDF for the crisis period (with 3 months lag) 2/		-0.21 *** (0.01)			-0.17 *** (0.01)	-0.20 *** (0.01)		
NBU net claims on banks, UAH billion					0.028 *** (0.005)			
Ratio of excess bank reserves to reserve money (with 5 months lag)						-0.14 *** (0.04)		
Interest rate on interbank loans, overnight (with 3 months lag)						-0.08 *** (0.03)		
CPI, y-o-y							-0.005 (0.016)	
GDP growth, y-o-y							-0.023 (0.015)	
Expected CPI (NBU survey), y-o-y								-0.12*** (0.04)
Business Outlook Index for the next 12 months (NBU survey)								-0.024*** (0.008)
Constant	4.28 *** (0.15)	4.64 *** (0.20)	4.67 *** (0.46)	X	4.30 *** (0.18)	6.03 *** (0.42)	4.50 *** (0.36)	6.82 *** (0.78)
Number of observations	89	89	39	89	90	87	89	89
Log likelihood	-110.5	-138.9	-64.5	-216.0	-126.9	-127.9	-109.5	-105.0
R-squared	0.90	0.81	0.76	0.88	0.86	0.84	0.90	0.91
Adjusted R-squared	0.90	0.80	0.76	0.87	0.85	0.83	0.90	0.91

Source: Staff estimates.

Note: The dependent variable is the spread between the average interest rates on households term deposits in UAH and FX with maturity of up to 1 year. Estimations were performed using Ordinary Least Squares (OLS) method. Standard errors are in parentheses. ***, **, and * indicate significance at 1 percent, 5 percent, and 10 percent level, respectively.

1/ Estimated for post-crisis period (from March 2010 to June 2013).

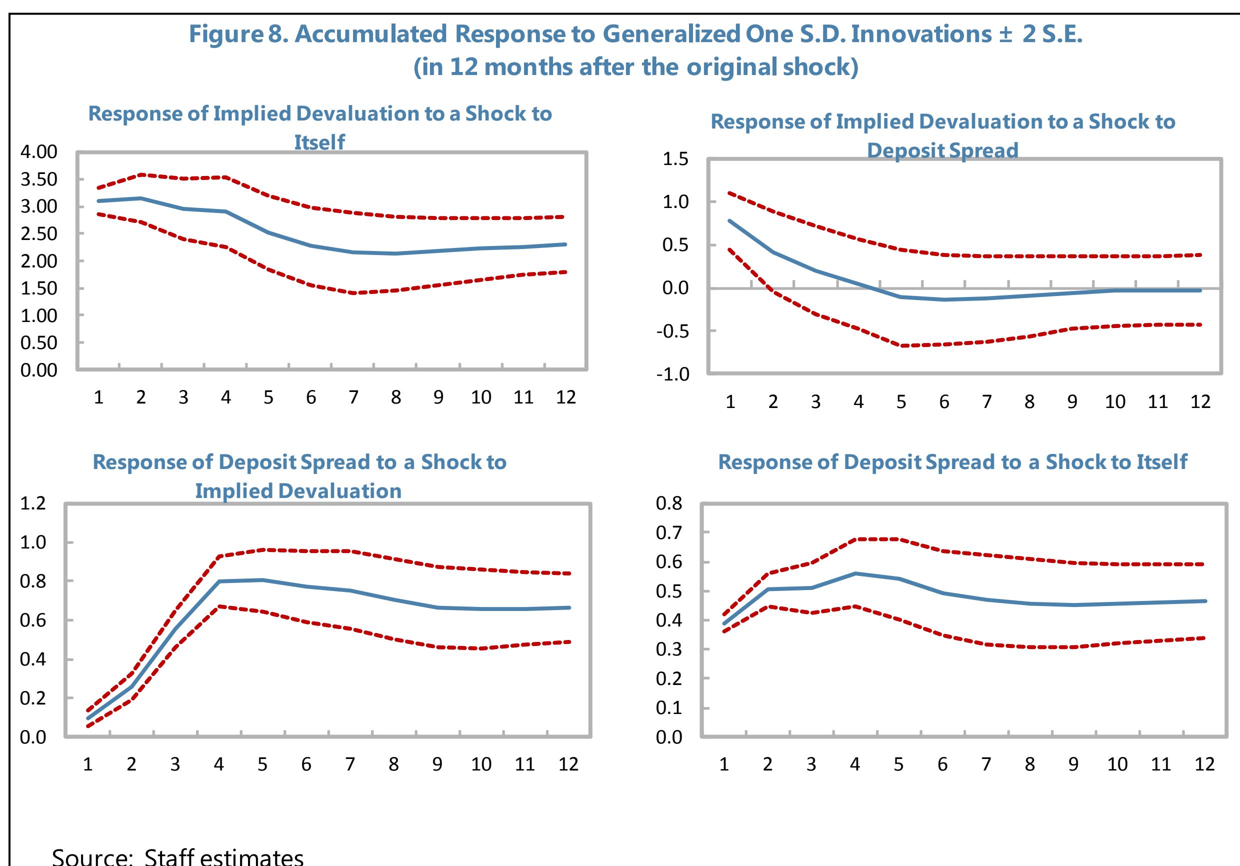
2/ Equal to the variable "NDF contracts on hryvnia for 1 year" for September 2008 - February 2010 and 0 for all other months.

To confirm robustness of our estimates, we ran several procedures. Granger causality test strongly confirmed that the adjusted NDF implied devaluation series caused the evolution of the deposit interest rate spread but not vice versa. It also rejected hypothesis that either GDP growth, or expected economic conditions (from the NBU quarterly survey), or actual and projected inflation

granger-caused deposit interest rate spread. Moreover, inflation series had unexpected strong negative correlation of **-0.50** with the deposit spread series. If taken at face value, this suggests that the spreads should be higher in the period of low inflation (as they did in late 2012), which has no economic sense. Once again, this confirms that in Ukraine, inflation was not among the main determinant of the deposit interest rate spread in recent years.

To better understand modalities of the pass through from devaluation expectations to deposit spread, we estimated a simple vector autoregressive model (VAR). The series for both adjusted NDF implied devaluation and deposit spread are non-stationary in levels but stationary in first difference. Even though the series exhibit very similar dynamics (Figure 7) and have very high correlation, the standard tests rejected hypotheses of their cointegration. This opened the way for estimating a standard VAR for the first differences. We estimated VAR with three lags including these two series, and then produced standardized accumulated impulse responses (Figure 8). Next, we used them to study the impact of one variable on another and estimate the pass through, which can be calculated by dividing the accumulated response of the spread variable to the accumulated shock in the devaluation variable. According to this analysis, the pass-through coefficient from the implied devaluation to the deposit spreads reaches as high as **0.35** in seven months after original devaluation expectation shock, and then, after some fluctuations, settles at about **0.29** in 12 months after the shock (Table 2). In other words, when devaluation expectation increase by 1 percentage point due to an economic shock, deposit spreads increase eventually by 0.29 percentage points.

Figure 8. Accumulated Response to Generalized One S.D. Innovations ± 2 S.E.
(in 12 months after the original shock)



Source: Staff estimates

Table 2. Pass Through from Devaluation Implied in the NDF Contracts on Hryvnia to the Deposit Interest Rates Spread

Months	Pass-through coefficient 1/
1	0.03
2	0.08
3	0.19
4	0.27
5	0.32
6	0.34
7	0.35
8	0.33
9	0.31
10	0.30
11	0.29
12	0.29

Source: Staff estimates.

1/ Widening of spread in response to 1 percent increase in implied devaluation.

Conclusions and policy implications

Our results confirmed that the devaluation expectations is the most important factor shaping the deposit interest rate spread and thus sustaining high interest rates on hryvnia deposits. According to various estimates, an additional 1 percentage point of the devaluation expectation contributes about **0.26–0.30** percentage points to the deposit spread. And as it contributes to the deposit spread, it raises proportionally the interest rates on term deposits in hryvnia. Therefore, harnessing devaluation expectations is a critical precondition for reducing hryvnia deposit rates.

By implication, high deposit interest rates translate into high credit rates for economy. Normally, one would expect the loan rates to be above deposit rates, with the difference between them accounting for such items as transaction costs, credit risks provision, and bank operational profits. In Ukraine, this was the case in the years before the crisis of 2008 (Figure 5). After the crisis, the difference between deposit and the medium-term lending rates nearly disappeared. Still, the loan rates can hardly go and stay for a long time below the deposit rates (otherwise, the companies taking bank loans could simply deposit them in another bank for higher rate). Thus, reducing hryvnia deposit rates is critically important for cutting credit rates for economy. And, as summarized above, this requires reducing the devaluation expectations first.

Our analysis has identified one important exception associated with the crisis episode of 2008–09, when the skyrocketing devaluation expectations did not result in proportionally high deposit rates spread. What was the reason of a wide deviation between the implied

devaluation and deposit spreads in 2008–09, and why this did not happen again in 2011 or late 2012 (Figure 7)? In our view, this was due to the different policy response to the crisis events and market pressures. In 2008, the authorities allowed steep devaluation of the national currency, but introduced a number of measures for providing liquidity to banks and restricting deposit outflow from them. NBU provided ample stabilization loans to banks, particularly those experiencing deposit outflows, and bailed out several banks that became insolvent. Also, it introduced a temporary ban on the early withdrawal of term deposits, which was in place from October 2008 to May 2009 (with a modification in December 2008). In these circumstances, banks refrained from raising deposit rates even as they lost about 25 percent of hryvnia deposits and 20 percent of foreign currency deposits in six months from September 2008. On the contrary, in late 2012 NBU chose to defend the exchange rate peg at all cost despite mounting devaluation pressures, including by squeezing banks' liquidity. That forced the banks to compete hard for deposits and raise deposit rates to the level when they look attractive even amid high devaluation expectations. As a result, the devaluation was avoided, and hryvnia deposits in banks increased by 20 percent in the six months from November 2008, while foreign deposits stagnated.

Providing concrete recommendations on how to reduce the devaluation expectations goes beyond the scope of this paper. Our results confirmed only that the unusually high devaluation expectations resulting from the economic policy mix implemented in 2012–13 gave rise to high deposit interest rates. This suggests that significant changes in the exchange rate regime and monetary policy priorities are required to lower hryvnia interest rates in the economy.

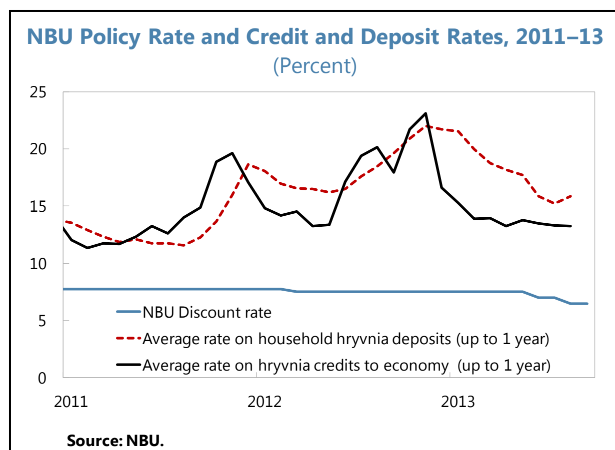
Annex V. Ukraine: Enhancing the Operational Monetary Policy Framework[1]

This annex outlines proposals for refocusing NBU's operational framework from controlling banks liquidity to managing short-term interest rates, which is critically important step on the way towards inflation targeting and more flexible exchange rate regime.

Comprehensive reform of the NBU monetary policy framework is required to improve its efficiency and adjust to new challenges. The existing operational framework aims to regulate banks liquidity on a high-frequency basis through a mix of market and administrative measures. This is particularly important for ensuring exchange rate stability, which has long been the main operational objective of the NBU. However, this framework made short-term market interest rates volatile and unpredictable at the times of exchange rate pressures. It also limited policy transmission through the interest rate channel and discouraged interbank market development. To facilitate transition to a flexible exchange rate regime and eventual adoption of the inflation targeting, NBU should shift the focus from controlling liquidity volumes to managing short-term interest rates.

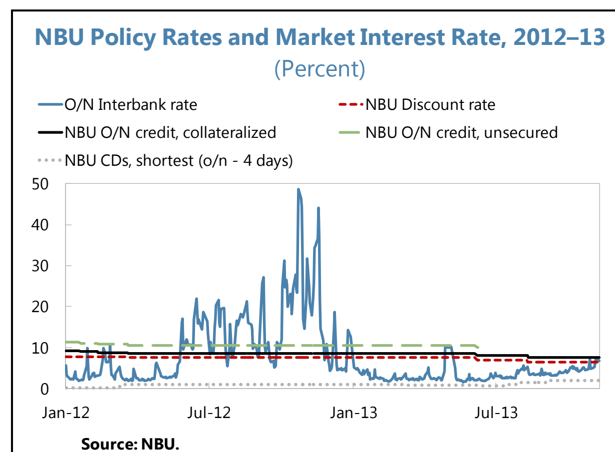
Interbank rates deviated particularly far from the official policy rates in the 2012:H2, amid intensive pressures on the pegged exchange rate. During this period, the interbank rates hovered in double digits and reached as high as 50 percent in November 2012. Meanwhile, the official NBU rates remained unchanged, with the policy rate set at 7.5 percent, and the rate for providing unsecured refinancing to bank at 10.5 percent. NBU strictly rationed financing provided to banks at the official rates, thus reducing their relevance as indicators of short-term credit rates. For banks, this episode demonstrated that in case of liquidity stress they cannot rely on the NBU refinancing, while the cost of interbank credit can be prohibitively expensive. This prompted banks to maintain high liquidity "buffers," which diminished their potential for providing credit to economy. Also, it undermined the transmission mechanism from the NBU policy rates to the bank credit rates and, ultimately, to economic growth and inflation.

NBU Policy Rate and Credit and Deposit Rates, 2011–13
(Percent)



Source: NBU.

NBU Policy Rates and Market Interest Rate, 2012–13
(Percent)



Source: NBU.

[1] Prepared by Michael Gorbanyov with the inputs from David Vávra.

Introducing the new operational monetary policy framework would involve three main reforms.

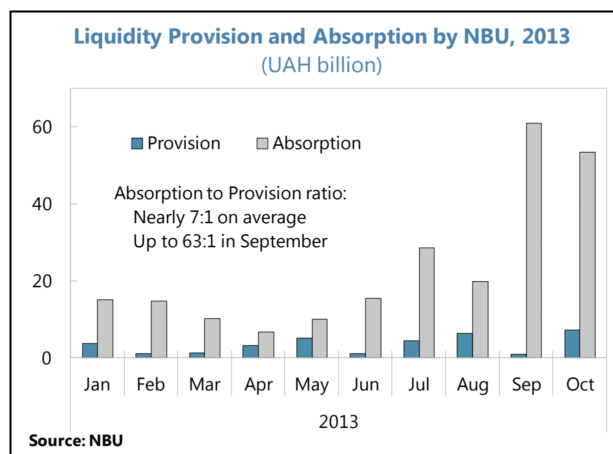
- First, increase the role of the NBU policy rate in steering market interest rates, which can be achieved by promoting the operational instrument with the interest rate closely linked to the policy rate.

- Second, create automatic standing facilities that banks can freely use for borrowing from and lending to the NBU without fear of formal or informal sanctions or stigma associated with using official financing, which would set the limits of the "corridor" for short-term market interest rates.

- Finally, introduce a reserve averaging period and give more flexibility to banks in managing their liquidity over it.

- If successfully implemented, the new system would ensure that the short-term market interest rates fluctuate around the key policy rate within the corridor defined by the standing facilities.

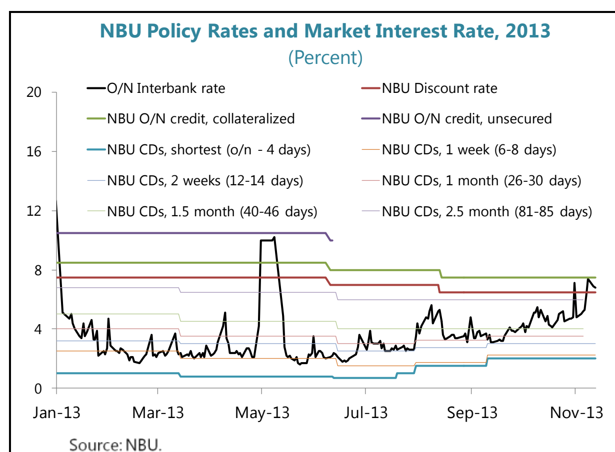
To increase the role of its policy rate, the NBU can directly link to it the rates on its main money market operational instruments. In the beginning, the NBU could set up a system of two main instruments supporting the key policy rate: one that provides liquidity and another that absorbs it. The interest rate on both would be pre-set and firmly linked to the policy rate (for example, by using a constant differential), and the difference between them should be relatively small, around 50 basis points. Both instruments should be auctioned regularly and initially rather frequently (but not on the same day). Over time, one of these two instruments will likely become redundant, except for the moments of liquidity stress. In this way, the system will evolve towards having only one key instrument, most likely the one absorbing liquidity. This is consistent with the liquidity surplus prevailing in the banking system, and NBU liquidity absorption operations by far outpacing liquidity provision in 2013.



For the main liquidity absorbing instrument, the NBU could use the already existing auction for placing 7-day or 14-day certificates of deposits (CDs). For the complementing liquidity providing instrument, NBU can use 7-day or 14-day repurchasing agreements (repos). And whatever auction format is chosen, these main instruments should be provided in price-setting (as opposed to price-taking) manner. To prop the importance of these two instruments, all other operations at the short end of the yield curve should be discontinued as soon as possible. Moreover, longer-term

operations could be phased out as well. While it is important that a reliable hryvnia yield curve is gradually developed using long-term benchmark securities, they should be issued by the government rather than the central bank, as is the standard practice in other countries. Nevertheless, as long as the NBU continues to offer longer-term instruments, it should do so strictly in a price-taking fashion, not to compromise the price-setting role of its main instruments at the short end of the yield curve.

To introduce the "corridor" for short-term interest rates, the NBU can use the existing overnight deposit and refinancing (Lombard) facilities. The NBU already operates an overnight (O/N) collateralized refinancing facility, which provides liquidity at a fixed rate. This refinancing facility can form the upper limit of the interest rate corridor under the new policy framework (Figure 2). As there is no shortage of assets considered as eligible collateral, we welcome the NBU decision to phase out the non-collateralized O/N lending facility from June 2013, which reduced the NBU credit risk exposure. And the recently introduced unlimited placement of overnight CDs could create the lower limit of the corridor. These standing facilities on both sides of the corridor should operate in a fully automatic regime, and access to them should be made very easy for all solvent banks (at their discretion). The interest rates "corridor" could be set rather wide at first, but shortened gradually (as NBU started to do in July-September). Eventually, it can be narrowed to 200–300 bps, which is most effective for controlling the interbank rates.



NBU Policy Rates and Market Interest Rate, 2013
(Percent)
Source: NBU.

Finally, allowing for flexible management of liquidity by banks is a cornerstone of interbank market deepening and strong monetary policy transmission. The NBU has developed a complex system of differentiated reserve requirements for various types of deposits, which are readjusted regularly (about twice per year). It requires banks to meet obligatory reserve requirements daily (subject to some ad hoc exceptions). Moreover, banks have to deposit 40 percent of the required reserves in a special account with the NBU and cannot use it even during the day. The reform would require banks to meet the reserve requirements on average over a

Reserve Requirements, 2011–13
(Percent)

Date of change	Time deposits of non-financial corporations and households			Current accounts and demand deposits of non-financial corporations and households			Deposits of non-resident deposit-taking corporations and non-resident other financial corporations		
	UAH	FX		UAH	FX		UAH	FX (except Russian ruble)	in Russian ruble
		short-term	long-term		non-financial corpo-rations	house-holds			
Jul 1, 2011	0	6	2	0	8		0	2	0
Nov 30, 2011	0	7.5	2	0	8		0	2	0
Mar 31, 2012	0	8	2	0	8.5		0	2	0
Jun 30, 2012	0	9	3	0	10		0	3	0
Jul 1, 2013	0	10	5	0	10	15	0	5	0
Oct 1, 2013	0	10	7	0	10	15	0	5	0

Source: NBU.

period of two weeks or one month, allowing them flexibility to manage their liquidity within this period. Also, the reserve requirements on foreign exchange and hryvnia deposits could be made more uniform. As a first step, NBU can consider introducing a small positive reserve requirement on hryvnia deposits, which are now exempt. Also, changes to the reserve requirements should become less frequent and come with advance guidance giving banks enough time to prepare.

Implementation of the main elements of the new policy framework can be completed within a year. They can be made operational simultaneously with the shift to a more flexible exchange rate regime, which the new monetary policy framework would support. Good reception of the new measures by the banking community would require intensive communication. Practical experience and feedback from the market participants would help refine the new instruments and make the enhanced operational monetary framework most effective in achieving NBU's policy objectives.

Annex VI. Determinants of Sovereign Borrowing Costs from International Markets[1]

Large part of Ukraine's debt is financed externally. The high exposure to external financing makes Ukraine vulnerable to shocks. Our analysis suggests that changes in sovereign borrowing costs heavily depend on: (i) movements in global market sentiment that is beyond the control of Ukrainian authorities; and (ii) domestic macroeconomic, external, and fiscal fundamentals that are affected by economic policies. The results suggest that targeted policy measures should be put in place to improve macroeconomic fundamentals, maintain access to international capital markets, and reduce borrowing costs going forward.

Background

Ukraine's sovereign heavily relies on external sources of debt financing. Over the last decade, the share of the FX-denominated debt in the general government total debt was fluctuating around 70 percent. Quasi-sovereign entities (SOEs), including Naftogaz and Ukrainian Railways, are also financing parts of their debt externally.

Heavy reliance on external debt financing makes Ukraine's sovereign highly exposed to sudden changes in global market sentiment. The ratio of government's external debt to GDP has risen from 9.7 percent in 2007 to 22.2 percent in 2012. Large placements of Eurobonds took place in 2012–13, and secondary market rates on Eurobonds have risen recently. The cost of external financing depends on two main determinants: global factors and domestic fundamentals (macroeconomic, external, and fiscal). Global factors are not under control of the Ukrainian authorities and represent a major uncertainty for their borrowing costs. Domestic economic fundamentals, at least some of them, could be directly influenced by economic policies and could cushion the impact of global factors.

This paper provides an empirical assessment of global and domestic factors driving sovereign borrowing costs in Ukraine. Existing empirical studies analyze panels of emerging markets (EM) and estimate pooled coefficients measuring sensitivity of sovereign borrowing costs in these groups of countries as a whole to changes in global factors and economic fundamentals (Csonto and Ivaschenko, 2013). However, the results that are valid for a panel of EMs may not be valid for individual countries (Nickel et al., 2009). Our objective is to estimate Ukraine-specific sensitivity coefficients and come up with policy recommendations based on these estimates.

How to measure external borrowing costs?

External borrowing costs of EMs, including Ukraine, are driven by four main sources of risk. *Credit risk* represents the risk of default arising due to country's inability or unwillingness to meet its obligations. *Interest rate risk* reflects the exposure of sovereign bond's market value to unexpected

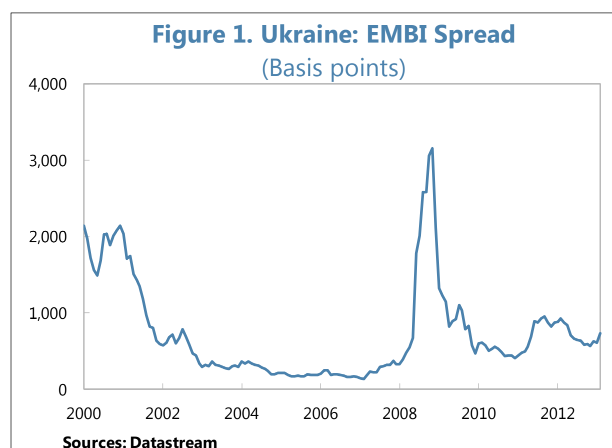
[1] Prepared by Tigran Poghosyan (Fiscal Affairs Department).

interest rate changes. *Exchange rate risk* measures the exposure of sovereign bond's market value to currency movements. *Liquidity risk* highlights the likelihood that investor may not be able to sell the bond on the secondary market, at least, without a large discount.

The EMBI spread index by JP Morgan provides a measure of credit risk.[2] The EMBI spread index is calculated as the weighted average difference in yields between Ukraine's sovereign and quasi-sovereign bonds and U.S. Treasuries. To control for the exchange rate risk, the index only includes U.S. dollar denominated Ukrainian bonds. To control for the interest rate risk, the index matches the duration of Ukraine's bonds and U.S. Treasuries and makes adjustments for unusual bond characteristics (floating coupons, principal collateral, rolling interest guarantees, etc.). Finally, to minimize the liquidity risk, the index includes only bonds with sufficient secondary market liquidity, a minimum face value of USD 500 million, and at least 2.5 years of maturity at the time of inclusion. Nevertheless, the liquidity risk is not fully eliminated from the index, and the EMBI spread could slightly overstate the credit risk especially in periods of global financial stress.

The EMBI spread index for Ukraine has been volatile over the past decade (Figure 1). The index started from a relatively high level (2000 basis points) in the beginning of 2000s on the back of debut issuances in international markets and macroeconomic volatility persisting in the aftermath of the Russian crisis in 1998. Starting from 2002 the EMBI index has steadily declined and comfortably settled at around 250 basis points level until the Lehman crisis at end-2008. The rapid reduction in the spread was supported by improved macroeconomic fundamentals (high growth rate, declining debt ratio, etc.) and benign international environment ("great moderation"). However, this period was also characterized by the buildup of macroeconomic imbalances (real exchange rate appreciation, widening of the current account deficit, rapid expansion of credit) exposing the economy to shocks. When the Lehman crisis unfolded, EMBI spreads for Ukraine jumped more than 10 times to historically record 3,000 basis points level. Following the crisis, the movements in spread were quite volatile. The spread has declined to 500 basis points in 2009, following the start of the 2008 SBA with the IMF. However, it climbed up to 1,000 basis points at end-2011 on the back of Greek debt restructuring woes, continuing difficulties with resolving the euro area crisis, and supported by a slowdown of economic reforms in Ukraine. Since then and until most recently, the spread has been on a declining trend fueled by quantitative easing policies by the U.S. Federal Reserve system and the launch of "Abenomics" in Japan. This declining path was interrupted in June 2013 following Federal Reserve chair Bernanke's "tapering" remarks on May 22, 2013.

Figure 1. Ukraine: EMBI Spread
(Basis points)



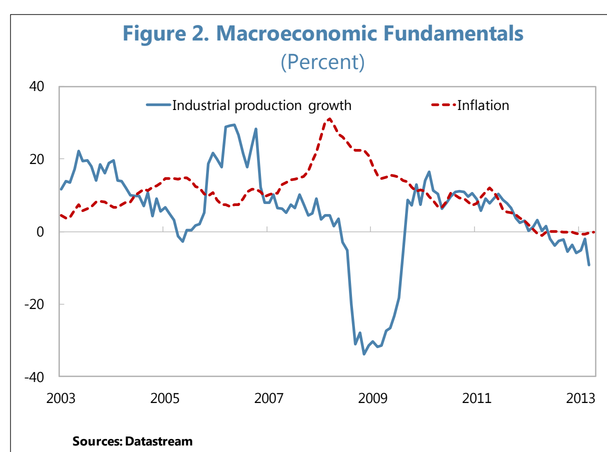
[2] The EMBI index currently covers 32 emerging economies.

What are the main drivers of external borrowing costs?

External borrowing costs of EMs depend on domestic fundamentals, which directly influence sovereign credit risk. The ability of the sovereign to meet its obligations depends on fundamental drivers of public debt sustainability.

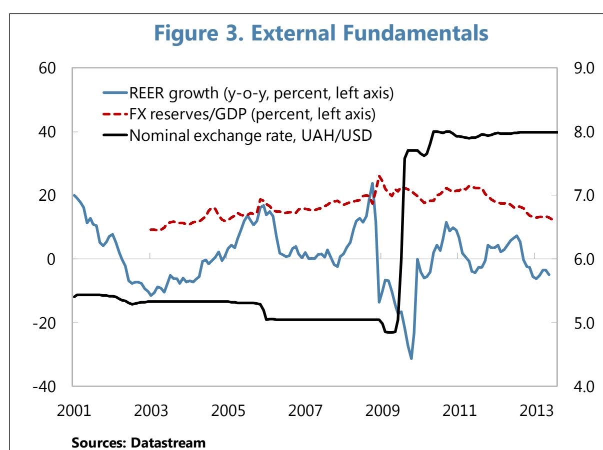
- ***Macroeconomic fundamentals.*** High economic growth reduces spreads through improved debt sustainability driven by lower interest growth differential. The impact of inflation is uncertain. On the one hand, high level of inflation can lead to higher spreads if inflation is regarded as a proxy for a bad economic management (Min et al., 2003). On the other hand, moderately high inflation helps to "inflate debt away" and improves the tax base that government can use to service its debt (Alexopoulou et al., 2009).

  In Ukraine, monthly economic growth proxied by industrial production index was quite high (12 percent on average) and inflation moderate (10 percent on average) prior to the crisis (Figure 2), contributing to the compression of sovereign spreads. During the crisis, economic growth dipped and inflation soared, contributing to the sharp hike of the spread. In the aftermath of the crisis and until most recently, both economic growth and inflation were on a declining path.



- ***External fundamentals.*** Real exchange rate depreciation should generally enhance debt sustainability and reduce borrowing costs through improved external competitiveness (Min et al., 2003). However, improvements in external competitiveness driven by a rapid depreciation in nominal exchange rate can undermine fiscal sustainability if the share of foreign currency denominated debt is high. High levels of FX reserves enhance a country's ability to service its external debt and should reduce its external borrowing costs (Edwards, 1984; Aizenman et al., 2013).

  In Ukraine, the real exchange rate appreciated steadily, reaching 20 percent in the run-up to the crisis (Figure 3). This appreciation was fueled by a flat nominal exchange rate and high inflation. In the aftermath of the crisis, a rapid nominal devaluation

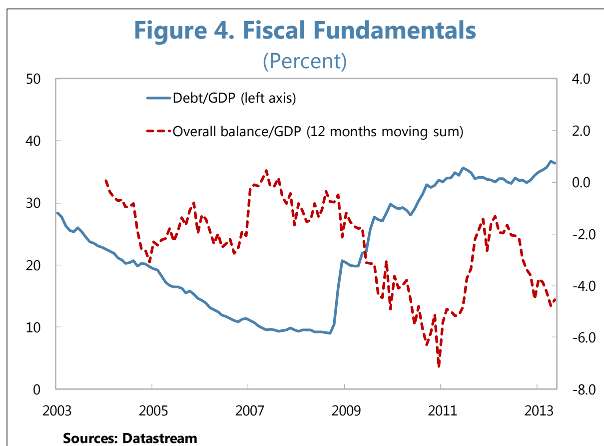


resulted in a record 30 percent real depreciation in 2009. The improved external competitiveness contributed to the compression of the spread in 2009. The FX reserves-to-GDP ratio has risen from 10 percent in 2003 to 20 percent at the onset of the crisis. Supported by the IMF program, the reserves did not decline rapidly during the crisis. However, more recently FX reserves started to decline, coming down back to the 10 percent of GDP level. This was largely driven by inflexible nominal exchange rate policies pursued by the authorities in the aftermath of the crisis, the consequent real exchange rate appreciation, and large repayments of FX loans falling due in 2013.

- ***Fiscal fundamentals.*** High fiscal deficit leads to higher borrowing costs through increased financing needs and rising supply of debt (Laubach, 2009; Baldacci et al., 2008). High levels of public debt also lead to higher borrowing costs, as high debt is more vulnerable to macroeconomic shocks and is more difficult to sustain (Engen and Hubbard, 2004; Baldacci and Kumar, 2010).

In Ukraine, fiscal fundamentals have been improving in the run-up to the crisis (Figure 4). Supported by high growth rates, the debt-to-GDP ratio has declined from 30 percent at the beginning of 2003 to 10 percent in mid-2008. The fiscal space quickly eroded in the aftermath of the crisis, with the debt-to-GDP ratio rising back to 30 percent level in two years. The debt ratio continued its increasing trend in 2012–13 on the back of high deficits, and is rapidly approaching the 40 percent threshold identified as vulnerable for EMs by the IMF's debt sustainability framework.

Figure 4. Fiscal Fundamentals
(Percent)

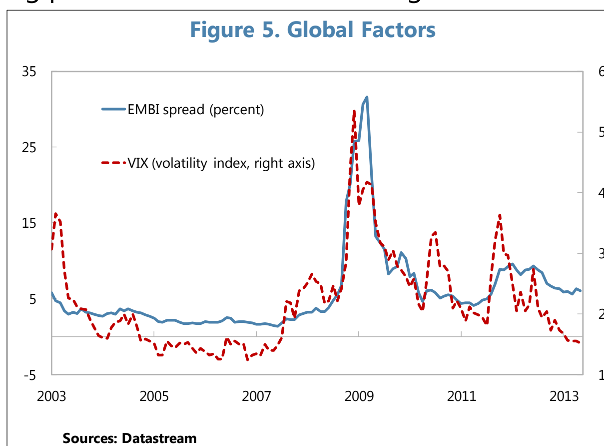


Sources: Datastream

However, domestic fundamentals alone are not reliable predictors of sovereign borrowing costs. First, economic fundamentals are slow moving variables and statistics on these variables is available at a low frequency (quarterly or monthly). Hence, these variables by definition cannot explain the higher frequency changes in EMBI spreads. Second, as mentioned above, EMBI spreads reflect also liquidity risk, which is mostly driven by global liquidity conditions influencing decisions of international investors even in the presence of unchanged credit risk (Balakrishnan et al., 2009). Third, economic fundamentals can sometimes lag market perceptions (Monfort and Mulder, 2000; Sy, 2002). Finally, market perceptions can sometimes overreact to economic fundamentals, especially at the early stages of the crisis (Mulder and Perelli, 2001).

Global factors are also important drivers of sovereign borrowing costs, especially in the short-run. Various studies have shown that there is a strong positive correlation between global factors and EM bond spreads, which tends to increase during global events (Gonzalez-Hermosillo, 2008). Several studies have shown that global liquidity and risk appetite conditions play an important role in the determination of EM sovereign bond spreads (Eichengreen and Mody, 1998; Christofides et al., 2003; Baldacci et al., 2012; Hilscher and Nosbusch, 2010). Some studies found that global factors explain between 50 to 80 percent of the variability in sovereign spreads of EMs (Gonzalez-Rozada and Levy Yeyati, 2008; Hartelius et al., 2008). Most empirical models nowadays include global factors as determinants of EM bond spreads. The most widely used determinant employed in the literature is the VIX index proxying global risk aversion.[3] As shown in Figure 5, VIX index closely tracks the dynamics of EMBI spread in Ukraine, suggesting a strong association between the two.

Figure 5. Global Factors



Sources: Datastream

How sensitive are Ukraine's borrowing costs to global factors and domestic fundamentals?

We regress Ukraine's EMBI index on global factors and domestic macroeconomic, external, and fiscal fundamentals (Table 1). The intercept-only regression shown in column (I) suggests that the EMBI spread in Ukraine has averaged at 5.7 percent level (intercept) over the sample under consideration. In column (II), we include the crisis dummy that takes the value of 1 during October 2008–Dececember 2009 and obtain a coefficient estimate of 12.9 percent. The large coefficient on the crisis dummy suggests that macroeconomic instability during the crisis period coupled with the vulnerabilities built up before the crisis has led to a dramatic widening of the spread in the order of magnitude of exceeding twice of its historical average and a consequent loss of market access. The impact of other determinants can be summarized as follows:

- ***Global factors.*** One unit increase in VIX leads to about 40 basis points increase in EMBI spread. The strong impact of global risk aversion suggests that changes in Ukrainian sovereign borrowing costs are highly vulnerable to changes in global market sentiment.[4]

[3] The Chicago Board Options Exchange Volatility Index (VIX) is a measure of the market's expectation of stock-market volatility over the next 30-day period. It is a weighted blend of prices for a range of options on the S&P 500 index.

[4] The adjusted R^2 in column (III) is 0.75, suggesting that increase in global risk aversion and deterioration of domestic fundamentals during the crisis period explain three quarters of the EMBI spread variation. However, in a separate exercise we found that the magnitude of R^2 heavily depends on the sequencing of factors entering the specification. For instance, additional contribution of global factors to R^2 is only 0.1 if VIX enters the specification after controlling for all domestic fundamentals.

Table 1. Estimation Results: Factors Explaining the EMBI Spread in Ukraine

		(I)	(II)	(III)	(IV)	(V)
Crisis dummy		12.98***	6.57***	4.70***	6.78***	7.49***
(=1 for Oct 2008-Dec 2009)		[2.06]	[1.58]	[1.35]	[1.13]	[1.05]
VIX	Global factor		0.41***	0.37***	0.41***	0.42***
			[0.05]	[0.04]	[0.06]	[0.07]
IP growth	Macro factors			-0.12***	-0.10***	-0.09***
(y-o-y, percent)				[0.03]	[0.03]	[0.03]
Inflation				-0.13***	-0.16***	-0.13***
(y-o-y, percent)				[0.02]	[0.02]	[0.04]
REER appreciation	External factors				0.09***	0.11***
(y-o-y, percent)					[0.03]	[0.03]
FX reserves/GDP					-0.13	-0.19**
(percent)					[0.09]	[0.09]
Debt/GDP (lagged)	Fiscal factors					0.05*
(percent)						[0.03]
Deficit/GDP						1.14**
(percent)						[0.51]
# obs.		126	111	110	110	110
R^2 adjusted		0.59	0.75	0.81	0.82	0.83

Note: The dependent variable is EMBI spread in percentage points. Estimations are performed using OLS estimator. Intercept is included in estimations but not reported. The sample period is Jan, 2003-May, 2013. Robust standard errors are in parentheses. *, **, and *** denote significance at 10, 5, and 1 percent levels, respectively.

- ***Macroeconomic fundamentals.*** A 1 percentage point increase in industrial production annual growth rate leads to about 9 basis point reduction in spreads; the same increase in CPI leads to 13 basis points reduction. The negative sign on the inflation variable suggests that the positive effects of inflation on debt sustainability (increase in the taxable base) outpace the negative effects (bad economic management). All in all, the negative signs of both coefficients suggest that sovereign spreads will be under upward pressure should slowdown in economic activity and deflationary tendencies persist going forward.

- ***External fundamentals.*** A 1 percentage point increase in REER pushes spreads up by 11 basis points. The positive impact of a 1 percentage point decline in FX reserves-to-GDP ratio is even stronger: 19 basis points. The latter finding suggests that the declining trend in FX reserves, if not reverted, can increase sovereign borrowing costs even further.

- ***Fiscal fundamentals.*** A 1 percentage point increase in debt-to-GDP ratio pushes spreads up by 5.5 basis points; the same increase in deficit-to-GDP ratio pushes them up by to 114 basis points. The higher sensitivity of spreads to deficit ratio is related to scaling issues, as one percentage point increase in deficit per month is equivalent of 12 percentage points increase per annum. The high sensitivity of borrowing costs to debt ratio provides a strong case for fiscal consolidation, which is essential for restoring the fiscal space eroded in the aftermath of the crisis and reducing external borrowing costs in Ukraine.

Conclusion

Ukraine's borrowing costs heavily depend on global factors and domestic fundamentals (macroeconomic, external, and fiscal). Appropriate macroeconomic policies should be put in place in order to strengthen domestic economic fundamentals and maintain access to external markets at sustainable borrowing rates. In addition, expansion of FX reserves and other buffers is important to provide cushion against future changes in global market sentiment. The importance of buffers has been vividly illustrated following recent Fed tapering remarks, when EMBI spread of Ukraine have risen by a larger amount than that of regional peers with better fundamentals (Figure 6).

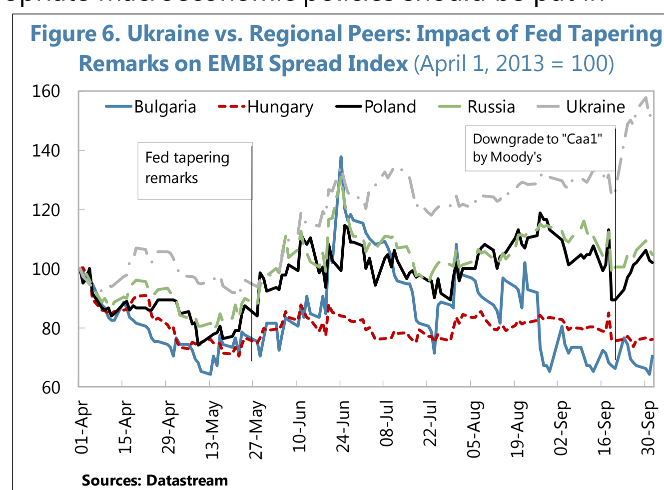


Figure 6. Ukraine vs. Regional Peers: Impact of Fed Tapering Remarks on EMBI Spread Index (April 1, 2013 = 100)

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Annex VII. Ukraine: Government Expenditures—Options for Fiscal Consolidation[1]

Background

Ukraine suffers from external imbalances and low growth. A de facto exchange rate peg policy pursued by NBU worsened external competitiveness and hampered credit growth. Headline inflation has fallen rapidly on account of tight monetary policy, flat utility prices, and decelerating economic activity. Expansionary fiscal policies introduced additional rigidity to current expenditures and contributed to the further worsening of external imbalances. Public debt-to-GDP ratio tripled from its pre-crisis levels and is on path to exceed 40 percent, often considered a danger zone for emerging economies, putting pressure on near term refinancing needs and the sovereign risk premium.

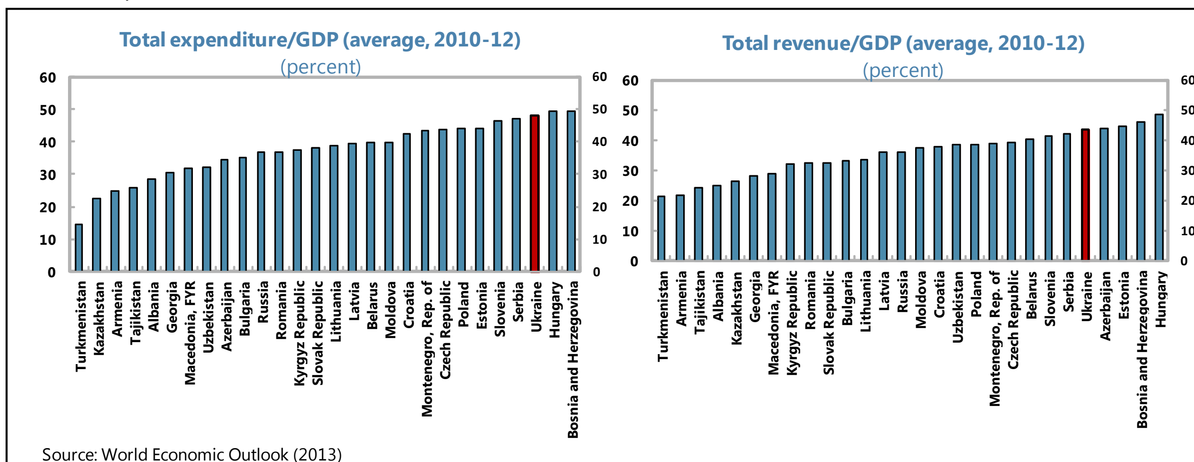
Fiscal consolidation policies are needed to stabilize the economy, and some progress has already been made in certain areas of fiscal structural reforms: (i) a new tax code was approved in 2010, which treats all taxes under one legal framework and sets up the near-term tax policy outlook; (ii) a new customs code reduced the time for customs clearance from 24 to four hours and set up a "single window" shop; (iii) a comprehensive pension reform approved in late 2011 aligned the retirement age for women (from 55 to 60) to men (60) and increased the years of service for pension eligibility, with expected medium-term annual savings of 1.8 percent of GDP; (iv) some progress was made to strengthen tax administration by centralizing the Large Taxpayers Office; (v) some progress was made in automating tax refunds, with the latest data showing that 50 percent of all VAT receipts being refunded via automated system; and (vi) amended double taxation treaty with Cyprus was ratified, and transfer pricing regulation was adopted by Parliament.

However, further structural fiscal reforms in the area of public expenditure are imperative to maintain macroeconomic stability and sustain medium-term economic development. Fiscal consolidation will contribute to the reduction of external imbalances, will help regaining fiscal space lost in the aftermath of the crisis, and will reduce financing needs and lower sovereign risk premium. There are good reasons for the consolidation to be largely expenditure-driven, as the level of government expenditures relative to the GDP is very high. Moreover, it is current expenditures that should be subject to consolidation, as capital expenditures have already been reduced to historically low levels. There is very limited room for revenue-based consolidation, as the level of government revenues relative to the GDP is already high and it would be difficult to raise revenues substantially without harming growth prospects.

[1] Prepared by Linda Kaltani (European Department) and Tigran Poghosyan (Fiscal Affairs Department).

Diagnostics: Comparison of government expenditures in Ukraine and other transition countries

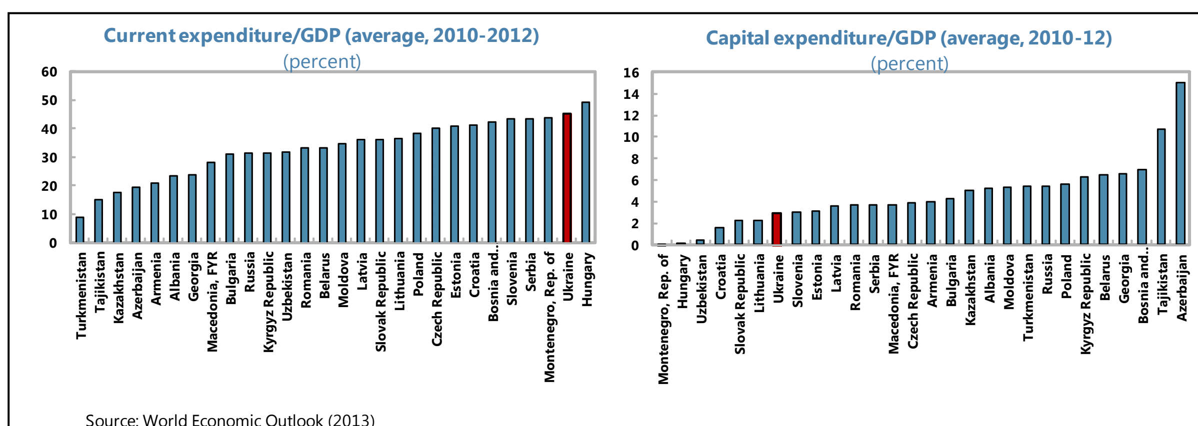
Government expenditures in Ukraine are high. There is scope to achieve the much needed fiscal consolidation by reducing public expenditures, which are high in absolute (close to 50 percent of GDP) and relative (third largest among comparator countries) terms. The case for expenditure-driven consolidation is further justified by little room for tax rate hikes given the already high revenue-to-GDP ratio (close to 45 percent of GDP, fifth largest among comparator countries).



Source: World Economic Outlook (2013)

Comparisons with other transition countries suggest that high current expenditures are the underlying cause for high government spending. Current expenditures in Ukraine (45 percent of GDP) are the second highest (after Hungary) among comparator countries. By contrast, capital expenditures (3 percent of GDP and falling further in 2013) are relatively low. This low level of capital expenditures, if sustained for a long period, can harm long-term growth prospects (Acosta-Ormaechea and Morozumi, 2013). Shifting the composition of spending from current to capital expenditures is therefore needed to establish a more growth-friendly structure of public spending, especially in the much-needed infrastructure projects.

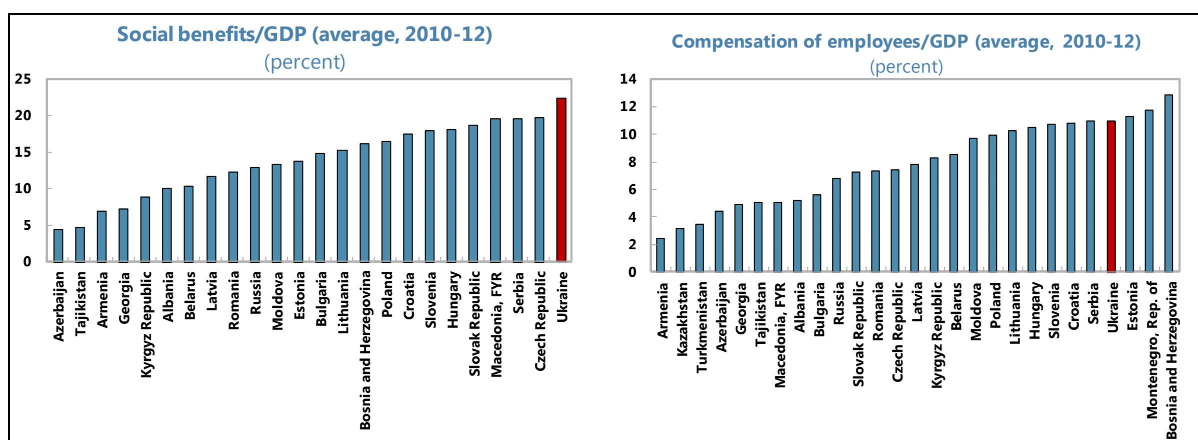
The skewed distribution of spending is in part a legacy of the boom years. During 2002–08, expenditure growth outpaced that of revenues. Constrained by financing considerations, sharp expenditure cuts during the 2009 recession squeezed capital expenditure to make room for wages, pensions and various transfers. In fact, in Ukraine there is a large discrepancy in execution rates for current expenditures and capital expenditures (97 percent versus 70 percent) as capital expenditures are less rigid than current expenditures. Capital investment in infrastructure averaged just 2 percent of GDP over the last decade, around one-fourth the level of dynamic emerging market economies in Asia. Years of underinvestment and inefficient use of resources have left public infrastructure in disrepair and have generated a significant backlog of needed public infrastructure investments.



Source: World Economic Outlook (2013)

One of the current spending items that stands out as high is social benefits. Social benefits spending in Ukraine (including pension and non-pension benefits) at 22 percent of GDP level stands out as the highest among comparators. The pension reform implemented in 2011 aimed at containing this spending category (pension expenditures) in the long-run, but short-term benefits of the reform were eroded by ad-hoc increases in pension benefits.[2]

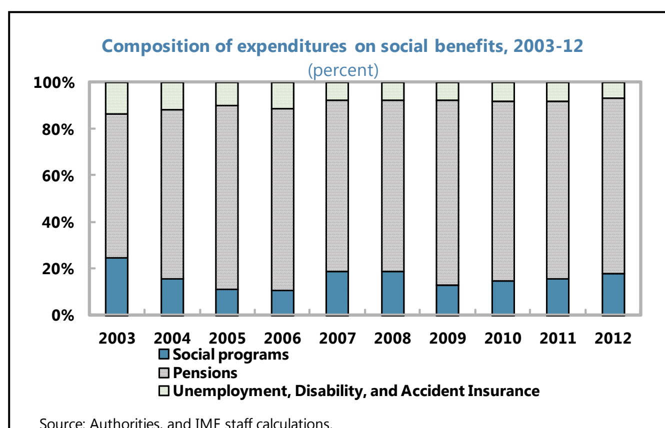
Another expenditure item that is relatively high is that compensation of employees, which exceeds 11 percent of GDP. Average public sector wage levels in Ukraine are below the economy-wide average with the exception of public administration which reflects a small share of public employment. The main reason for the high wage bill is the size of public sector employment (about one third of total employment).



[2] The 2011 pension reform included the following cost-reducing measures: (i) gradually raising the retirement age for women to 60 years, (ii) lengthening the insurance period to qualify for minimum pension benefit; (iii) gradually converging special and early pension regimes with the regular one, mainly through lengthening the service period; and (iv) capping the maximum pension at 10 subsistence minimums. Long-run savings from this reform were projected to be 1.8 percent of GDP annually, and fiscal gains in the first three years of implementation were projected to be 0.5 percent of GDP annually.

Pension benefits

The main contributor to the high social benefits in Ukraine is its pension component. Pension expenditures take up three quarters of total social expenditures in Ukraine and increased from 12 percent of GDP in 2004 to about 17 percent of GDP in 2012. The introduction of a multi-pillar pension system launched in 2004 (transition from PAYG to individual-account-based second pension pillar) has been delayed. Gains from the 2011 pension reform were partly eroded through generous ad-hoc pension benefit increases. As a result, the pension fund continues to run large deficits.



Source: Authorities, and IMF staff calculations.

Total pension expenditure in the 2013 budget (17.8 percent of GDP) is one of the highest in the world. Transfers from the central government finance a large part of this expenditure. Specifically, they cover central government-supported pension payments (including privileged pensions and top-ups covering the differential between basic pensions and the subsistence minimum-4.3 percent of GDP) and the pension fund deficit (1.5 percent of GDP).

Pension Fund Revenue and Expenditure in 2013

Expenditure			Revenue		
Category	Amount		Category	Amount	
	mln UAH	Percent		mln UAH	Percent
PF own expenditure	192,779	13.5	PF own revenue	171,018	12.0
CG-financed expenditure	61,470	4.3	Opening balance from 2012	2,200	0.2
			Contributions	164,285	11.5
			Other revenue	4,534	0.3
			CG-financed expenditure	61,470	4.3
			Deficit covered by CG	21,761	1.5
Total expenditure	254,249	17.8	Total revenue and financing	254,249	17.8

Source: Authorities; IMF staff calculations.

The average pension level in Ukraine is not high, but retirement eligibility rates are excessive. The total number of pensioners is 13.6 million, about a third of the total population of Ukraine. The average monthly pension is UAH 1,471, but more than three quarters of pensioners (about 10 million) receive pensions less than UAH 1,500 per month (compared to an average economy-wide wage of UAH 2,722). The average pension jumps to UAH 2,479 per month for

Indicators	Number of pensioners (persons)	Number of pensioners (percent of total)	Average pensions (UAH, per month)
Receive pensions in total amount of which:	13,639,739	100	1,471
up to 900 UAH	329,799	2.4	762
901 UAH - 1000 UAH	2,099,010	15.4	981
1001 UAH - 1100 UAH	2,702,765	19.8	1,052
1101 UAH - 1200 UAH	2,610,823	19.1	1,144
1201 UAH - 1300 UAH	1,078,498	7.9	1,245
1301 UAH - 1400 UAH	706,134	5.2	1,347
1401 UAH - 1500 UAH	551,756	4.0	1,448
above 1500 UAH	3,560,954	26.1	2,479

Source: Authorities, IMF staff calculations.

3.5 million pensioners earning more than UAH 1,500 per month. This jump is largely driven by privileged pensions, which are generous and not means-tested. The skewed distribution of pensions is further illustrated by the fact that 44 percent of total pension spending is directed to the 26 percent of total pensioners located in the above UAH 1,500 per month bracket. The average replacement rate at 50 percent is among the highest in the region.

A few key parameters can be used to summarize the financial situation of the pension system. The pension system in Ukraine is PAYG and can be described by the following identity:

$$\tau(\beta WP) = \beta WP - \alpha WC$$

where: α=contribution rate, β=pension replacement ratio, W=average wage, P=number of pensioners, C=number of contributors (workers), τ=share of total expenditures covered by CG as deficit financing.

Rearranging the above equation yields the below expression for deficit financing ratio:

$$\tau = 1 - \frac{\alpha}{\beta}\frac{C}{P}$$

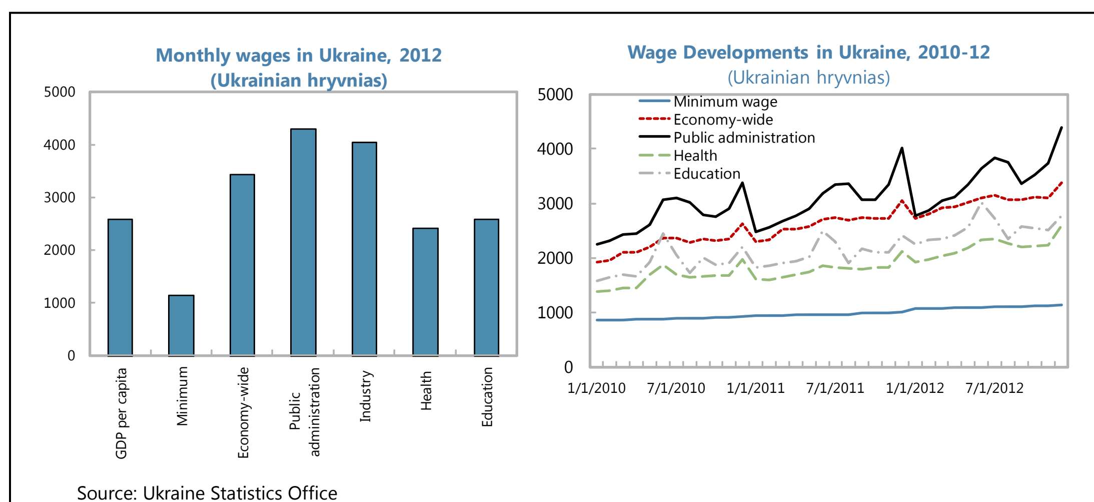
which suggests that PF deficit financing can be reduced by: (i) increasing the contribution rate (α); (ii) increasing the number of contributors (C); (iii) reducing the pension replacement ratio (β); and/or (iv) reducing the number of eligible pensioners (P).

Guided by the above accounting, the following measures could be considered by the authorities to improve the soundness of state pension finances:

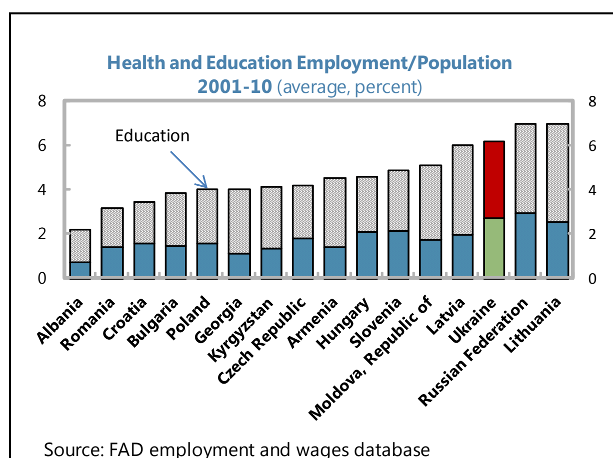
- Reduce the accrual rate back to 1% (from current 1.35 %)
- Repeal indexation of pensions by 20 percent of average wage growth (if higher than the CPI growth) and keep only CPI indexation
- Delink minimum pension benefits from minimum subsistence and introduce means testing for minimum subsistence supplement
- Reduce unfunded privileged/special pensions through: (i) widening the contribution period to qualify for such benefits; (ii) raising the retirement age and service period; and (iii) converging the accrual rate and indexation for civil servants to the general system
- Consider further increases in the retirement age in line with the increase in life expectancy

Compensation of employees

Though low on average, wages in the public sector are heterogeneous and have been rising rapidly. The average wage in the public sector does not appear to be excessively high, but wages in public administration exceed economy-wide wages, and wages in education also appear to be relatively high. Furthermore, public sector wages display a growth trend that exceeds that of inflation and nominal GDP, with generous wage hikes reemerging in 2011–13, primarily through the issuance of supplementary budgets. Given no significant changes in employment, the large wage increases have contributed to an increase in the wage bill as a share of GDP for every year since 2010. The wage bill has climbed from 10.4 percent of GDP in 2011 to a projected 11.7 percent in 2013.



Public employment is high, especially in health and education sectors. Employment in the education and health sectors is in fact third largest among transition countries and constitutes over 65 percent of total public employment. The main concern with health and education employment is the fact that it is not linked to output performance but rather to old Soviet-style norms which do not capture the needs of a changing society with declining demographic trends. Furthermore, despite the high employment and relatively large spending in the social sectors (top third of the transition countries for education and top half for health), Ukraine scored worse than comparator countries in terms of outcome measures for health and education such as life expectancy (20th highest), DPT (diphtheria, pertussis, and tetanus) immunization (27th highest), primary (12th highest) and secondary (13th highest) school enrollment.



Wages and Employment in the Public Sector, 2012–13

2013	# of employees			average wage			wage bill		
	Total	State	Local	Total	State	Local	Total	State	Local
Health	1,105,518	108,562	996,956	2,845	3,273	2,799	37,744	4,264	33,480
Education	1,640,878	281,790	1,359,088	3,294	3,534	3,244	64,861	11,950	52,911
Other budgetary	636,591	310,493	326,099	3,597	4,186	3,035	27,474	15,598	11,876
Civil service	469,381	336,593	132,788	4,966	5,197	4,379	27,970	20,992	6,977
Total	3,852,368	1,037,437	2,814,931	3,419	4,242	3,116	158,049	52,804	105,245
2013-2012 growth	**# of employees**			**average wage**			**wage bill**		
(%)	Total	State	Local	Total	State	Local	Total	State	Local
Health	-0.7	-15.1	1.2	3.8	19.4	2.1	3.1	1.4	3.3
Education	-1.5	-1.1	-1.6	8.7	12.7	7.8	7.0	11.5	6.1
Other budgetary	-0.2	-1.7	1.3	8.3	10.0	6.7	8.1	8.1	8.1
Civil service	7.5	11.3	-1.1	4.3	4.3	2.8	12.2	16.1	1.7
Total	0.0	0.6	-0.3	7.1	10.6	5.4	7.1	11.3	5.1

Source: Ukraine Statistics Office.

Given the above analysis, the following measures could be considered by the authorities to reduce the public wage bill:

- Contain public sector wage growth below CPI growth for a couple of years to offset large real growth rates in 2012–13, with the aim of reducing the wage bill to 10 percent of GDP in the medium term.
- Perform functional analysis of critical sectors to identify areas for efficiency enhancements.
- Reassess appropriateness of public sector norms and speed up the shift to per capita allocation of resources and performance-based budgeting.
- Conduct public employment census to identify areas where main problems lie, to eliminate vacant positions by gradually introducing elements of attrition in public employment.

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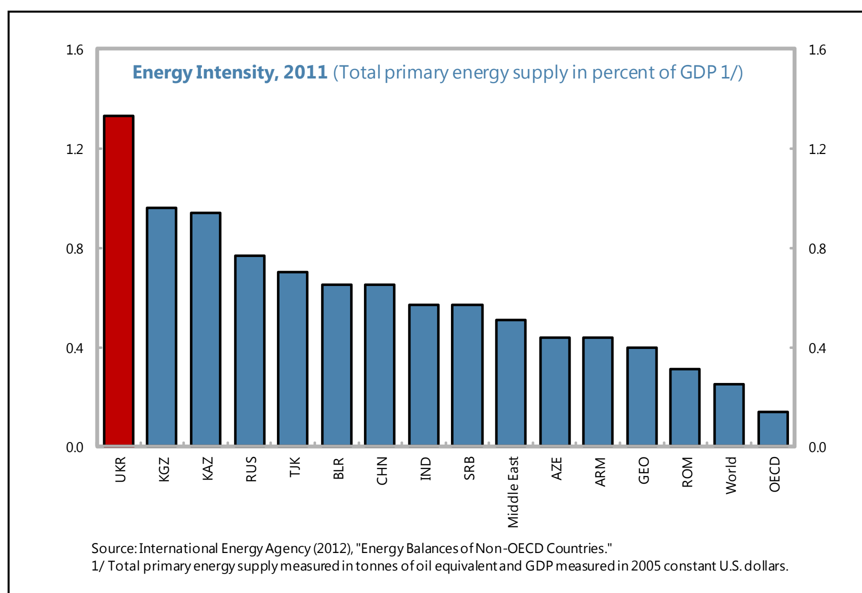
Annex VIII. Reforming Energy Subsidies in Ukraine[1]

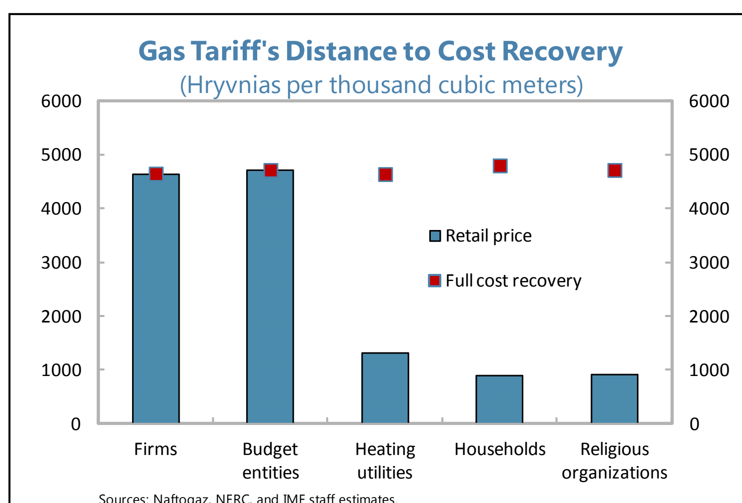
Background

Despite it being well endowed with energy products, the energy sector in Ukraine exhibits mounting losses that have taken macroeconomic proportions and risk undermining macroeconomic stability. Ukraine is very energy inefficient in terms of energy intensity. In fact, Ukraine's energy intensity is twice as large as that of Russia and ten times higher than that of the OECD. This is not just driven by the economy's production structure but also by inefficiencies in production and consumption. Reforms of the sector have progressed very slowly, and its losses continue to aggravate external imbalances as well as fiscal performance. Furthermore, an unreformed energy sector undermines Ukraine's growth potential and its ability to catch-up with its European neighbors.



Source: International Energy Agency (2012), "Energy Balances of Non-OECD Countries."
1/ Total primary energy supply measured in tonnes of oil equivalent and GDP measured in 2005 constant U.S. dollars.

Ukraine's energy sector problems are to a large extent caused by large energy subsidies that bridge the gaps between retail and cost-recovery prices for gas and heating. While retail prices for industrial consumers and budget-funded entities reflect the full pass through of import prices, the utility companies serving households currently receive gas at 28 percent of full import pass-through price while the average household pays about 19 percent of the full import pass-through price. Despite the subsidized gas input, utilities' prices

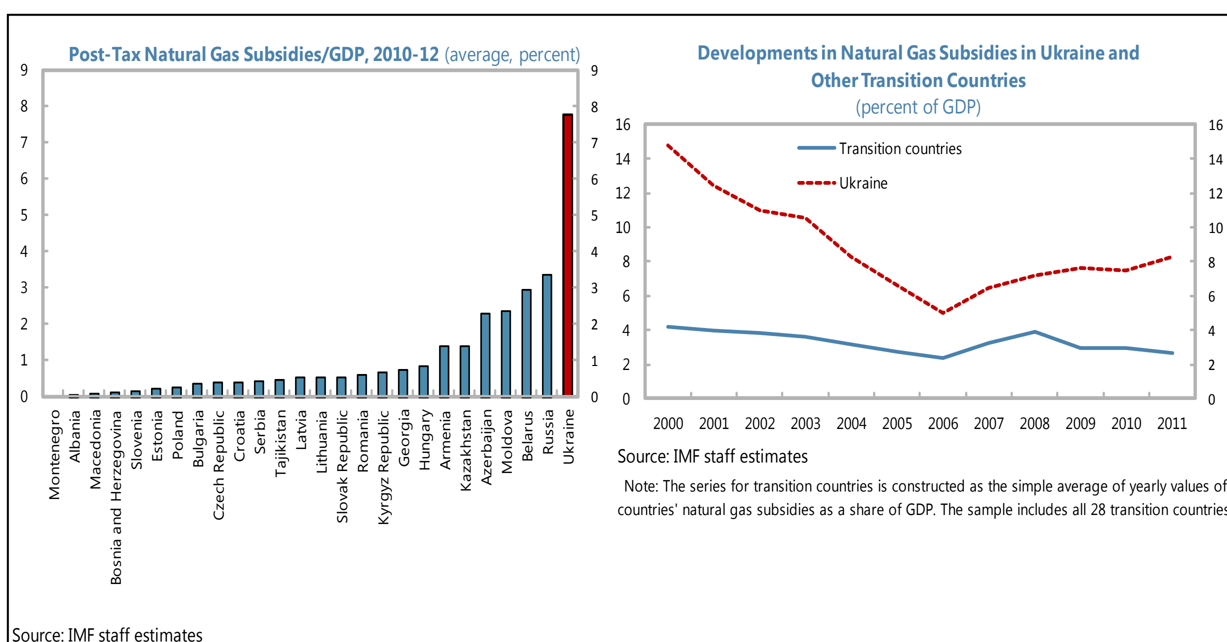


Sources: Naftogaz, NERC, and IMF staff estimates.

[1] Prepared by Linda Kaltani.

to households are, on average, only about 70 percent of their cost-recovery level net of a return on investment.

The energy market is segmented across various consumers leading to arbitrage opportunities and undermining energy sector transparency. Market prices to the industrial sector have stimulated the search for efficiency gains and have led to a dramatic reduction in consumption. However, demand by households and district heating companies has remained remarkably stable reflecting low price elasticity but also waste by households given the very low tariffs. Furthermore, a cost-plus approach to pricing by district heating companies inflates input costs and stifles the search for efficiency gains. Finally, given large tariff differentials across consumer groups, there are strong incentives to siphon off cheap gas intended for households to higher-paying industrial customers.



Source: IMF staff estimates

Note: The series for transition countries is constructed as the simple average of yearly values of countries' natural gas subsidies as a share of GDP. The sample includes all 28 transition countries.

Source: IMF staff estimates

The large energy sector subsidies weigh heavily on public finances, which pose risks to medium-term fiscal sustainability. The large subsidies are a legacy of the break-up of the Soviet Union when Ukraine, accustomed to very low energy prices, faced large energy price adjustments. While on the decline until 2006 and converging to the average for transition countries, post-tax energy subsidies on gas and heating started to increase again when Russia started to raise gas prices for Ukraine.[2] The 2009 gas contract between Ukraine and Gazprom

[2] Post-tax subsidies are defined as the difference between a benchmark price (in the case of Ukraine this would be the international price for gas appropriately adjusted for transport and distribution costs) and the price paid by energy consumers. The benchmark price includes an adjustment for efficient taxation to reflect both revenue needs (for example, energy should be taxed the same way as any other consumer product) and a correction for negative consumption externalities (for instance, pollution).

reinforced this trend. By 2012, post-tax energy subsidies amounted to 7.6 percent of GDP.[3] Previous attempts to dismantle subsidies have failed amid hesitation by strong vested interests and political economy considerations. Nevertheless, many transition countries have already tackled energy sector subsidies successfully and useful lessons can be drawn from their reform experiences.

Drawing from other countries' best practice experiences, Ukraine should design an energy subsidy reform that can begin relatively quickly, though proceed gradually. Evidence from other countries seems to suggest that a successful reform strategy must have three key ingredients: (i) analytical clarity about the size and distribution of existing subsidies; (ii) programs to mitigate the impact of subsidy removals on the most vulnerable; (iii) effective communication to various stakeholders of the need for reform.

Empirical Evidence

Cross-country evidence suggests that energy subsidies are generally ill targeted (IMF 2013). Energy subsidies have wide-ranging economic consequences. They undermine a government's fiscal position through higher fiscal deficits, lower outlays for priority public spending, or higher taxes. Underpriced energy leads to a misallocation of resources through overconsumption as well as balance of payments pressures when the country is an energy importer. In addition, it deters investment in the energy sector. Finally, energy subsidies can undermine institutions and reinforce inequality.

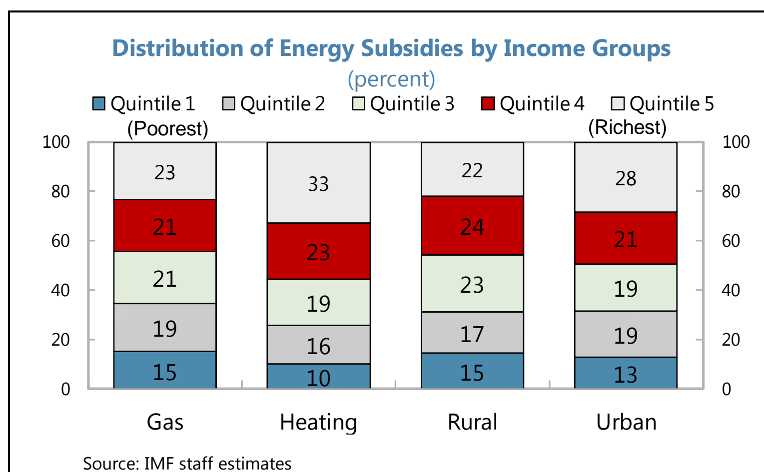
Econometric estimates performed by staff suggest that natural gas subsidies have a negative, substantial, and statistically significant impact on real per capita GDP growth (see Table below).[4] Another important finding of the regression analysis is the positive and significant impact of capital investment on economic growth pointing to the likelihood that energy subsidies, by draining government resources, may undermine the growth-generating channels of the economy such as human and capital investment. Finally, subsidies may also impact growth performance indirectly by undermining fiscal sustainability, increasing debt,

[3] Of this amount only 1.3 percent of GDP was recorded on budget (as cash injections and subventions to local government to pay heating utilities). The rest is either below-the-line operations such as recapitalization bonds or off-budget write-off of arrears as well as non-central government sources like early receipt of gas transit fees from Russia's Gazprom. Currently direct transfers to Naftogaz and heating utilities are recorded in the budget at the beginning of the fiscal year, but generally these are insufficient to cover all their financing needs. This in turn leads to amendments to the state budget. The remainder is covered by recapitalization bonds. Recapitalization bonds are treated as a financing item in the central government budget notwithstanding Naftogaz's large past and expected future losses, which would call for its recording as transfers in the budget based on GFSM 2001. Obviously the indirect subsidies to heating utilities for purchasing gas at a subsidized price are also not recorded in the budget.

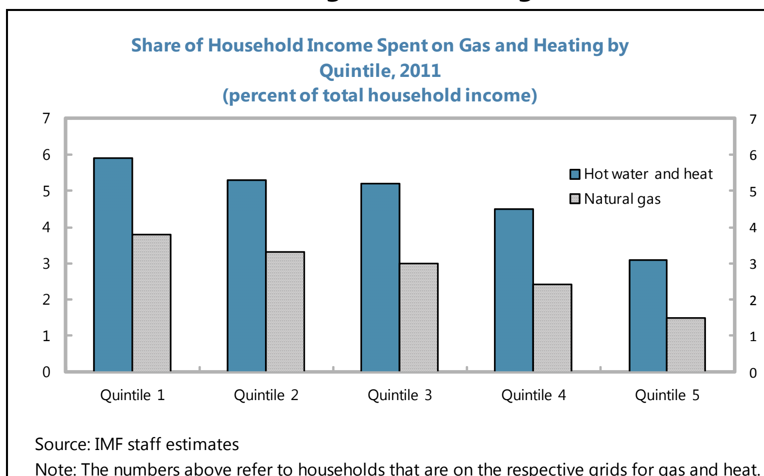
[4] The growth regressions point to an inconclusive effect of total energy subsidies (kerosene, gasoline, diesel, and natural gas) but to a highly significant and negative effect for natural gas subsidies. The regression results are presented for both, a fixed effects estimation and a generalized method of moments (GMM) estimation which also addresses concerns about endogeneity, which are common in growth regressions.

eroding a government's ability to invest in pro-growth spending like health, education, infrastructure, as well as exacerbating economic volatility. This implies that the coefficients reported in the regressions table may underestimate the total negative impact of energy subsidies on growth.

Energy subsidies are unfair as they accrue mainly to the affluent. In Ukraine, the bottom quintile receives 13.6 percent of total subsidies, while the top quintile receives nearly twice this amount (26.5 percent). The unequal distribution of energy subsidies is more pronounced for heating compared to natural gas. More affluent urban dwellers are the foremost beneficiaries of subsidies as district heating is virtually only available in urban areas. The skewed distribution of subsidies is in part driven by the fact that benefits are awarded to categories of households or individuals without regard to the economic well being of the recipient. The discounts for the purchase of housing utilities provided by Ukraine's privilege programs are the largest source of assistance for families in mitigating the cost of natural gas and district heating. Housing privileges are skewed toward higher-income households because they are calculated as a share of total spending and a larger share of households in the upper income quintiles qualifies.



Poorer households spend a larger share of their incomes on gas and heating. For households connected to the respective gas and heat pipelines, the share of expenditures on heat and gas in total net income amounts to 9.7 percent for households in the first quintile compared to 4.6 percent of net income for households in the fifth quintile. Overall, poor households that are connected to the grid pay for utilities a share of their net income that is around double that of richer households.



Restarting Energy Sector Reforms

Ukraine faces the challenge of designing and implementing a broad-based energy reform agenda. A comprehensive reform plan in Ukraine would stand on four pillars: (i) adjust energy tariffs to cost-recovery levels and eliminate chronic losses in Naftogaz, the state-owned gas holding company, while protecting the most vulnerable; (ii) accelerate heat/gas metering installation and energy saving efforts, as a complement to the indispensable tariff hikes; (iii) diversify gas imports away from Russia; and (iv) increase domestic gas exploration and production, including by overcoming obstacles delaying exploration of Ukraine's shale gas reserves.

A broad-based and sizable adjustment of energy prices is urgently needed and offers the best prospect for bringing Naftogaz finances to a sustainable footing. Significant increases in gas and heating tariffs are essential, as a fiscal measure to reduce the fiscal cost of subsidies and also as a key structural reform to reduce energy use and help diversify the economy. To kick off the reform process, tariffs for households and utilities should increase immediately by at least 40 percent. Furthermore, a schedule should be adopted to raise tariffs to the cost recovery level over the next three years through semiannual increases of 20 percent until mid-2016. Tariffs to industry would increase broadly in line with exchange rate movements. Higher tariffs, somewhat higher gas sales to industry (due to improvements in Ukraine's competitiveness and the incipient economic recovery), as well as efficiency gains would lead to operational cost recovery for Naftogaz in the medium term.

To offset the effect of tariff adjustment on the poor, the existing system of targeted social assistance would need to be scaled up to protect the bottom two quintiles of the income distribution. This would imply the need to refocus the social assistance system so that support is given on the basis of income rather than privileges. Income is already used as a qualification criterion for the provision of the Guaranteed Minimum Income (GMI) as well as housing utilities subsidies, and the World Bank believes that these programs can be scaled up within a six-month period. Currently the Ministry of Social Protection oversees a network of local government offices at which citizens can apply for need-based assistance for both GMI and housing utilities (heating/natural gas/other) subsidies using a single application. The system includes procedures for validating eligibility and implementing assistance. However, currently GMI receives only 4 percent of the social assistance budget. Its benefits are well-targeted with criteria for inclusion being very stringent and benefits being low. Coverage is extremely low at less than 5 percent of the households in the bottom quintile.[5] Ultimately, Ukraine would need to move toward the consolidation of social assistance into a single cash-transfer system such as GMI by shifting out of benefits focused on the cost of housing utilities into targeted cash benefits.

[5] This situation calls for scaling up GMI. Such scaling up would need to strike a balance between excluding a deserving household against including a household that should not qualify.

- **A few reform options could be implemented in Ukraine within a one year horizon:**

  - *Scale up GMI*. The goal for the authorities would be to increase GMI coverage. However, increased coverage has to be carefully managed to ensure that targeting performance is not undermined. The government can increase the income threshold that would allow for more poor people to be covered by the program while also increasing the benefit amount. Scaling up GMI would require improving the infrastructure for targeting and delivering social assistance by improved management information systems with universal access throughout the system and improving the procedures for approving applicants and auditing procedures for certifying eligibility. In particular, the information network among local offices and the Ministry of Social Protection can be improved.

  - *Restructuring of current benefit for housing utilities*. One way of reforming these subsidies is by introducing a cost-sharing system rather than the existing cap system, which rewards households that spend more a certain share of their income on utilities. Such a reform would limit utilities benefits to a predefined group of poor households and can be implemented almost immediately with minimal adjustment to the current infrastructure.

  - *One-off cash transfers.* These transfers could be linked to the tariff increase for a predefined share of the population and for households expected to have difficulty paying the higher tariffs. Such transfers could be a supplement to the GMI for certain months of the year, such as the heating season.

  - *Lifeline tariff for gas and heating.* Setting lifeline tariff entails providing a minimal amount of gas and/or heating at heavily subsidized prices to households. This option could be implemented if sufficient progress is made on meter installation. Gas meter installation is underway and at a good point but district heat meters are further behind, so there could be a differentiation between heat and gas treatment.[6] Problems with collection underperformance could be addressed with this tariff as well since it could be required that customers be current on their bills to receive the benefit.

Designing a public communication campaign

The findings of the analysis discussed above should be embedded in a communication campaign and should be discussed in various public forums. The government would need to reach out to all stakeholders in a consultative process to make the case that subsidy reform is broadly beneficial. The pillars of the campaign could be organized around the following themes:

- **Energy subsidies are a legacy of the past; they are expensive, inequitable, and unaffordable.** Due to a protracted lack of investment in the past 25 years, the system is

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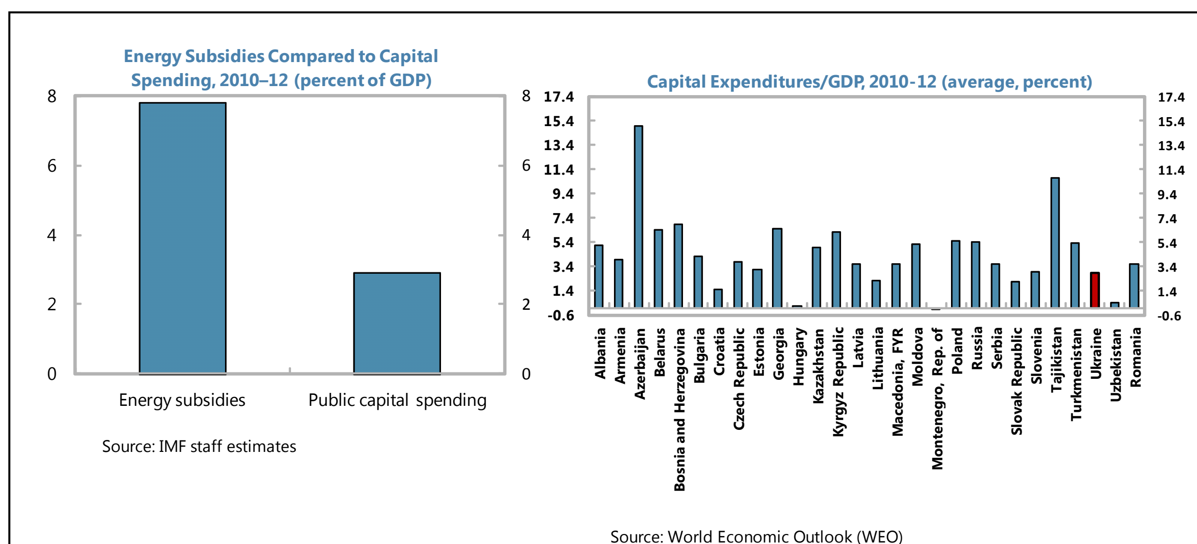
[6] The installation of meters with control systems would help this effort by linking household payment to actual consumption thus affecting financial incentives of households.

degraded and in urgent need of rehabilitation. Urgent reforms are necessary since there aren't sufficient financial resources for enhancements. About 60 percent of heat is currently wasted, pointing to major potential savings if the necessary investment is put in place. Energy subsidies are not a 'free lunch' for the population. If budgetary outlays on subsidies are not reduced, either taxes or the budget deficit would be higher and would likely fall disproportionally on households in the upper quintiles of the income distribution and those who pay taxes, given the size of the grey economy.



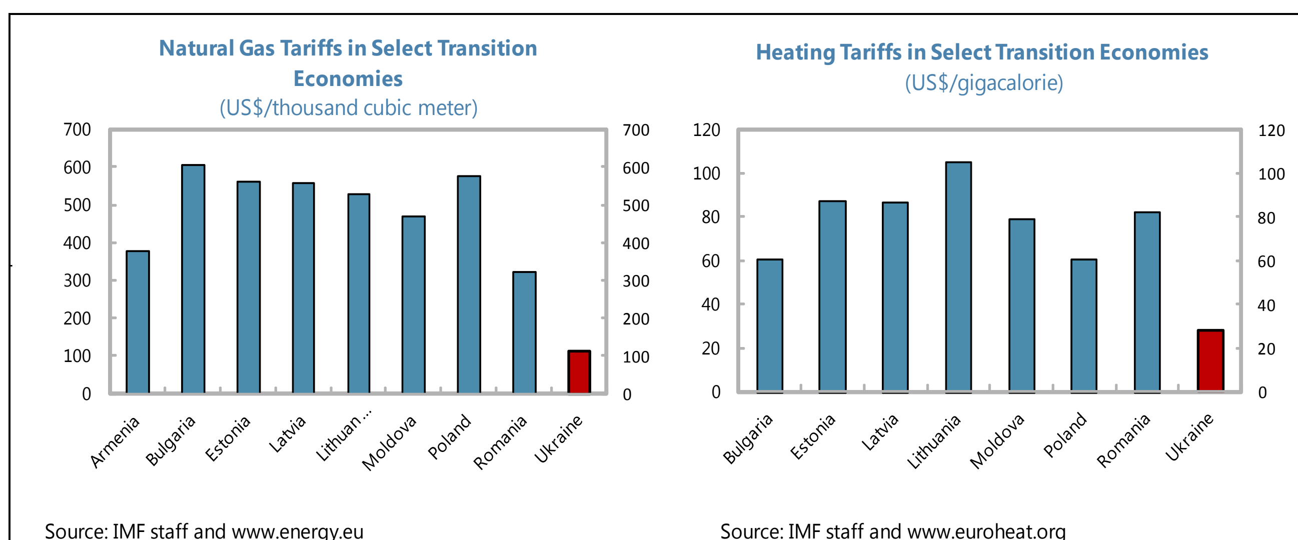
- **The opportunity cost of subsidies is high in terms of foregone public investment and underperforming economic growth.** Foregone public investment means that the government is spending less on higher priority public spending such as health, education and infrastructure investment which in turn hampers economic growth and employment. Capital expenditure is only a fraction of energy subsidies. It is also relatively low relative to other transition countries and significantly lower than in dynamic emerging market economies in Asia.

- **Almost half of the population will receive social assistance to protect it from the effects of the reform.** Identifying the most vulnerable is feasible, so this reform proposal can be implemented quickly while also scaling up means-tested social assistance programs for the poor. To the extent that GMI cannot be scaled up fast enough to protect those that are deemed most vulnerable, heating assistance will be provided to them in the winter months. The infrastructure for targeting and delivering social assistance and for monitoring the performance of the system will be enhanced through awareness campaigns, improved management of information systems, and improved procedures for approving applicants and certifying eligibility.

- **Energy policy will be designed and implemented in a transparent manner.** An automatic price adjustment mechanism will need to be instituted and will be implemented by the

National Commission for State Energy Regulation (NERC) and National Commission on the Regulation of the Communal Services (NURC). Such a mechanism would need to be publicly reviewed at predefined frequencies. While the existence of the regulators for energy and heating is an important initial condition for energy reform, the challenge will be to enhance their independence both financially and politically. Furthermore, the regulatory framework would need to be changed so as to focus on regulating the rate of return to energy providers. Finally, budgets would need to explicitly reflect the costs of energy subsidies in order to create an appropriate environment for their elimination. Full integration in the budget of quasi-fiscal subsidies would improve transparency and reduce fiscal risks.

- **While past reform attempts have not been successful, neighboring countries have also grappled with similar energy challenges, and success stories can be tapped on.** Energy subsidies were tackled in Ukraine in the past but not in a comprehensive manner. To a great extent this was due to powerful vested interests that resisted such reforms. In addition, there was a lack of a broader energy strategy; less emphasis on EU integration; and lack of a clear understanding by the general public of how expensive and unequally distributed such subsidies were. Though energy subsidy reforms are a key challenge for the future, past attempts have registered smaller successes that can positively contribute to future reform efforts. For example, regulators are already in place in both the natural gas and heating sectors. Ukraine's acceptance to become a candidate for the Extractive Industry Transparency Initiative (EITI) will contribute to enhancing transparency in the energy sector. Finally, there is also a much deeper understanding of who the beneficiaries of energy subsidies are as well as of Ukraine's matrix of social assistance programs. Together with experiences from other countries (experiences of Armenia and Moldova are presented in the box below), energy subsidy reforms can be successfully implemented in Ukraine if there is a strong political will as well as buy-in from various groups of society.



Box 1. Examples of Transition Countries Tackling Energy Subsidy Reforms

Armenia

- After gaining independence, Armenia significantly underpriced electricity (providing subsidies to the tune of 11 percent of GDP). Early price adjustments did not completely eliminate quasi-fiscal subsidies, and increasing gas prices led to an exacerbation of the problem. In 1999, Armenia introduced a cash transfer program that replaced child and family allowances. This new program was used as a mechanism to help beneficiaries maintain their real consumption in the face of higher electricity bills. Continued efforts were made to increase the coverage of the cash transfer program. In addition, one-off cash transfers were made to low-income households and households considered at risk of struggling to cope with higher electricity prices.

- Furthermore, the Global Partnership on Output-based Aid (GPOBA) and the World Bank funded a scheme providing grants to poor households for individual heating solutions based on gas heaters and in some cases boilers. The drawbacks from the Armenia experience were that tariff increases for electricity caused some customers to switch to cheaper, often dirtier, fuel sources such as wood fuel or natural gas, while many poor households were pushed to not heat at all.

➢ *Takeaways for Ukraine:* GMI is critically important and could to be scaled up in coverage and benefit; one-off cash transfers may be necessary.

Moldova

- Like in other transition countries, increases in Russian gas import prices prompted tariff increases and overall reforms in the energy sector in Moldova. IMF and World Bank-supported programs were instrumental in pushing reforms forward. Important reforms related to: (i) Parliament transferred the responsibility for tariff setting from the municipal authorities to the energy regulator (ii) the energy regulator raised energy tariffs to financial cost-recovery levels; (iii) the power to appoint the energy regulator's council of administration and approve its budget was transferred to Parliament.

- To mitigate the impact of higher energy tariffs on the most vulnerable, the central government provided support alongside the municipal assistance scheme as a bridge until the new targeted social assistance system was fully deployed. Interesting steps taken on the social assistance front were the improved capacity of social services and the continuous awareness campaigns to increase applications and expand enrollment in the new means-tested social assistance program so as to more quickly phase out the old category-based compensation system. Furthermore, the guaranteed minimum income and the cold-month assistance were increased.

- Finally, the Ministry of Labor and Social Protection allocated additional resources to strengthen its capacity to promptly process applications for the cash transfer program in order to ensure adequate access to social assistance. The main drawbacks of the reforms in Moldova have been the uneven implementation, with heating arrears remaining a challenge and pressure from the municipality of Chisinau to limit heating tariff increases.

➢ *Takeaways for Ukraine:* NERC and NURC should be de facto independent with appointments of its members done by Parliament rather than the President. Awareness campaigns can be put in place in order to increase applications for GMI and/or housing utilities subsidies. Finally, the resources of the Ministry of Social Protection may need to be re-assessed to ensure that it has the capacity to handle a potentially much larger number of beneficiaries.

Determinants of Real per Capita GDP Growth				
	Fixed effects estimation		GMM Estimation	
Total energy subsidies	-0.374 ***		0.0003	
	0.143		0.003	
Natural gas subsidies		-0.607 **		-0.016 **
		0.263		0.008
Initial income			-0.057 *	-0.072 ***
			0.030	0.03
Capital investment	0.217 ***	0.223 ***	0.005 ***	0.005 **
	0.038	0.038	0.002	0.002
Openness	0.021	0.022 *	0.001 *	0.000
	0.014	0.014	0.000	0.000
Infrastructure development	0.113 *	0.084	0.005	-0.002
	0.067	0.064	0.003	0.047
Financial development	-0.025	-0.026	0.000	0.000
	0.017	0.017	0.001	0.001
Constant	-3.467 *	-3.192 **	0.231	0.214
	1.764	1.755	0.198	0.161
Observations/countries	518/64	518/64	518/64	518/64
Arellano-Bond test for AR(1) in first differences			0.004	0.000
Arellano-Bond test for AR(2) in first differences			0.111	0.109
Sargan test of overidentifying restrictions			0.122	0.151
Hansen test of overidentifying restrictions			0.198	0.274

Source: IMF staff calculations.

* 10 percent significance; **5 percent significance; ***1 percent significance

Notes: Robust standard errors in parentheses. All estimations control for year dummies.

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Annex IX. Boosting Potential Growth in Ukraine Through Structural Reforms[1]

Structural reforms are critical for boosting growth potential in Ukraine and ensuring balanced and sustained development in the medium term. We have identified areas of major structural constraints, which impede private investment on the demand and supply side. Based on our assessment and findings of the European Bank for Reconstruction and Development, European Union, World Bank and the Organization for Economic Cooperation and Development, we recommend developing a medium-term structural reform strategy with clearly defined reform priorities to ensure consistent and coherent approach in addressing major obstacles to growth. In addition, we emphasize the importance of thorough implementation and execution of law and regulations.

A challenging way ahead towards improving competitiveness and boosting economic growth

The economic crisis exposed weaknesses of the Ukrainian economy, putting in question sustainability of the country's growth fundamentals. In 2000–07 Ukraine enjoyed an annual growth of 7–7.5 percent on average, supported by favorable external environment and commodity prices, capital inflows and rising productivity. At the outbreak of the crisis, a rapid deterioration of external conditions and large capital outflows severely hit Ukraine. With the Fund programs in place and a boost from one-off factors,[2] the country temporarily succeeded in restoring economic growth, only to face another recession starting from 2012:H2. Large twin deficits, a monetary policy focused on defending an overvalued exchange rate and strong dependence on commodity prices have left Ukraine vulnerable to shocks. In addition, the unsustainable mix of policies has taken its toll on investment and productivity, thus adversely affecting Ukraine's growth potential.[3]

Structural reforms are critical if Ukraine is to enjoy a sustainable economic growth in a medium and long term. Policy measures aimed at reducing domestic demand and restoring macroeconomic stability, including by ensuring exchange rate flexibility, cutting fiscal deficit, and addressing energy sector imbalances and inefficiencies are indispensible for reviving economic growth in Ukraine. However, to revamp potential growth and ensure a balanced and sustained development, the country needs to strengthen its economic fundamentals by addressing long-standing constrains to growth. To this aim, structural reforms directed towards enhancing

[1] Prepared by Beata Jajko.

[2] The 2008 Stand-By Arrangement (SBA) and 2010 SBA had only one and two reviews concluded, respectively; one-off factors in 2011include: preparations for the UEFA Euro Cup 2012 and good grain harvest.

[3] Our estimates show that Ukraine's potential growth in the medium term, absent policy changes, might be some 3 percentage points lower then what the country could enjoy if it had a consistent and sustainable policy mix in place and after having addressed major structural inefficiencies.

country's competitiveness by unlocking private sector's potential need to be put in place. These reforms are also crucial for increasing Ukraine's income per capita and for ensuring its steady convergence to the income levels enjoyed by more developed regional peers.[4] Ukraine's success will largely hinge on broad political support for reforms and their timely and thorough implementation.[5]

Notwithstanding some progress made in improving structural indicators, further enhancement is strongly needed. Ukraine was among economies recognized by the World Bank as making the most improvement in the 2014 Doing Business (DB), which ranks countries based on business regulations and their enforcement in small and medium-size companies over their life cycle. The country advanced by 28 ranks to 112th place (out of 189 countries) in the ease of doing business and from 50.97 to 58.44 in the distance to the "frontier,"[6] with progress highly concentrated on dealing with construction permits and registering property. Improvements were made from a low base, and Ukraine continues to lag behind CESEE peers. There is also a substantial variation in performance among DB categories which may point towards important regulatory obstacles for investment.[7] In another complex measure of competitiveness—the 2013–2014 Global Competitiveness Index (GCI) of the World Economic Forum(WEF), Ukraine's overall rating deteriorated from 73 to 84 position (out of 148 countries), right after a short-lived progress made in the 2011–2012 rating (Figure 1). In addition, governance in Ukraine remains weak, as reflected in the World Bank Worldwide Governance Indicators. Economic freedom continues to be severely repressed. In the 2013 Index of Economic Freedom (IEF) of the Heritage Foundation, Ukraine was ranked 161st (out of 177 countries) and was the only country among CESEE classified as having repressed economic freedom.

More decisive progress is also required in implementing recommendations of the Group of the States against Corruption (GRECO), the Council of Europe anti-corruption monitoring body. Based on the latest report (March 2013), only 14 out of the 25 recommendations were implemented satisfactory or dealt with in a satisfactory manner (GRECO, 2013). In addition, the 2012 Corruption Perception Index (CPI) of Transparency International in Ukraine was the

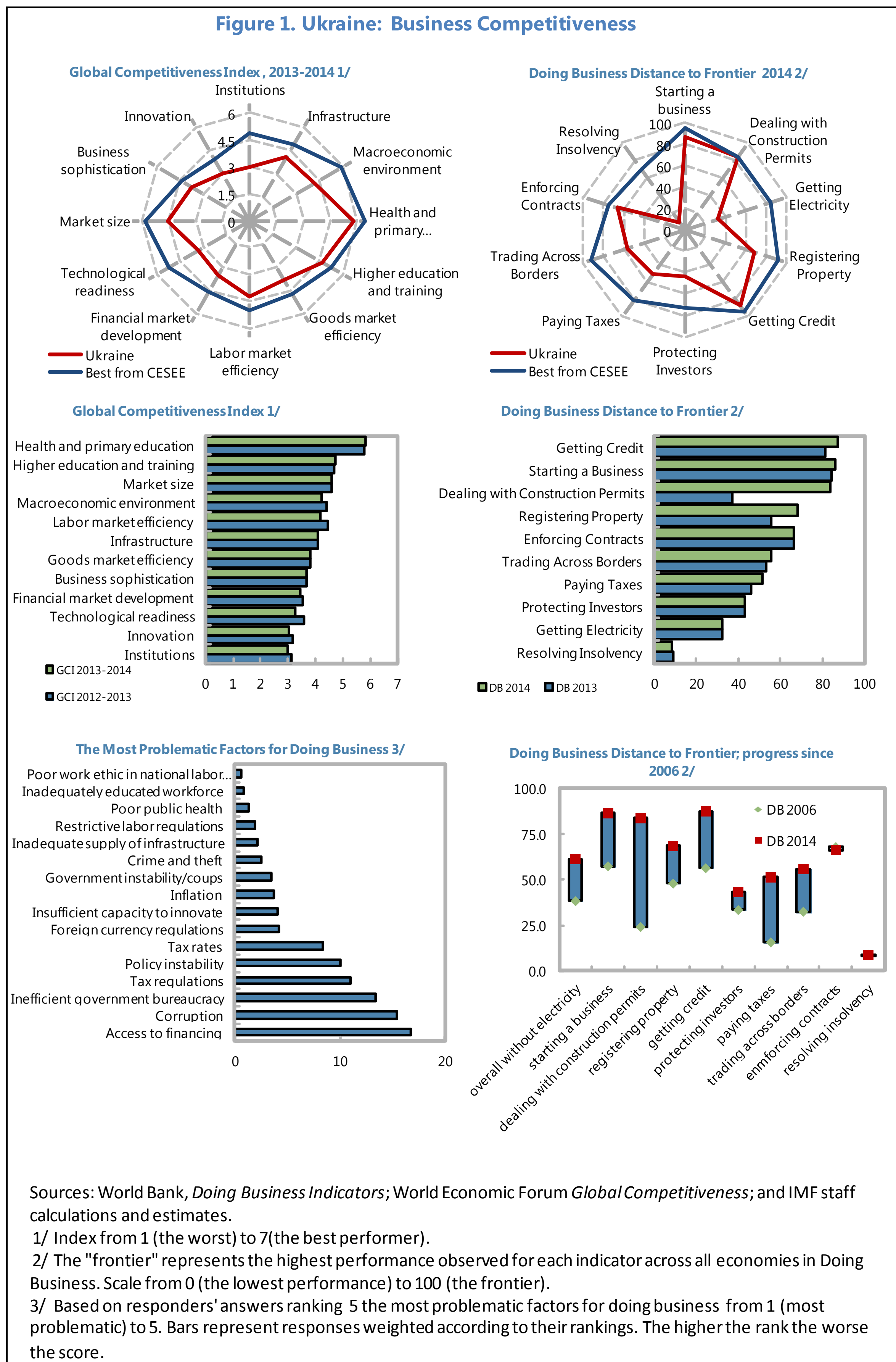
[4] In 2012 per capita GDP PPP in Ukraine equaled ¼ of the European Union average and was the lowest among CESEE peers. CESEE: Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, Poland, Romania, Russia, Serbia, The Slovak Republic, Slovenia, Turkey, Ukraine.

[5] Ukraine's track record reveals problems, heavily influenced by a political cycle, with consistent and coherent implementation of structural reforms, which includes cases of backtracking on reforms. For more information see staff reports on 2012 Article IV Consultation, Ex-Post Evaluation of Exceptional Access Under the 2008 and 2010 SBAs.

[6] The ease of doing business ranking compares economies with one another (economies are ranked from 1 to 189); the distance to the "frontier" benchmarks economies against the "frontier" in regulatory practice, measuring the absolute distance to the best performer for each indicator. The "frontier" represents the highest performance observed for each of the indicators across all economies included in *Doing Business*. An economy's distance to frontier is measured on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier. WB (2014), p. 10.

[7] See WB 2014.

Figure 1. Ukraine: Business Competitiveness



Sources: World Bank, *Doing Business Indicators*; World Economic Forum *Global Competitiveness*; and IMF staff calculations and estimates.

1/ Index from 1 (the worst) to 7(the best performer).

2/ The "frontier" represents the highest performance observed for each indicator across all economies in Doing Business. Scale from 0 (the lowest performance) to 100 (the frontier).

3/ Based on responders' answers ranking 5 the most problematic factors for doing business from 1 (most problematic) to 5. Bars represent responses weighted according to their rankings. The higher the rank the worse the score.

highest among CESEE, confirming that corruption remains a serious issue in Ukraine (Figure 2). Recently—as part of the efforts to meet requirements of the association agreement with the EU—the authorities have undertaken measures to pass anti-corruption legislation and address judicial weaknesses. In order to ensure a steady progress in reducing corruption, these efforts need to continue in a decisive and comprehensive matter, with strong emphasis on implementation and execution.

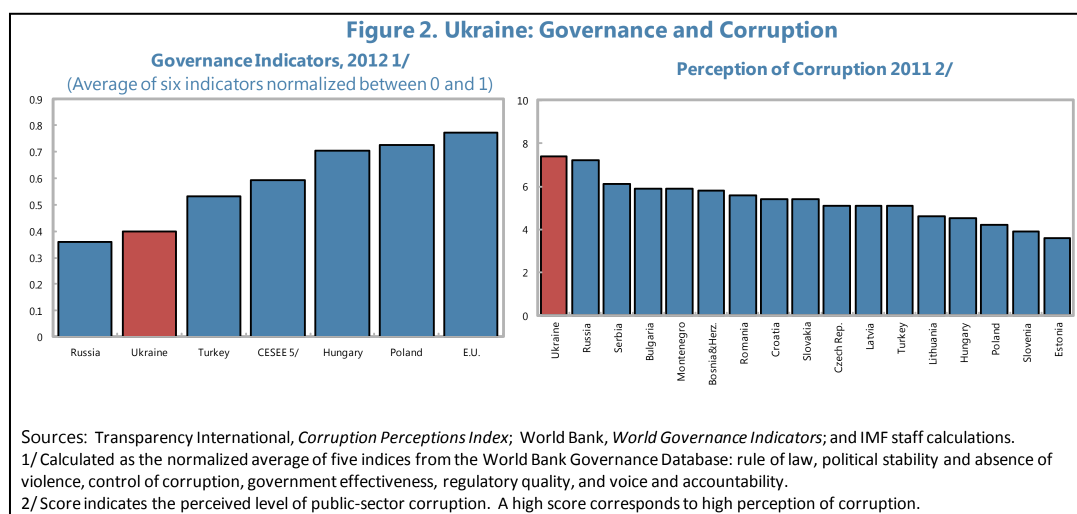


Figure 2. Ukraine: Governance and Corruption

Sources: Transparency International, *Corruption Perceptions Index*; World Bank, *World Governance Indicators*; and IMF staff calculations.
1/ Calculated as the normalized average of five indices from the World Bank Governance Database: rule of law, political stability and absence of violence, control of corruption, government effectiveness, regulatory quality, and voice and accountability.
2/ Score indicates the perceived level of public-sector corruption. A high score corresponds to high perception of corruption.

Identifying obstacles to growth and setting reform priorities

Growth diagnostic studies offer a useful and practical tool for identifying structural constrains to growth and setting countries' reform priorities. The growth diagnostics proposed by Hausmann et al. (2005) provides a useful framework for identifying the most biding constrains to growth. The framework underscores the importance of setting policy priorities which are likely to provide "the biggest bang for the reform buck", instead of offering a broad "laundry list" of possible measures. The growth diagnostics approach aims at identifying which of the determinants of economic growth (such as returns to investment, private appropriability of returns or access to finance) are the major source of impediments to higher growth. As a next step, economic distortions associated with these determinants are being analyzed in order to reveal those, which removal is most likely to grant the largest positive effect on growth. The findings can later be used to develop policy measures to adequately target major distortions in a right sequence.

Demand and supply impediments to investment limit Ukraine's growth potential. A general analysis based on a decision tree as in Hausmann et al. (2005) reveals that growth in Ukraine is kept low by "low return to economic activity" and "high cost of finance" (Table 1). Generally, well-educated labor force (although skill mismatches between labor demand and supply do exist), large market size and geographical location remain Ukraine's strengths. However, flaws in the business climate, governance and infrastructure impede demand for investment. On the supply side, investment is hindered by distortions in access to financing.

The growth diagnostic analysis can largely benefit from competitiveness ratings and business climate surveys. Studies that serve as a base for these ratings, including those of the World Bank, World Economic Forum, EBRD, OECD or the Heritage Foundation, offer a good platform for a cross-country comparison. Their diverse focus and degree of detail provide good opportunity for using a combination of these studies to identify areas in which a country lags behind its peers. This approach helps reduce possible limitations of a single rating (indicator). To some extent, it also helps avoid drawing conclusions about country's competitiveness and business environment based solely on narrow-based or short-lived improvements (not followed by a broader spectrum of required reforms). A heatmap comparing each country against its regional peers may serve as a practical example of such an approach. When applied to CESEE, a heatmap shows that Ukraine specifically lags behind regional peers in (i) institutions and (ii) business and service regulation (Table 2). The country also compares unfavorably in openness to trade and FDI, financial market rigidity, and in innovation.

A cross-country comparison of structural indicators uncovers major economic distortions in Ukraine relative to CEESE peers. Structural deficiencies in institutions stem from three major groups of distortions: (i) weak protection of property rights; (ii) corruption, low transparency of government policies, and favoritism; and (iii) an inefficient legal system. Ukraine is thus missing key basic ingredients of healthy business climate and good governance, which are essential for everyday business activity, attracting private investment and for private sector development. In addition, business and services regulations fail to promote competition and suffer from bureaucratic procedures. Non-tariff and sector-specific restrictions are a drag on trade and inflow of FDI and hurt Ukraine's innovation potential. Vulnerabilities in the financial sector and an underdeveloped equity market constitute major structural deficiencies effecting financing and, as a result, restricting private investment from the supply side (Table 3).

The identified economic distortions are broadly in line with findings of the EBRD, EU, WB and the OECD. Their reports[8] enumerate weak institutions and the rule of law, and problems with access to financing (including the underdeveloped financial sector) as major factors adversely affecting investment in Ukraine and contributing to the existence of informal sector and grey economy. Specifically, the reports underscore deficiencies in private sector development stemming from: (i) corruption and favoritism in government decisions; (ii) poor implementation and law enforcement; (iii) lack of regulatory transparency and frequent changes in legislation; and (iv) inefficient justice system. In addition, trade distorting measures, unstable public procurement rules, the-still-existing delays in VAT refunds, and incidence of illegal corporate raids are considered to be obstacles in attracting investment. On sector-specific issues, the studies conclude that corrective measures should be directed towards addressing the long-standing inefficiencies in the gas and energy sectors, restoring healthy intermediation in financial sector and improving competitiveness in the agricultural sector.

[8] Including European Commission (2011), EBRD (2011), EBRD (2012), EU (2013), OECD (2011), OECD, et al. (2012B), WB (2010), WB (2014).

A way forward—boosting efficiency of the economy and unlocking growth potential

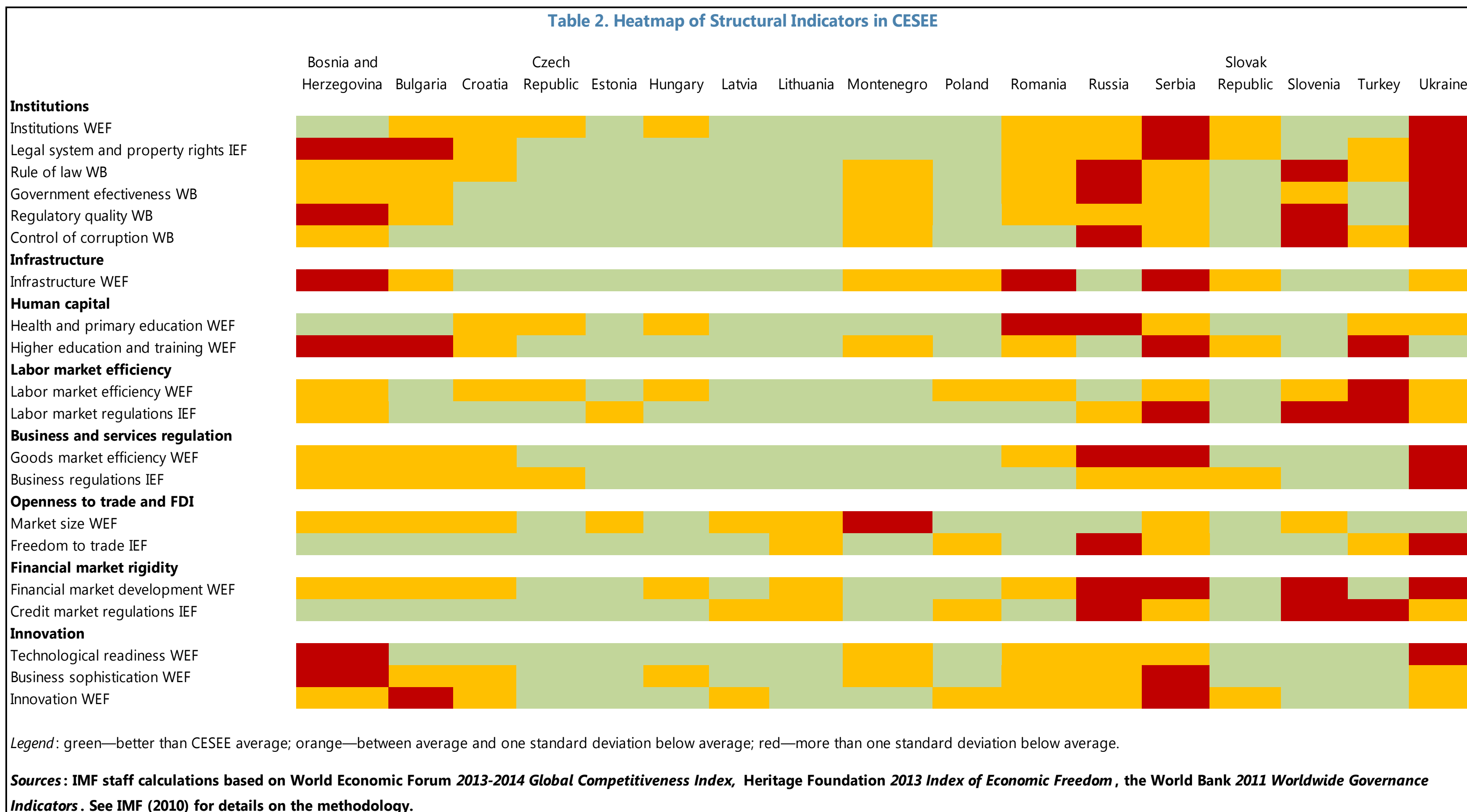
In order to unlock growth potential and ensure steady convergence to the best performers among CESEE Ukraine needs to overhaul its macropolicy mix and put in place a coherent medium-term structural reform strategy. Correcting existing imbalances and restoring macroeconomic stability in line with staff advice is critical, but structural reforms cannot be put on hold. The country has reached the efficiency-led stage of development, which is the second out of three (factor-driven, efficiency-driven and innovation-driven) stages of development, according to X. Sala-i-Martin and E. Artadi (2004). A growth strategy based on cost advantage will no longer suffice, and emphasis needs to be put on efficiency-driven growth and on innovation.[9] Therefore, a medium-term structural reform strategy would work to Ukraine's benefit and ensure a consistent and comprehensive approach in targeting and removing major obstacles to growth. To this aim, this strategy should include (i) clearly defined reform priorities; (ii) specific timeline for their implementation, with due regard to appropriate sequencing; and (iii) adequate implementation, execution and monitoring mechanisms.

Table 1. Ukraine: Constraints to Growth / What Keeps Growth Low?

1. Return to economic activity	**2. Cost of finance**
1.1. Social returns (i.e., low investment in complementary to capital factors of production) - Geography – *strategic location, large market size, but discrepancies between east and west (industrial development concentrated in the eastern part);* - Human capital – *solid education, but existing skill mismatches between labor demand and supply;* - Infrastructure – *underprovision and weaknesses in infrastructure, specyfically in transport, logistic and energy;*	2.1. International finance **-** *volatile; access to foreign capital largely depends on macroeconomic stability, authorities' willingness to conduct reforms and on global risk perception; sometimes ease of access to foreign capital (investors' profit seeking) may mask the urgency for reforms;*
1.2. Appropriability - government failures: (i) micro risks: *weaknessess in governance and the rule of law; poor property rights and contract enforcement; corruption ; room to improve competition;* (ii) macro risks: *high vulnerabilities, external imbalances, inconsistent policy mix;* - market failures (information and coordination externalities leading to sub-optimal investment): *underperformance in export diversification and sophistication, weaknesses in technology absorption and innovation;*	2.2. Local finance - domestic saving - *below CEESE average (since 2009); a downward trend in domestic savings to GDP ratio;* - intermediation – *vulnerabilities in the financial sector; underdeveloped equity market;*

Sources: IMF staff analysis; World Bank *Ukraine-Country Economic Memorandum;* World Bank *2014 Doing Business;* World Economic Forum *2013–2014 Global Competitiveness Index* . See Hausmann et al. (2005) for details on a decision tree.

[9] See WEF (2013).



Legend: green—better than CESEE average; orange—between average and one standard deviation below average; red—more than one standard deviation below average.

***Sources*: IMF staff calculations based on World Economic Forum *2013-2014 Global Competitiveness Index*, Heritage Foundation *2013 Index of Economic Freedom*, the World Bank *2011 Worldwide Governance Indicators*. See IMF (2010) for details on the methodology.**

Table 3. Ukraine: Most Problematic Areas of Distortions	
Structural indicator	**Most problematic areas of distortion**
Institutions	weak protection of property rights corruption, undocumented extrapayments, favoritism weak judicial independence, judiciary is subject to various pressures to influence court decisions weak efficiency of legal framework in settling disputes and challenging government actions and regulations weak transparency of government policymaking weak auditing and reporting standards weak legal protection of minority shareholders' interests weak reliability of police services in enforcing law and order
Business and services regulation	market dominated by a few business groups and weak effectiveness of anti-monopoly policy in promoting competition taxes reduce incentives to invest administrative complexity creates uncertainty in commercial transactions completing licensing requirements is still time-consuming and costly weak efficiency of custom procedures
Openness to trade and FDI	non-tariff barriers constrain trade freedom underdeveloped investment framework with several sectoral restrictions, bureaucracy
Financial market rigidity	soundness of banks weak affordability of financial services for businesses undeveloped financing through local equity market underdeveloped regulation and supervision of securities exchanges
Innovation	limited technology transfer by FDI weak cluster development
Source: IMF staff analysis based on: World Economic Forum *2013-2014 Global Competitiveness Index;* Heritage Foundation *2013 Index of Economic Freedom;* and the World Bank *2011 Worldwide Governance Indicators.*	

Reform priorities need to be defined based on their impact on growth. They should also guarantee broad-based improvements to ensure that obstacles to investment on different levels and in different dimensions are addressed. Having a strategy designed and executed from a growth perspective would also help avoid a trap of targeting structural indicators that offer only narrow-based advances in competitiveness ratings without effectively addressing major economic distortion adversely influencing investment activity. Such a strategy could build on the President's Reform Program for 2010–14, which currently shapes the structural reform agenda in Ukraine. The starting point for defining reform priorities should, however, be their re-focusing on broad-based benefits to growth in the medium term.

Given the broad scope of structural deficiencies in Ukraine, reform priorities should simultaneously address impediments to investment on the demand and supply side. An emphasis needs to be equally put on creation of a solid legal framework, efficient implementation of regulations, and the execution of law. In particular, it will be essential to strengthen the judicial system, simplify or repeal burdensome government regulations, step-up anti-corruption measures, including by enhancing the anti-money laundering (AML) framework,

and strengthen the financial system. The following specific reform priorities would be recommended based on staff's analysis and recommendations of the EBRD, EU, WB and OECD:

Institutions

- continue to reform the justice system to improve its efficiency and governance and ensure fair resolution of commercial disputes;
- establish an independent business ombudsman, as recommended by a number of business organizations and IFIs, to respond to concerns about unfair business practices and advocate swift action to resolve such concerns;
- strengthen administrative, judicial and operational enforcement capacity to protect property rights;
- avoid frequent changes in regulations, reduce delays in issuing regulations and ensure their effective implementation (avoid administrative discretion);
- enhance implementation and law enforcement;

Business and services regulation

- reduce frequency and fragmented changes to public procurement law; establish a monitoring system to ensure proper implementation of public procurement;
- streamline administrative procedures in licensing and business permits;
- continue to address delays in VAT refunds through conventional measures;
- impose clear and consistent rules in tax administration;
- make the recently reformed corporate insolvency framework operational;

Openness to trade and FDI; Innovation

- remove the remaining foreign investment and trade restrictions in line with WTO commitments;
- ensure thorough implementation of the Custom Code;

Financial market rigidities

- fully implement the 2008 FSAP recommendations and recommendations of the 2013 Article IV report, including strengthen the overall legal, regulatory, and supervisory framework, and remove obstacles to capital market development;
- ensure consistent implementation and enforcement of supervision on consolidated basis, bank resolution framework, and of the law on disclosure of ultimate beneficiary owners.

In addition to the above-mentioned priorities, sector-specific policy measures, particularly in the gas and energy sector, would be beneficial for boosting economic growth in Ukraine. However, reforms in these areas are beyond the scope of our analysis presented in this note.

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INTERNATIONAL MONETARY FUND

UKRAINE

December 2, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND POST-PORGRAM MONITORING—INFORMATIONAL ANNEX

Prepared By European Department in Consultation with Other Departments

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FUND RELATIONS

(As of October 31, 2013)

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,309.44	100.00
Holdings	25.04	1.91

Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
Stand-by Arrangements	3,968.75	289.27

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	07/28/10	12/27/12	10,000.00	2,250.00
Stand-By	11/05/08	07/27/10	11,000.00	7,000.00
Stand-By	03/29/04	03/28/05	411.60	0.00

Projected Payments to Fund:[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	609.38	2,390.63	968.75		
Charges/Interest	14.68	26.47	7.90	1.37	1.16
Total	**624.06**	**2,417.09**	**976.65**	**1.37**	**1.16**

Exchange Arrangements:

In September 1996, the authorities introduced the hryvnia (UAH) at a conversion rate with the previous currency karbovanets (Krb) of KrB 100,000 to UAH 1. The NBU influences the exchange rate without announcing a specific path or exchange rate target by intervening in the interbank foreign exchange market, applying foreign exchange regulations and controls, and through moral suasion. Since 2009 the official exchange rate has remained close to UAH 8.0 per U.S. dollar, and from July 2012 it has been fixed at 7.993 UAH/USD. The average-weighed interbank market rate for U.S. dollar, as calculated by the NBU, did not deviate by more than 2 percent from the official NBU

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

rate since September 2009 (but interbank or cash exchange rates quoted by market sources often exceeded this threshold). Effective February 2, 2009, the classification of the de facto exchange rate arrangement was changed from managed floating with no predetermined path for the exchange rate to other managed arrangement, retroactively to April 30, 2008, due to the revision of the classification methodology. Since March 1, 2010 it has been classified as stabilized arrangement. Meanwhile, the NBU has been developing a more robust monetary policy framework focused on domestic price stability with greater exchange rate flexibility. A transition to a free floating exchange rate is planned when the financial system recovers and the transmission mechanisms mature.

On September 24, 1996, Ukraine accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. Ukraine currently maintains two multiple currency practices arising from (i) the use of the official exchange rate for certain government transactions; and (ii) the requirement that a Ukrainian resident who sells the previously purchased foreign exchange not used within 10 days (including when FX was returned to the resident because the counterpart failed to fulfill its obligations under an import contract) shall transfer 100 percent of the positive difference from the sale price, on a quarterly basis, to the State budget.

FSAP Participation:

A joint World Bank–International Monetary Fund mission conducted an assessment of Ukraine financial sector as part of the Financial Sector Assessment Program (FSAP) in 2003, and the Financial Sector Stability Assessment (FSSA) report (IMF Country Report No. 03/340) was considered by the Executive Board on May 14, 2003. The observance of the following standards and codes was assessed: Basel Core Principles for Effective Banking Supervision; Code of Good Practices on Transparency in Monetary and Financial Policies; CPSS Core Principles for Systemically Important Payment Systems; OECD Principles for Corporate Governance; Accounting and Auditing Practices; World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights System; and AML/CFT Methodology.

An FSAP update was undertaken in 2007. The observance of the following standards and codes was assessed: Basel Core Principles for Effective Banking Supervision; and IOSCO Core Principles of Securities Regulation. A Financial Sector Stability Assessment (FSSA) was considered by the Executive Board as part of the 2008 Article IV consultation.

The next FSAP for Ukraine has been scheduled for the second half of 2014 prior to the 2014 Article IV consultation.

ROSCS

A Data ROSC Module was conducted in April 3–17, 2002, and was considered by the Executive Board on August 5, 2003 (IMF Country Report No. 03/256). A Fiscal Transparency Module (experimental) was issued in September 1999, and an update in April 2004 (IMF Country Report No. 04/98).

Safeguards Assessments:

The most recent safeguards assessment of the NBU was completed on February 1, 2011. The assessment found that the NBU has strengthened its safeguards framework since the 2008 assessment by implementing the majority of the related recommendations. However, the deferred implementation of some provisions under the new NBU law enacted in 2010 weakens its effectiveness. The assessment also found that new financial risks have emerged because of special legislation and resolutions impairing the NBU's autonomy. Steps are being taken to address these issues, including with the approval of a law repealing the requirement that bank recapitalization bonds are subject to mandatory repurchase at their face value by the NBU.

UFR/Article IV Consultation:

Ukraine is on a 12-month consultation cycle. The last Article IV consultation was concluded on June 29, 2012 and a report was published on our external website: www.imf.org.

RELATIONS WITH THE WORLD BANK

(October 2013)

Country Partnership Strategy

The World Bank Group's Country Partnership Strategy (CPS, 2012-16) was discussed by the Board of Directors on February 16, 2012. The CPS aims to assist Ukraine in overcoming implementation bottlenecks identified in the Presidential Program and thus help make progress in the ambitious reform and EU integration agenda. The World Bank Group will adjust its policy dialogue, lending, investment, and technical assistance to respond to the government's demonstrated commitment. The CPS is organized around two pillars, both emphasizing importance of improved governance. Pillar I supports relations between government and citizens, focused on improving public services, sustainability and efficiency of public finances, and a more transparent and accountable use of public resources. Pillar II supports productive cooperation between government and business by focusing on growth, competitiveness and job creation, improvements in business climate, promotion of domestic and foreign direct investments to achieve productivity improvements, and channeling public investment into critical public infrastructure.

The World Bank Group's assistance to Ukraine in the new CPS will be calibrated to match the scope and instruments of support to the strength of the authorities' commitment, capacity and track-record in key areas of potential engagement. Specifically, investment loans will be offered where governance risks are manageable, where a track record of implementation has been established and capacity built and where there is broad consensus on general policy framework. Analytical and advisory services will be offered to help strengthen reform consensus and build capacity. Development policy lending will be contingent on a sustainable macroeconomic framework and progress in tackling key governance weaknesses.

World Bank Program

The current investment lending portfolio includes nine operations totaling US$ 1.9 billion, of which almost 50 percent has been disbursed. Among the projects in the public sector are a Public Finance Modernization Project (US$50 million) and a Statistical System Modernization Project (US$42 million). The Hydropower Rehabilitation Project and additional financing (US$166.0 million) were approved in June 2005 and November 2009, respectively, and the Power Transmission Project (US$200 million) was approved in August 2007. The Board approved an Energy Efficiency Project (US$200 million) in 2011. In infrastructure, the Bank's Board approved a Roads and Safety Improvement project in 2009 for US$400 million and Second Roads and Safety Improvement Project for US$450 million in 2012 (both currently under implementation). The Bank also has an Urban Infrastructure Project (US$140 million), designed to provide financing to local governments and utilities for priority investments in water and wastewater. In the financial sector, the Second Export

Development Project (EDP2; US$154 million plus additional financing of US$150 million), which builds on the success of the first project, promotes the export sector access to finance.

The investment lending program for the first two years of the CPS envisages base level support in the range of US$500 million per annum. The current investment lending pipeline for FY14 includes an operation to support scaling up targeted social assistance, a second Urban Infrastructure project and a District Heating Energy Efficiency Project for a total of US$850 million, which may change based on the government's demand and the Bank's lending capacity. In FY15–16, additional investment lending may be envisaged in the following areas: (i) transport and trade facilitation; (ii) energy efficiency and energy security; (iii) municipal services and governance; (iv) health services and financing; and (v) private sector development and access to financing.

The calibrated engagement leaves room for an upward revision of lending amounts through Development Policy Lending (DPL) should reforms accelerate and consistent progress on governance be made. The Programmatic Financial Sector DPL series and cross-sector DPL series supporting improved economic governance and competitiveness could be launched subject to the government's request for IBRD resources, a sustainable macroeconomic framework, tangible progress on governance/structural issues, IBRD's financial capacity, and global economic developments.

All areas of engagement will build on strong diagnostic work and technical assistance, with focus on building consensus in society regarding policies and processes to tackle key structural challenges. Main areas for analytical and advisory assistance (AAA) will be: (i) the investment climate, including advice in key policy areas such as agriculture, land, business regulations; (ii) fiscal, tax and PFM; (iii) energy efficiency and governance (including gas sector modernization); (iv) financial sector stability and development; (v) municipal governance and service delivery; (vi) social reforms (targeted social assistance and pension reform); and (vii) health sector reforms. Partnerships in policy dialogue and AAA with the European Commission (EC), the International Monetary Fund (IMF), United Stated Agency for International Development (USAID), European Bank for Reconstruction and Development (EBRD) and other bilateral donors will continue and be expanded where possible.

Indicative IBRD Knowledge Services, FY13–14

Pillar 1: Improving public services and public finances	Pillar 2: Improving policy effectiveness and economic competitiveness
Structural and Governance Reforms TA (Programmatic)	Structural and Governance Reforms TA (Programmatic)
Gas and Heating Tariff Reform TA	Financial Sector TA (Programmatic)
Municipal Energy Efficiency Finance	Private Sector Development TA (Programmatic)
Solid Waste Management Sector Review	Agriculture and Landing Monitoring TA
Effective Response to HIV/AIDS	Ukraine Smart Grid Project PPG
Support to Family and Community Services	Partnership for Market Readiness in Ukraine TA
	IDF Pilot Health reform

Bank-Fund Collaboration

According to Joint Management Action Plan on Fund-Bank collaboration on Ukraine, the staff teams agreed that the Fund and Bank would support Ukraine's efforts to: (i) pursue fiscal consolidation whilst finding fiscal space to increase public investments needed to support private sector growth and to tackle pressing social issues; (ii) move forward with energy sector and utility tariff reforms whilst protecting the poor; (iii) complete rehabilitation and strengthen oversight of the banking system; (iv) strengthen the monetary policy framework; and (v) improve the investment climate. The teams agreed to the following division of labor and coordination:

- ***Restoring confidence and fiscal sustainability:*** Strengthening public finances and tackling long-standing problems through advancing structural reforms would underpin medium-term fiscal sustainability and growth. The Fund program and the Bank's assistance are designed to support the authorities' efforts to lower budget deficits and to: (i) tackle key budgetary rigidities to gradually reduce the footprint of the public sector on the economy; and (ii) support reallocation of resources from transfers and other current spending toward growth-enhancing capital investments and better targeted social support. To this end, the Bank, in coordination with the Fund, has recommended a series of structural measures to reform the pension system. The Fund and Bank teams work closely through their programs to push the implementation of a sequence of reforms aimed at putting the pension system on sound financial footing and reducing its strain on public finances. In the context of administrative reforms in Ukraine, the Bank and Fund will continue to provide advice aimed at ensuring a leaner and more efficient public service. The Bank will continue to provide project financing for the public sector, including a Public Finance Modernization Project, a Statistical System Modernization Project, and the ongoing investments to modernize social assistance services. The Bank also plans to focus on improving the efficiency of public spending. The Bank and Fund will also coordinate on supporting the authorities' efforts to strengthen debt management.

- ***Reforming and modernizing the energy sector whilst improving targeting of safety nets:*** Energy sector reforms will continue to aim at improving energy efficiency of the economy,

eliminating the need for budgetary support to Naftogaz, and encouraging investment in gas exploration, extraction, and transportation. The Bank's support for the authorities' energy sector reforms will continue to focus on infrastructure modernization through a sequence of investment loans, including in areas of hydropower rehabilitation, power and gas transmission, and energy efficiency. The Fund will focus on supporting efforts to phase out Naftogaz's deficit, including through a program of steady gas prices and utility tariff increases to advance cost recovery and reduce fiscal and quasi-fiscal deficits generated by the company. The Bank and the Fund will continue to work together on supporting reforms that depoliticize price-setting mechanisms of public utilities and improve payment discipline. To improve transparency of reporting in the gas sector, the Bank will support and advise the authorities on Extractive Industries Transparency Initiative. The Bank team will continue its advice on improving targeting of social assistance to protect poor households from higher utility tariffs and other necessary fiscal reforms. The Bank and Fund teams will work closely to support implementation of this reform agenda.

- ***Preserving banking sector stability while deepening financial intermediation:*** In light of macroeconomic risks, preserving stability of the banking system and deepening healthy financial intermediation are key policy priorities in the financial sector. The Fund and the Bank will continue to coordinate closely in advising the National Bank of Ukraine on improving the regulatory and institutional supervisory framework aimed at making Ukrainian banking system more resilient to shocks. The Fund and the Bank will also provide well-coordinated policy advice and technical assistance to the authorities on strengthening the crisis preparedness framework, including analysis of evolving risks, preparation of contingency plans for the system and specific institutions, and enhancing resolution tools. The teams will also work closely on supporting further development of a framework that recognizes and facilitates resolution of impaired loans, including development of a strategy to pro-actively address barriers to nonperforming loans' effective resolution and any necessary changes to the existing legislation and regulations, including tax treatment. The Bank will continue its technical assistance to other financial sector regulators on select issues in improving the regulatory and supervisory regime for non-bank financial institutions.

- ***Developing a more robust monetary policy framework:*** Focusing monetary policy squarely on domestic price stability with greater exchange rate flexibility under a more independent NBU will facilitate inflation reduction, discourage dollarization and excessive risk-taking, and provide a buffer against frequent external shocks. The Fund will lead in this area, including through policy advice, and also by providing technical assistance on strengthening monetary policy and operations frameworks and establishing necessary preconditions for moving toward inflation targeting regime over the medium term. The Fund will continue to provide technical assistance as needed for implementing the authorities' strategy for liberalization of the foreign currency market. It will also work with the authorities as needed on addressing remaining shortcomings in the governance of the NBU identified in the context of the recent Safeguards Assessment.

- ***Improving investment climate:*** Deep and sustained improvements of the business environment are key for generating strong and sustained economic growth fueled by private sector. In support of this objective, the Bank Group will lead in this area supporting measures and reforms to reduce entry and exit barriers to enable creation of new businesses and to allow a faster reallocation of resources in the economy. The Bank would also support measures to improve fair competition and to overcome governance and regulatory barriers to trade and FDI. The Fund will provide support for the authorities' efforts as appropriate.

World Bank Contact: Lalita Moorty, Lead Economist; Anastasia Golovach, Economist; (Tel.: 380-44-490-6671).

Ukraine: Bank and Fund Activities in Macro-Critical Structural Reform Areas, September 2013–December 2014

Work Programs	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank	UA-Municipal energy efficiency financing	Ongoing	November 2013
	Ukraine Agriculture and Land Monitoring TA	Ongoing	December 2013
	Ukraine Municipal Solid Waste Management Sector Review	Ongoing	October 2013
	Improve implementation for effective response to AIDS epidemic	Ongoing	March 2014
	Mitigating the Impact of Gas and Heating Tariff Increases	Ongoing	March 2014
	Fiscal, Structural, and Governance TA	Ongoing	May 2014
	Ukraine - Road Sector Policy Dialog	Ongoing	May 2014
2. Fund	2013 Article IV Consultation and Post Program Monitoring	October 17–29, 2013	Board discussion mid-December 2013
	Ex-Post Evaluation of Exceptional Access Under the 2010 Stand-By Arrangement	November 2013	Board discussion mid-December 2013
	TA mission on implementation of the *System of National Accounts 2008*	2014:Q1	2014:Q1
	TA mission on expenditure rationalization	January/February 2014	January/February 2014
	FSAP	Prior to 2014 Article IV Consultation	2014:H2
	2014 Article IV Consultation	2014:H2	2014:H2

RELATIONS WITH THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

(November 2013)

Since Ukraine joined the EBRD in 1992, the Bank has been active in supporting the country's transformation towards market economy. As of end-October 2013 the EBRD's portfolio in Ukraine reached €4.8 billion (with 2013 signings of €630 million) with most of it being in the private sector. The Bank's country exposure in Ukraine is its second largest after Russia, accounting for approximately 1/8th of the Bank's overall portfolio. The portfolio represents roughly an equal exposure across the Bank's three main industry sectors: Industry & Commerce, Financial Institutions and Energy & Infrastructure. The EBRD's focus in Ukraine is to achieve a transition impact through funding of projects (debt and equity) in both private and public sectors. This has been supported by a range of technical cooperation and policy dialogue.

During the financial crisis of 2008–09, the EBRD pursued a country specific crisis response program for Ukraine in coordination with various stakeholders, including the authorities, other IFIs and international donors. In 2009, despite the increased country risk, the EBRD invested €1.1 billion in Ukraine, a record level for the country. Almost two-thirds of the total amount was invested in the banking sector to help support stability and confidence. During the crisis, the EBRD also undertook a complete reassessment of business needs in the corporate sector, which suffered from a terms-of-trade shock and financial sector de-leveraging, which resulted in investments of over €250 million in 2009. A further €220 million was invested in the infrastructure and energy sectors. During 2010 and 2011 total investments remained at roughly €1.1 billion, but were more equally balanced across the Bank's main sectors. Starting from 2012, however, the Bank has noticed a marked decline in the demand for development loans—particularly in the nonagribusiness corporate sector—due, in a large part, to the deteriorating investment climate. In response, the Bank has become increasingly involved in coordinating key players (including the IMF) to address corruption and unfair business practices in Ukraine as a key policy initiative to improve the business climate

The Bank's country strategy for 2011–14 was approved in April 2011. It focuses on addressing Ukraine's important transition challenges in all key sectors, including (i) sustainable energy through energy efficiency and renewable energy, as well as on energy security; (ii) unlocking Ukraine's agricultural and industrial potential; (iii) providing good quality and reliable infrastructure; and (iv) dealing with the legacy of the crisis in the financial sector. The Bank is currently working on the country strategy for 2014–18.

The Bank has also been active in developing the local private sector and encouraging inflows of FDIs and it has also supported a number of medium and large local clients, including Nibulon, MHP, Ukrplastic and Lugzentrokuz. Small and medium-size enterprises have been reached via credit lines offered to them via partner banks. The Bank has actively participated in financing several leading

international investors (including Lafarge, Air Liquide, Multi Developments and Louis Dreyfus) and cross-border transactions with sponsors from other countries of operation.

The EBRD has continued its support to SMEs through its Small Business Support program (SBS) through advice and mentoring at the enterprise level and development of a sustainable infrastructure in the country for business advisory services. In May 2010 the Bank rolled out in Ukraine its hallmark Business Advisory Services (BAS) Programme, which supported nearly 200 small and medium-size enterprises to improve production quality and market performance, business processes and organizational structures. International operational and technical know-how has also been made available to Ukrainian SMEs through the Enterprise Growth Programme (EGP). Manufacturing companies with high value added benefited from international expertise bringing improvements in corporate governance, business transparency and corporate social responsibility. The Bank may consider further expansion of its advisory services in Ukraine's regions.

The EBRD has been actively working with the government of Ukraine to enable the Bank and other IFI's to provide loans denominated in Hryvna. On July 30 2013, President Yanukovych signed a law that allows the EBRD, the International Finance Corporation and other international financial institutions to issue bonds in Hryvna through which the IFI's can fund their local currency lending, particularly for the SME and municipal borrowers. Parliament had adopted relevant amendments to the law on securities and the stock market on July 4, 2013. Operating regulations guiding the implementation of the law still need to be issued by appropriate financial sector regulators in Ukraine in order to allow the EBRD to actually issue locally.

The EBRD has also been working with the Ukrainian authorities to develop new derivatives legislation which would allow hedging of foreign exchange risk and enable swap transactions and introduce important concepts, such as netting and close-out netting. The final draft is now with the Cabinet of Ministers, and the EBRD is largely satisfied with its content. The next step will be the submission of the draft to the Rada for adoption.

In the Agribusiness sector the Bank has been actively involved in policy dialogue in grain sector; promoting greater transparency and predictability of policy interventions and better policy making and coordination between the government and the private sector. Two round tables involving public and private sector stakeholders were organized and resulted in a creation of a working group, which was instrumental in advising the government that grain export quotas deter much needed investments into the sector. The EBRD would like to build on this positive experience in the grain sector and is looking at possibilities of supporting efforts to launch policy dialogue in the dairy sector between the key dairy market regulators and the industry.

The Bank continues to pursue its strategic goal of supporting sustainable development in respect of environment, natural resources and energy. Together with other IFIs, the EBRD continues to explore mechanisms for supporting the authorities as they pursue modernization of the Ukraine's gas transit system and implementation of the March 2009 EU-Ukraine memorandum of understanding, which is the cornerstone of EU-Ukraine cooperation in the field of energy. In particular, the Bank is assisting

with the modernization and rehabilitation of the main trans-European energy networks of Ukraine and investments in modern and energy efficient generation, transportation and distribution of energy. These aims are complemented by a support to reforms in the energy sector to advance its liberalization and promote private sector involvement. In addition, the Bank is actively supporting diversification of supply sources and promoting alternative fuels and development of renewable energy sector in Ukraine—having signed five private deals (solar, wind, biomass) for the total amount of €54 million over the last year alone—and in natural resources, the Bank extended USD 70 million loan to Coal Energy, a private independent Ukrainian coal producer, which was the first project for the Bank in Ukraine that includes investment in coal mining along with strong health and safety and energy efficiency components.

In the area of nuclear safety, the Bank is working to improve the safety standards at the existing nuclear power plants and in 2013 signed a €300 million Nuclear Safety sovereign loan with Energoatom as part of a major €1 billion project to be co-financed by Euroatom, the safe decommissioning of Chernobyl NPP and the creation of a safe confinement for its Unit 4.

In the municipal sector the Bank signed four loans for a total amount of €50 million during 2012–2013 with Ukrainian municipal utilities for the upgrade and modernization of district heating and water systems. These represent the first loans under municipal but without sovereign guarantees, following the amendment of the budget framework promoted by the Bank which removed critical hurdles in the financing of municipal investment projects by means of lending under municipal guarantees. The projects will benefit from a substantial grant co-financing of €25 million from E5P Fund and Swedish SIDA. Further, in the municipal sector the Bank provided a €152 million sovereign loan to finance Dnipropetrovsk Metro completion project, which is to be co-financed by the European Investment Bank. The EBRD has a strong pipeline of municipal projects, first of all in the district heating sector, where the country has a huge potential for efficiency improvements, but the scope of further investments will largely depend on progress with the tariff reform.

In transport, the Bank continued to promote commercialization of major state operators providing two nonsovereign loans for a total amount of €99 million to the national railways for renewal of the freight rolling stock and to the air navigation service provider for the system modernization. In addition, the Bank continued financing of the rehabilitation of the main pan-European road corridors and supporting independent private transport companies.

STATISTICAL ISSUES

(November 2013)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but is broadly adequate for surveillance. Among Ukraine's economic and financial data, there are some shortcomings, particularly in national accounts, government finance statistics (GFS), and external sector statistics.
National Accounts: The National Accounts (NA) are broadly in line with the *1993 SNA*. An STA multitopic technical assistance mission in April 2010 flagged financial account, sector balance sheets and estimates of financial intermediation services indirectly measured, as the parts of the system that remain to be developed. In line with previous recommendations, a number of changes were implemented in 2009–10 that improved compilation of the quarterly national accounts (QNA). Volume measures of GDP have been rebased using 2007 as the reference period but a number of recommended methodological improvements remain to be implemented. There is room to increase the State Statistics Committee of Ukraine's independence from the government in its ability to improve data accuracy through flexible revisions for the annual NA and the QNA. Starting from 2011, Ukraine is one of the beneficiaries of the *STA TA project on Capacity Building for Sustainable Compilation of Real Sector Statistics in Eastern Europe*. As part of this project, officials of the State Statistics Service (SSS) participated in three workshops on national accounts/price statistics. In addition, the SSS requested assistance for implementation of the *System of National Accounts 2008,* and a TA mission is expected to visit Ukraine during the first quarter of 2014. **Price statistics:** The weights of CPI are updated annually; geometric means are used at the very first level of price aggregation (beginning with January 2010 observations) and scientific sampling of outlets was introduced beginning with January 2011 observations, with the results being published within six days of the end of the reference month. The geographical coverage is limited to urban areas. The CPI excludes price changes for owner occupied housing.
Government finance statistics: Compilers are cognizant of the *GFSM 2001* methodology and reference materials. However, the lack of a strong legal framework for compiling GFS and its incomplete statistical coverage are significant shortcomings. The full adoption of the *GFSM 2001* system depends on strengthening of primary data sources, government accounting reform (undertaken under the International Public Sector Accounting Standards), and successful completion of the GFS component of the World Bank project on the development of statistics. A lack of clarity on the stock of VAT refund claims prevents a full assessment of the underlying fiscal performance.
Monetary statistics: Since September 2006, the NBU uses the Standardized Report Forms (SRF) for reporting monetary data to STA and EUR. Data for December 2001–August 2006 have also been converted into the SRFs and used as the basis for publication of monetary statistics in the *IFS*.

<table>
<tr><td colspan="2">External Sector: The compilation system relies heavily on the International Transactions Reporting System, customs declaration database, and enterprise surveys, providing a broad coverage of data on a timely basis. Nevertheless, direct data collection through enterprise surveys and a more intensive use of available data sources would improve data quality in the areas of financial services, travel, compensation of employees, workers' remittances, and reinvested earnings. Goods statistics could benefit by improving the methodology for estimating the c.i.f./f.o.b. conversion coefficient as well as by bringing reporting forms and instructions in line with the international guidelines. Efforts are also needed to reconcile direct investment data provided by the survey enterprises and ITRS, and to determine the sources of large FX cash held outside of the banking system classified under currency and deposits. In line with 2012 STA TA, improvements are needed regarding direct investment by improving the coverage of debt instruments data and the valuation of equity.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>Participant in the SDDS since January 10, 2003.</td><td>Data ROSC published on August 19, 2003.</td></tr>
<tr><th colspan="2">III. Reporting to STA</th></tr>
<tr><td colspan="2">The country's IFS page has been published since July 1996. On monetary statistics, data have been published since September 2006 using the SRF framework in the IFS and are available online. The authorities also report regularly the quarterly data on Financial Soundness Indicators. These data are disseminated on the IMF's website with observations beginning in 2005. Data on international investment position has been compiled and reported since 2002.</td></tr>
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Ukraine: Table of Common Indicators Required for Surveillance
(November 12, 2013)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality—Methodological soundness[7]	Memo Items: Data Quality—Accuracy and reliability[8]
Exchange Rates	11/11/2013	11/12/2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/2013	10/18/2013	M	M	M		
Reserve/Base Money	11/08/2013	11/12/2013	D	D	M	O, LO, O, O	O, O, O, O, NA
Broad Money	11/08/2013	11/12/2013	D	D	M		
Central Bank Balance Sheet	9/2013	10/18/2013	M	M	M		
Consolidated Balance Sheet of the Banking System	9/2013	10/18/2013	M	M	M		
Interest Rates[2]	11/08/2013	11/12/2013	D	D	M		
Consumer Price Index	10/2013	11/11/2013	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	9/30/2013	10/25/2013	M	M	M	O, LO, LO, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	9/30/2013	10/25/2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	9/30/2013	10/25/2013	M	M	M		
External Current Account Balance	9/30/2013	11/1/2013	M	M	M	O, LO, LO, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	9/30/2013	11/1/2013	M	M	M		
GDP/GNP	Q2 2013	9/2013	Q	Q	Q	O, LO, O, O	O, LO, O, O, LO
Gross External Debt	7/2013	9/2013	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); or Not Available (NA).

[7] Reflects the assessment provided in the data ROSC published in August 2003 and based on the findings of the mission that took place in April 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
December 16, 2013

1. **This statement provides information that has become available since the staff report for the Article IV consultation and the first Post-Program Monitoring was circulated to the Executive Board.** This information does not alter the thrust of the staff appraisal.

2. **Recent macroeconomic data came broadly in line with staff projections.** Gross output in agriculture expanded by 43 percent y-o-y in October, supporting expectations that the economy may be gradually emerging out of the recession. The pace of decline in industrial production slowed as well, to -4.9 percent y-o-y from -5.6 percent in September. However, the state-owned energy company Naftogaz continued to accumulate liabilities to Gazprom for unpaid gas imports (about US$2 billion as of end-November), the settlement of which the authorities are seeking to defer to 2014.

3. **The decision not to sign the Association Agreement with the EU last month led to mass protests and a political crisis which persists, despite the government's survival of a no-confidence vote on December 3.** The authorities reaffirmed their aspiration for EU integration, and a Ukrainian delegation is going to Brussels to discuss aspects of the implementation of the association and free trade agreement with the EU. At the same time, the authorities have been reportedly seeking external financing from Russia and China. Under the current circumstances, the content of the 2014 budget and the timing of its adoption remain uncertain.

4. **Markets have reacted negatively to the recent events with Ukraine's Eurobond yields and CDS spreads widening sharply to multi-year highs.** The National Bank of Ukraine (NBU) gross reserves declined to US$18.8 billion at end-November (about 2.2 months of import coverage). So far, the exchange rate has remained broadly stable, supported by NBU interventions, and the commercial banks report only a small uptick in household deposit withdrawals. However, the demand-supply imbalance in the foreign exchange market persists, raising the risk of market-forced exchange rate adjustment in case of intensified pressures.

INTERNATIONAL MONETARY FUND

Press Release No. 13/531
FOR IMMEDIATE RELEASE
December 19, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation, First Post-Program Monitoring, and Ex Post Evaluation of Exceptional Access with Ukraine

On December 16, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the 2013 Article IV consultation and the first Post Program Monitoring Review, as well as the Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement with Ukraine.[1]

The Ukrainian economy has been in recession since mid-2012, and the outlook remains challenging. In January–September 2013 GDP contracted by 1¼ percent y-o-y, reflecting lower demand for Ukrainian exports and falling investments. Consumer prices stayed flat, held down by decreasing food prices and tight monetary policy. Weak external demand and impaired competitiveness kept the trailing 12-month current account deficit elevated at about 8 percent of GDP by end-September despite a significant reduction in natural gas imports. The high current account deficit amid less favorable international market environment pressured international reserves, which fell below the equivalent of 2½ months of imports by end-October 2013. Under currently planned policies, modest growth should return in 2014, driven by improvements in external demand, strong grain exports, and continuing consumption expansion. However, this outlook is subject to significant risks, emanating from the inconsistent policy mix and heightened political and economic uncertainty in recent weeks.

The fiscal stance loosened in 2012–13, contributing to the buildup of vulnerabilities. Large pension and wage increases, generous energy subsidies, and soccer cup spending led to a widening of the combined deficit of the general government and the state-owned company Naftogaz to 5½ percent of GDP in 2012. In 2013, the combined government-Naftogaz deficit is projected to expand to 7¾ percent of GDP.

[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.

An inefficient and opaque energy sector continues to weigh heavily on public finances and the economy. Overall energy subsidies in Ukraine reached about 7½ percent of GDP in 2012. The very low tariffs for residential gas and district heating cover only a fraction of economic costs and encourage one of the highest energy consumption levels in Europe. As a result, Naftogaz's losses in 2013:H1 more than doubled and the company is late on payments for imported gas.

Tight monetary policy in 2012–13 focused on defending exchange rate stability while accommodating the expanding fiscal deficit. In part reflecting deficit monetization, base money increased by nearly 15 percent in the year to September 2013. To ensure steady supply of foreign exchange to the market, the authorities tightened foreign exchange regulations and controls, which increased transactions costs in the economy.

The banking system appears stable at present, but vulnerabilities persist. A high average capital adequacy ratio of 18 percent provides some cushion against risks stemming from an elevated non-performing loan ratio of 14 percent. High interest rates offered by banks induced a more than 30 percent increase in hryvnia deposits in the year to November, while credit to the economy expanded only modestly, constraining economic activity.

Ukraine remains current on all its payments to the Fund, and the authorities have reaffirmed their commitment to repay all outstanding Fund credit. On the obligation basis, outstanding Fund credit to Ukraine would decline below 200 percent of quota by February 2014 and below 100 percent of quota by September 2014.

In accordance with IMF procedures for arrangements entailing exceptional access, the Executive Board discussed an ex-post evaluation (EPE) of Ukraine's experience under the Stand-By Arrangement (SBA) approved in July 2010. The EPE finds that the SBA-supported program was appropriately designed to address Ukraine's most important vulnerabilities, and delivered some notable achievements, including the passage of pension reform in 2011. However, the program quickly went off-track as the authorities stopped implementing the agreed policies, reflecting insufficient ownership. The same issues that had derailed previous programs in Ukraine hindered the completion of the 2010 SBA, particularly the reluctance to sufficiently adjust energy prices and increase exchange rate flexibility.

The EPE draws several lessons for future IMF engagement with Ukraine and other countries from the experience of the 2010 program. First, exceptional access and long-duration arrangements may be too ambitious in countries with low program policy ownership; arrangements with lower access focused on critical areas may have better prospects of success. Second, a mechanism to terminate off-track arrangements could be useful in designing future IMF programs, especially when program ownership is an issue. Finally, prior actions continue to be a powerful tool for implementing program policies, as they were responsible for the majority of the achievements under the 2010 SBA.

Executive Board Assessment[2]

Executive Directors noted that, despite the Ukrainian authorities' efforts to maintain macroeconomic stability amid worsening economic conditions, the current macroeconomic policy mix has generated large external and fiscal imbalances and has contributed to deepening the recession. Directors recommended the authorities implement a package of comprehensive policy adjustments in several areas, including curtailing the fiscal and external current account deficits, phasing out energy subsidies, strengthening the banking sector, and improving the external competitiveness of the economy.

Directors concurred that the overvalued exchange rate has contributed to a widening external current deficit, loss of competitiveness, and steady depletion of international reserves. At the same time, a tight monetary policy, focused on defending exchange rate stability and based on the extensive use of administrative controls, has stifled growth. Against this background, Directors advised the authorities to allow greater exchange rate flexibility and to accelerate the transition to an inflation targeting framework.

Directors welcomed the reported positive developments in the banking sector. Banks' exposure to foreign exchange risk has declined and bank capitalization and provisioning have risen, providing a cushion against risks stemming from high non-performing loans. Directors warned, however, that maintaining financial stability leaves no room for complacency and recommended the authorities enforce consolidated supervision and high reporting standards, proceed with independent audits of vulnerable banks, and develop contingency plans to support banks in case of need.

Directors stressed the importance of fiscal consolidation for the overall adjustment effort. High budget expenditure should be reduced by rationalizing public procurement, restraining the growth in public sector wages and employment, and limiting pension indexation to inflation. In addition, authorities should refrain from unaffordable tax cuts. Directors agreed that these measures would reduce the fiscal deficit to a sustainable level over the medium term while creating space for essential public investment.

Directors underscored the need for a comprehensive energy sector reform. They stressed that upfront, meaningful, and broad-based tariff increases are essential for reducing large quasi-fiscal losses, attracting new investments, and improving governance. Energy tariff increases should be accompanied by measures to protect the most vulnerable households. Directors welcomed the authorities' plans to continue with energy-saving reforms, increase domestic gas production, and

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

diversify energy imports, but stressed that these measures cannot substitute for the indispensable tariff adjustments.

Directors noted the uneven progress in improving the business climate. They welcomed the streamlined procedures for starting a business, registering property, and dealing with construction permits. Directors stressed that much more needs to be done to enhance institutional capacity, strengthen the judicial system, improve law enforcement and tax administration, and eradicate corruption.

In discussing the ex post evaluation report on the 2010 SBA, Directors noted some important achievements, including the 2011 pension reform, but regretted the authorities' insufficient ownership, which undermined the program. Directors agreed that, in view of Ukraine's track record, arrangements with lower access and strong prior actions would be most appropriate. While most Directors concurred that arrangements of shorter duration would also be preferable, some others underscored that the structural nature of many of Ukraine's economic problems calls for maintaining a sufficiently long time horizon.

Ukraine: Selected Economic Indicators, 2010–14

	2010	2011	2012	2013	2014
				Projections	
Real economy (percent change, unless otherwise indicated)					
Nominal GDP (billions of Ukrainian hryvnias)	1,083	1,302	1,409	1,432	1,503
Real GDP	4.1	5.2	0.2	-0.3	1.0
GDP deflator	13.8	14.3	8.0	2.0	4.0
Unemployment rate (ILO definition; percent)	8.1	7.9	7.5	8.0	8.0
Consumer prices (period average)	9.4	8.0	0.6	-0.3	1.6
Core inflation (period average) 1/	8.6	7.7	3.3	0.2	1.4
Nominal monthly wages (average)	17.7	17.5	14.9	9.0	5.6
Real monthly wages (average)	7.6	8.8	14.2	9.3	3.9
Public finance (percent of GDP)					
General government balance 2/	-5.8	-2.8	-4.5	-5.7	-4.6
Overall balance (including Naftogaz operational deficit)	-7.4	-4.3	-5.5	-7.7	-6.6
Structural general government balance	-3.7	-3.0	-4.5	-4.1	-4.1
Public debt (end of period) 3/	40.5	36.8	37.4	41.3	44.7
Money and credit (end of period, percent change)					
Base money	15.8	6.3	6.4	14.7	12.9
Broad money	22.7	14.7	12.8	16.8	14.1
Credit to nongovernment	1.1	9.5	2.2	7.8	8.2
Interbank overnight rate (annual average, percent) 4/	2.0	5.8	10.8	3.3	…
Balance of payments (percent of GDP)					
Current account balance	-2.2	-6.3	-8.1	-8.3	-8.2
Foreign direct investment	4.2	4.3	3.8	2.4	2.4
Gross reserves (end of period, billions of U.S. dollars)	34.6	31.8	24.5	18.5	11.2
Months of next year's imports of goods and services	4.2	3.7	3.0	2.2	1.3
Percent of short-term debt (remaining maturity)	73.3	55.4	40.0	32.3	18.8
External debt (percent of GDP)	86.0	77.2	76.6	76.7	75.3
Goods exports (annual volume change in percent)	9.3	7.1	2.0	-7.4	3.9
Goods imports (annual volume change in percent)	15.0	22.6	2.2	-5.5	2.6
Goods terms of trade (percent change)	0.3	7.6	-3.2	2.2	0.2
Exchange rate					
Hryvnia per U.S. dollar (end of period)	8.0	8.0	8.0	…	…

Sources: Ukrainian Authorities; and IMF staff estimates.

1/ Excludes unprocessed food, fuel, and administrative services.

2/ The general government includes the central and local governments and the social funds. In 2013, the general government deficit includes recognized arrears (1.3 percent of GDP).

3/ Government and government-guaranteed debt (includes debt to IMF).

4/ For 2013, average of rates for the first ten months.

Statement by Oleksandr Petryk, Alternate Executive Director for Ukraine
December 16, 2013

My Ukrainian authorities greatly appreciate the professional and operational cooperation between Ukraine and the Fund, and the technical and financial assistance from the IMF to our country. The Fund's assessments and recommendations are reviewed and analyzed carefully and meticulously by my authorities. Many previous recommendations have been implemented, some of them very quickly; others required a longer time to complete, given the need to introduce appropriate legislation, to establish political consensus in society and to coordinate with other reforms.

The authorities are paying close attention to the Fund's views on the risks stemming from the global and regional financial difficulties. They fully acknowledge that the state of the global economy is uncertain and vulnerable. Recession continues in Europe and puts a drag on Ukraine's economy. On the one hand, there is some slowdown in economic growth in Russia and China. As these countries and regions are the main trading partners of Ukraine, demand for our major export products is under pressure. On the other hand, the prices for imports, particularly with regard to energy, are high. Together, this is creating unfavorable terms of trade and pressure on the current account, which is likely to continue if external circumstances do not alter and domestic policies are not changed. As a result of the volatile external environment, Ukraine's external position has deteriorated and economic growth has stalled. The country entered a recession in the fall of 2012; the current account deficit widened to over 8 percent of GDP; and gross international reserves dropped to 2.1 months of future imports coverage. Despite a decline both in GDP (-1.3 percent in Q3) and in industrial output (-5.2 percent in January-October), the Ukrainian economy showed signs of gradual recovery, largely driven by agriculture output growth and private consumption. Agriculture output growth amounted to 9.9 percent and retail trade amounted to 9.5 percent in January-October. Intensified trade tensions with regional partners since July 2013 restrained the pace of recovery, while hitting Ukraine`s exports and export dependent industries. Sluggish aggregate demand, a plentiful harvest, and a virtually stable exchange rate and utility tariffs were the principal factors for near zero inflation (0.2 percent y-o-y in November).

In spite of the difficult macroeconomic situation, high external imbalances, and problems in the fiscal and energy sectors in Ukraine, my authorities made significant efforts to implement important reforms in order to preserve price and financial stability and restore sustainable economic growth.

Monetary policy and financial system

The authorities have made significant progress in their preparation for the inflation targeting framework. The interest rate policy framework has been improved by enhancing the effectiveness of the overnight interest rate corridor. In mid-June 2013 the National Bank of Ukraine (NBU) started the placement of overnight deposit certificates. Accordingly, the

lower bound of the corridor is the interest rate on overnight deposit certificates, and the top bound is the rate on overnight loans with collateral by government securities.

A model-based system of macroeconomic analysis and forecasting has been developed and established by the NBU over the past years in order to support the monetary policy decision-making process.

A financial stability unit was established in the NBU one year ago. The unit started to work successfully in accordance with international experts' assessments. A modeling toolkit has been developed also for banking system stress testing purposes.

The NBU was able to achieve and maintain price stability and improve the performance of the banking system, gradually restoring confidence in it.

The authorities' policies contributed to the trend of dedollarization. The share of FX deposits decreased to 38.6 percent in October starting from 43.6 percent in the beginning of the year; right after the start of the financial crisis, it almost approached 50 percent. The share of FX loans fell to 35.4 percent from 37 percent in the beginning of the year; before the crisis it exceeded 50 percent.

Fiscal policy

The authorities have taken decisive steps on budget reforms. A new transfer pricing law was introduced on September 1 in line with the relevant provisions of the Tax Code. The implementation of transfer pricing will help prevent the artificial redistribution of assets in the system of transnational corporations and create the conditions for a fair competition environment. It also will reduce the tax burden on legitimate businesses as a result of the clear definition of their market value, while preventing cases of tax evasion. Additional budget revenues from this law will be near 0.5 billion Hryvnia in 2013.

Regulatory policy

According to the World Bank report on the ease of doing business (Doing Business 2014 "Understanding Regulations for Small and Medium-Size Enterprises") Ukraine has become a leader among the countries-reformers of the reporting period, jumping 28 positions in one year. Ukraine has made the biggest breakthrough in the areas of "building permits" (145 + positions), "registering property" (61 + position) and "loans" (11 + positions). The electronic taxation reporting system was improved; the declaration for VAT and Single Contribution was simplified; a licensing system, based on degrees of risk in construction, was introduced; and the registration of ownership of real estate was simplified last year.

Energy sector

In accordance with the EU directives program, economic reforms in Ukraine particularly envisage reform of the biggest state gas company "Naftogaz of Ukraine". This will lead to a removal of the cross-subsidization of production activity and will allow achieving transparency in the company`s financial sector including the establishment of clear rules for transfer pricing. A gas savings incentive system was introduced for heating communal companies. It limits the consumption of gas for heating at a reduced price. The consumption over these limits will be based on the import price. The economic effect is estimated to be 4.1 billion of Hryvnia in 2013. Domestic gas production has increased by 0.5 billion of cubic meters in 2013. My authorities, by attracting investments, developed a program for the modernization and renovation of the heating industry to improve the efficiency of heat-generating equipment and reduce heat losses.

Some results of the policy directed at the improvement of energy efficiency have already been achieved. The consumption of gas in Ukraine decreased by 7.2 per cent (y-o-y) in January-October 2013.

Despite the above mentioned achievements and actions, and taking into account accumulated misbalances and weaknesses, the authorities agree in general with the changes in macroeconomic policy proposed by IMF staff. However they have their own view on the size and speed of policy actions. Let's consider them in detail:

In the area of monetary policy and financial system

My authorities consider that a one-time adjustment of the exchange rate, as proposed by staff, may incur high risks for financial stability. Therefore, they propose a gradual transition to a monetary regime based on interest rate management and a more flexible exchange rate. The measures proposed to the staff were: (1) unification of market and official exchange rate; (2) widening of the exchange rate band to +/-10 per cent from the current level; and (3) further steps to increase the fluctuations of the exchange rate to deal with external mismatches, if needed. So, my authorities are ready to adjust the exchange rate to the level the Fund proposes, but they prefer to allow the market to achieve this level on its own. In this way it will not undermine the credibility of the central bank and its monetary policy, the cornerstone for further success of the new monetary framework.

Another benefit of a gradual adjustment of the exchange rate consists in the smoothing of negative effects for the banking system. The IMF staff estimates the reduction of bank capital at 2.25-4 percent of GDP as the result of the proposed devaluation and the concomitant rise in NPLs. The authorities are concerned that staff may underestimate the second-round effects of a large devaluation, and prefer to be on the safe side for financial stability reasons.

The Ukrainian authorities aim to keep inflation (at least its core component) in the target range of 4-6 per cent. IMF experts for many years emphasized the need for the introduction of inflation targeting in Ukraine. The NBU has done much on a technical level to achieve this, but a surge in inflation that inevitably accompanies a deep devaluation could, for a long time, undermine the NBU's credibility, which is indispensable for inflation targeting.

The NBU will continue its preparations to adopt a full-blown inflation targeting framework. This will involve strengthening its forecasting capacity, and upgrading the operational framework of monetary policy. Further IMF technical assistance on the design of the inflation targeting framework will be helpful.

In the area of fiscal policy

The authorities understand that fiscal policy should aim to support external adjustments and strengthen the medium-term fiscal sustainability. Fiscal consolidation will help contain domestic demand pressures and put public debt on a declining path. The Ukrainian authorities are ready to adjust both the general government and Naftogaz deficits as well as government guarantees since these are the main drivers of public debt. Fiscal consolidation at the general government level will be achieved through a balanced combination of revenue and expenditure measures. Besides, the choice of the projects for government guarantees will be based on strict selection criteria in order to find the projects with a maximum cost recovery effect, and with emphasis on energy saving technologies and improvement of the balance of payments.

My authorities are concerned that a too rapid depletion of fiscal stimulus could have strong negative effects on economic activity, with adverse consequences for fiscal sustainability as well. They concur with staff that fiscal consolidation is needed, but favor a more gradual pace in restricting the budget deficit and state guarantees in 2014.

In the energy sector

The authorities agree with the IMF staff on the need for a significant reduction of inefficient subsidies in the energy sector. However, in some areas they need more time to carry out the planned reforms in the most efficient way. They consider raising gas and heating tariffs gradually in 2014-2015, starting with an increase in gas tariffs for households who consume more than a specific predetermined level. This gradual approach will strengthen the preparatory steps necessary to determine target groups for energy subsidies. Otherwise, a wave of non-payments may arise after rapid hikes in heating tariffs for all categories of the population, potentially undermining the positive effects for the balance sheet of Naftogaz.

The Ukrainian authorities are ready to resume policy level discussions on a new Stand-by Arrangement with the Fund, which will help to stabilize the macroeconomic situation and to restore sustainable economic growth.

Proposed activities, supported by the IMF, will restore access for Ukraine (both Government and private sector) to international capital markets. Indeed, the increased flexibility of the exchange rate, fiscal consolidation and reduced energy subsidies are considered by a majority of experts (investors) to be prerequisites for the resumption of access to external financial resources. Nonetheless, market participants agree as well that a deep devaluation could be stressful for Ukraine's financial system and may subsequently restrict market funding sources.

My authorities thank the Fund for the continued constructive dialogue and agree with most of the assessments and recommendations. They recognize the necessity to accelerate reforms in the key policy sectors. However, consistency and balance in promoting reforms are key for preserving financial stability and political consensus in the Ukrainian society, and thus to realize the potential of the economy.