INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/263

UKRAINE

September 2014

FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE AND APPLICABILITY OF PERFORMANCE CRITERIA, AND A REQUEST FOR REPHASING OF THE ARRANGEMENT; STAFF STATEMENT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR UKRAINE

In the context of the First Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance and Applicability of Performance Criteria, and a Request for Rephasing of the Arrangement, 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 August 29, 2014, following discussions that ended on July 17, 2014, with the officials of Ukraine on economic developments and policies underpinning the IMF arrangement under the Stand-By Arrangement. Based on information available at the time of these discussions, the staff report was completed on August 18, 2014.
- A **Staff Statement** of August 29, 2014 updating information on recent developments.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Ukraine.

The following documents have been or will be separately released.

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

*Also included in Staff Report

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

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E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

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August 18, 2014

FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE AND APPLICABILITY OF PERFORMANCE CRITERIA, AND A REQUEST FOR REPHASING OF THE ARRANGEMENT

EXECUTIVE SUMMARY

The first review discussions took place in a context of heightened geopolitical tensions and deepening economic crisis. Intensification of the conflict in the East and escalation of the gas dispute with Gazprom, two of the key risks identified at the time of the program request, have materialized. These developments have affected confidence, balance of payment flows, economic activity, and budget execution. The banking sector has had to cope with larger-than-anticipated deposit outflows, and the exchange rate has depreciated more than expected at the time of the program request.

The authorities have implemented policies broadly as agreed, but significant pressures have emerged. All but one performance criteria for end-May were met and all structural benchmarks have been implemented, albeit some with a delay. However, the deterioration in the economic outlook, fiscal and quasi-fiscal pressures, and heightened balance of payment difficulties are putting the initial program targets in jeopardy. Two end-July PCs are estimated to have been missed; and the end-2014 targets are out of reach. All continuous PCs were met.

Discussions focused on the appropriate policy response to these short-term pressures and on reforms to support sustained growth. There was agreement that the policy effort should focus on compensatory measures to meet key program objectives, while allowing some temporary deviations from the initial targets. In particular, the NBU will limit the decline in reserves through market purchases; the government will take additional fiscal measures to keep public finances sustainable; and Naftogaz will strengthen current and past gas bills collection. Discussions also focused on reforms aimed at modernizing the monetary policy framework, preserving financial stability, addressing governance issues and improving the business climate.

Nonetheless, risks loom large. The program hinges crucially on the assumption that the conflict will begin to subside in the coming months. Should active fighting continue well beyond that, the small buffers under the revised baseline would be quickly exhausted, requiring a new strategy, including additional external financing. A further heightening of geopolitical tensions could also have significant economic consequences. Domestically, policymaking may become more difficult in case of early elections. Strong policy performance and adherence to the planned reforms is therefore critical.

Staff supports the authorities' request for completion of the first review and the waivers for nonobservance and applicability of performance criteria. The purchase released upon completion of the review would be in the amount of SDR 0.914 billion, of which SDR 0.650 billion will be used to finance the budget deficit.

Approved By
Poul M. Thomsen and Mark Flanagan

Discussions were held in Kyiv during June 24–July 17, 2014. The IMF team comprised Nikolay Gueorguiev (head), Michael Gorbanyov, Stéphane Roudet, Beata Jajko, Linda Kaltani (EUR); Tigran Poghosyan (FAD); Luis Cortavarría-Checkley, Elias Kazarian (MCM); Karim Youssef (SPR); and Jerome Vacher, Resident Representative. Poul M. Thomsen (Deputy Director, EUR), Ceda Ogada (Deputy General Counsel, LEG), Sebastiaan Pompe (LEG), and Oleksandr Petryk (Alternate ED) participated in policy discussions. Nikita Kannekanti and Christine Rubio provided support from headquarters.

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CONTEXT

1. The discussions on the first review took place against the backdrop of heightened security tensions, a deepening economic crisis, and a complex political situation.

- *Intensification of the conflict in the East.* The security situation in the East has deteriorated since the approval of the SBA, as military operations in the regions of Donetsk and Luhansk have intensified, leading to hundreds of casualties and severe hardship for the local population.
- *Deepening economic and confidence crisis.* The worsening security situation is affecting economic activity and budget execution. In addition, these developments have raised uncertainty, weighing on balance of payments flows. The banking sector is coping with larger-than-anticipated deposit outflows, and the exchange rate has depreciated by more than expected at the time of the program request.
- *Worsening gas price and arrears dispute.* In spite of EU-brokered negotiations, the disagreement between Naftogaz and Gazprom over gas import prices has escalated, leading to interruption of gas supplies from Gazprom.
- *Fluid political situation.* Petro Poroshenko was elected President on May 25. The President has expressed strong backing for the Fund-supported program and signed an Association Agreement with the EU, which now awaits parliamentary ratification. The government coalition broke down on July 24, and the Prime Minister resigned, but parliament rejected his resignation on July 31. Nevertheless, unless a new coalition is formed by late August, the President will likely call early parliamentary elections in October. However, both the government and the parliament will remain fully functional until the elections. Moreover, the parliament has adopted the supplementary budget, a key prior action for the review.

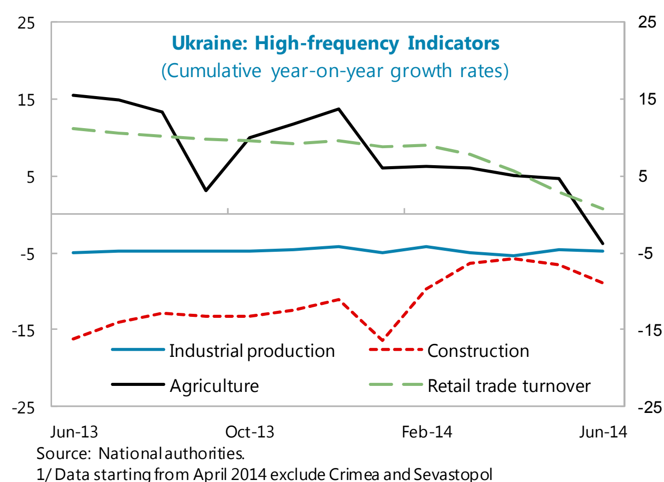
2. The authorities have implemented policies under the Fund-supported program broadly as envisaged, but significant pressures have emerged. All but one performance criteria (PCs) for end-May were met, as higher-than-expected volume of gas imports before the interruption of supplies from Gazprom and a larger than programmed exchange rate depreciation pushed Naftogaz' operational deficit—and hence the combined general government-Naftogaz deficit—above target. All the structural benchmarks for the review have also been implemented, although two of them with delays (MEFP Table 1). However, the conflict is weighing on the economic outlook and budget performance and curtailing the government's market access. In addition, the less favorable balance of payment is complicating the authorities' reserve accumulation strategy. In light of this, the end-July PCs on the combined general government-Naftogaz deficit and net international reserves (NIR) are estimated to have been missed. All continuous PCs were met.

3. Against this background, discussions focused on compensatory measures to bring the program back on track while allowing some temporary deviations from program targets. There was agreement on the necessity to recalibrate the fiscal deficit, NIR, and net domestic asset (NDA) paths in view of the unexpected impact of the conflict in the short-term. This was based on

the view that the intensification of the conflict in the East and the gas dispute constitute temporary and exogenous shocks, and the buffers in terms of reserves and debt servicing margins remain sufficient to absorb some of the impact. However, the changing circumstances also call for compensatory measures to ensure that the program objectives of stabilizing the economy and creating conditions for sustained growth are still achieved over the next couple of years. To this end, the authorities committed to a strong policy package, including a tightening of the fiscal policy stance and steps to bolster reserves.

RECENT ECONOMIC DEVELOPMENTS

4. The recession is deepening, as the unsettled security situation in the East weighs on economic activity (Figure 1). Real GDP declined by a milder-than-expected 1.1 percent in the first quarter. However, high-frequency indicators point to an acceleration of output decline, resulting from disruptions in activity in the industrialized East (see Box 1) and the impact of the conflict on business and consumer sentiment. Industrial production declined by 4.7 percent in real terms y-o-y in January–June, while construction dropped by 8.9 percent over the same period, with the decline accelerating lately. Agricultural output fell by 3.9 percent in January–June relative to a year ago as well. Retail trade turnover also contracted in May–June, barely remaining in positive territory in 2014:H1 (0.8 percent). Reflecting these developments, the State Statistical Service reported a preliminary estimate of a GDP decline of 4.7 percent y-o-y in 2014:Q2, and 3 percent for 2014:H1. Unemployment is on the rise as well—the rate edged up to 8.8 percent in 2014:Q1, from 8 percent a year ago.



Source: National authorities.
1/ Data starting from April 2014 exclude Crimea and Sevastopol

5. Exchange rate volatility has somewhat subsided, but the hryvnia reached a more depreciated level than expected, and inflation is on the rise (Figure 2). Largely reflecting political instability, risk aversion, and high liquidity, the exchange rate experienced very high volatility in March and early April. The NBU's blend of market and administrative measures, alongside the arrival of international financial assistance in May, stabilized the exchange rate and reduced volatility. From mid-April to late July, the exchange rate has fluctuated within a UAH 11.4–12.1/US$1 range, some 40–45 percent weaker than at end-2013. However, a renewed bout of geopolitical tensions in early August weakened it by another 8 percent to about UAH 13/US$1. Consumer price inflation accelerated at a faster-than-expected pace—from near zero in January to 12.6 percent y-o-y in July—primarily reflecting rapid pass-through from the currency depreciation and increases in administered prices.

6. Balance of payments developments have been less favorable than envisaged under the program, in spite of a lower current account deficit (Figures 3–4).

Box 1. The Economic Impact of the Conflict in the East

The Eastern regions affected by the conflict comprise a nonnegligible part of the economy. In 2012, the regions of Donetsk and Luhansk accounted for 15¾ percent of Ukraine's GDP. In 2014:Q1 their share in Ukraine's volume of industrial production amounted to 23 percent and 14½ percent in retail trade. In addition, 23 percent of total exports of goods and 6¾ percent of total goods imports were associated with the two regions.

In light of this, the sharp worsening in economic activity in the East is affecting Ukraine performance directly, with deeper drops in economic activity than in the rest of the country (table). In addition, the uncertainty generated by the conflict weighs on business and consumer confidence throughout the country, as well as investors' perceptions of Ukraine's country risk.

Household deposit outflows in the two regions in January–July 2014 (about 33 percent since end-2013) have been heavier than the average for Ukraine (19½ percent), generating additional bank liquidity needs. This has been still manageable, as before the crisis the two regions accounted for only about 11 percent of the household deposits in the country. Although local branches of the NBU in Donetsk and Luhansk have been closed, bank settlement is done in Kyiv and the payment system appears to be working more or less normally, including for payments for delivery of goods to and from Russia, although these deliveries have fallen sharply.

Tax collection in the Eastern regions—particularly for the taxes remitted to the State budget—has fallen sharply, in contrast with the rest of Ukraine (table). There have been intermittent disruptions in the work of the tax administration branches in Donetsk and Luhansk.

High Frequency Indicators Ukraine and the Eastern Regions

(Cumulative Y-o-Y Growth Rates) 1/

	Jan–Mar 2014	Jan–May 2014	Jan–Jun 2014
Industrial Production			
Donetsk	-13.0	-12.1	-12.3
Luhansk	-1.6	-2.0	-5.0
Rest of Ukraine	-3.5	-3.1	-2.9
Ukraine, total	-5.0	-4.6	-4.7
Agriculture			
Donetsk	0.4	2.7	-11.4
Luhansk	1.2	3.2	-11.3
Rest of Ukraine	6.3	4.8	-3.3
Ukraine, total	5.9	4.7	-3.9
Construction			
Donetsk	-7.3	-11.1	-19.1
Luhansk	5.9	-7.3	-16.9
Rest of Ukraine	-6.8	-5.8	-7.3
Ukraine, total	-6.4	-6.5	-8.9
Retail Trade			
Donetsk	6.8	0.4	-2.5
Luhansk	7.0	-1.9	-7.7
Rest of Ukraine	7.8	3.5	1.6
Ukraine, total	7.7	2.9	0.8
Exports of goods			
Donetsk	-19.2	-17.0	...
Luhansk	-14.9	-18.2	...
Rest of Ukraine	-3.5	-1.4	
Ukraine, total	-6.9	-5.1	...
Imports of goods			
Donetsk	-28.8	-33.7	...
Luhansk	-28.0	-28.5	...
Rest of Ukraine	-19.9	-17.0	
Ukraine, total	-20.5	-18.0	...
Unemployment			
Donetsk	9.1		
Luhansk	8.4		
Rest of Ukraine	8.8		
Ukraine, total	8.8		

Sources: National authorities; and IMF staff calculations and estimates.
1/ Data for Jan–Mar include and data for Jan–May and Jan–Jun exclude Crimea and Sevastopol.

Growth Rates of Tax Revenue in the East

(Percent; June 2014 relative to June 2013)

	State Budget 1/	Social Security Funds	Local Budgets	Total 1/
Donetsk	-30.3	-9.5	-10.4	-17.6
Share of total in 2014	4.6	10.7	10.9	7.6
Luhansk	-8.5	-10.0	-13.5	-10.3
Share of total in 2014	1.7	4.7	4.0	3.1
Rest of Ukraine	8.4	4.2	4.5	6.5
Ukraine, total	5.3	1.8	1.8	3.6

Source: National authorities.
1/ Before VAT refunds.

- Weak domestic demand and currency depreciation led to imports falling by 17¼ percent in January–May 2014. Exports contracted by some 6½ percent over the same period, led by chemicals, metals and machinery shipments. Exports to Russia—about a quarter of the total—in particular dropped by 24 percent from a year ago as a result of the rapidly deteriorating

relations between the two countries and disruptions in activity in the East. On balance, the current account deficit was US$740 million lower than expected (at about US$1.4 billion).

- Reflecting heightened uncertainty, net capital and financial account outflows were larger than expected by some US$2 billion. While rollover rates for banks and corporate entities were more robust than expected at the time of the program request, net FDI registered an outflow, and the banking system faced large foreign currency outflows (US$3.1 billion). Capital controls likely prevented larger outflows, but were not fully effective in stemming them.

- Overall, international reserves accumulation in January–June has been below expectations. End-June gross reserves stood at about US$17.1 billion, about US$1.2 billion short of the program projection.

MACROECONOMIC FRAMEWORK AND RISKS

7. The program's macroeconomic framework has been revised to account for recent developments, including delays in resolving tensions in the East (Table 1):[1]

- The revised baseline assumes that fighting in the East will begin to subside in the coming months. The main implications of the longer than initially expected duration of the conflict are lower tax revenues, higher needs for military spending, and lower consumption and investment in 2014–15 than at the time of program request.

- Specifically, as Box 1 indicates, the decline in economic activity in the East is much sharper than in the rest of the country. Industrial production, agriculture, construction, and international trade already show a double-digit decline in real terms in 2014:H1. This pattern is expected to have gotten even worse in recent months and improve only slowly towards end-2014 on the basis of reconstruction works after active fighting subsides. Unemployment in the East is expected to be in double digits already, although data for 2014:Q2 is not yet available. On this basis, staff expects the GDP in the East to decline by 15–20 percent this year. In contrast, in the rest of the country, economic activity indicators suggest a GDP drop in the mid-single digits—much milder not only compared to the East, but also compared to the 2009 crisis when GDP declined by about 15 percent. This shows that the adjustment is proceeding broadly as expected in most of Ukraine and underscores the importance of resolving the conflict quickly.

- In light of this, GDP growth projections have been revised downward to -6½ percent in 2014 (from -5 percent) and to 1 percent in 2015 (from 2 percent). Deeper declines in domestic demand in 2014 will be partly offset by larger net export contribution, exclusively due to lower

[1] As in the staff report for the SBA approval, the data presentation covers Ukraine including Crimea, except the fiscal accounts, which exclude Crimea starting in April 2014. The presentation will be revised once a comprehensive and consistent set of national accounts indicators for Ukraine's mainland is available. The high frequency indicators follow the data releases of the State Statistics Service of Ukraine, which in most cases exclude Crimea from April onwards.

imports. Exports growth will also be weaker than initially projected in 2014 as a result of rapidly deteriorating relations with Russia and disruptions in activity in the export-oriented East. In 2015, growth would be driven by a rebound in exports on the back of improved competitiveness, cessation of hostilities in the East, and the trade-enhancing effects of the Association Agreement with the EU. These effects would modestly support private consumption despite the headwind of tighter fiscal stance (¶31).

- The Hryvnia is projected to remain weaker than initially foreseen in response to the weaker balance of payments. In light of this and a faster-than-expected pass-through, CPI inflation is projected to reach 19 percent by end-2014 (compared to 16.2 percent at the time of the program request). GDP deflator inflation has also been revised up by about 3 percentage points in 2014. Successful implementation of program policies is expected to reduce inflation to 9 percent by end-2015.

- Consistent with recent developments, as well as the projected lower domestic demand and weaker currency, the current account deficit is now projected to reach 2.5 percent of GDP this year, compared to 4.4 percent of GDP at the time of the program request, and to remain at the same level in 2015. Capital and financial account projections are based on conservative assumptions reflecting recent trends. In comparison with the original program, the deterioration of the financial account during 2014–15 is driven by lower FDI, more conservative bank and corporate short-term borrowing, and larger FX outflows from the banking system. In addition, staff has revised its projections for the speed of implementation of externally financed projects given the difficult political environment. On balance, these effects imply a lower than expected pace of accumulation of reserves under the program.

8. Nevertheless, the revised baseline scenario faces large downside risks (¶51). Chief among these is an extension or even a worsening in geopolitical tensions—be it as a result of an intensification of the conflict in the East or further escalation of political, trade, and gas frictions with Russia. Any of these developments could weigh on confidence and lead to further balance of payment pressures, including higher foreign currency outflows from the banking sector. This would likely lead to deeper and longer recession, and further exchange rate depreciation, with attendant consequences on inflation, banks' balance sheets, and fiscal performance. Given the reduced buffers in the revised program, were these risks to materialize, a new program strategy will be needed, supported by significant additional external assistance.

MONETARY AND EXCHANGE RATE POLICY

Rebuilding a sufficient international reserve buffer, maintaining a flexible exchange rate, and refocusing monetary policy on price stability are key pillars of the Fund-supported program. Discussions for this review focused on compensatory measures to bring the program back on track while allowing reserves to absorb some of the balance of payments shock in the short run. In addition, progress was made in identifying the necessary preparatory steps for introducing inflation targeting

within the course of the SBA and in discussing reforms to strengthen NBU's governance and financial autonomy.

A. Recent Developments

9. The NBU has re-established its strong preference for a stable exchange rate since mid-April. Fearing that conflict-induced extreme currency depreciation would impair banking sector balance sheets, stoke inflation pressures and generate adverse inflation-depreciation spiral, the NBU has used a combination of market and administrative measures to stabilize the exchange rate since mid-April. It has reduced refinancing provided to banks and increased the policy interest rates, but has also applied moral suasion and temporarily revoked the FX trading licenses of 22 banks for "excessive speculation against the Hryvnia."

10. Performance against program targets was satisfactory through end-May, but the original program objectives for the rest of the year are out of reach.

- In May, the Ministry of Finance (MOF) managed to roll over only part of the maturing FX-denominated domestic debt securities and only into a short two-week maturity. The NBU made up the difference in late May by purchasing from the FX market the amount necessary to meet the end-May PC on its net international reserves. Nonetheless, the unfavorable balance of payments discussed above and the NBU's preference for exchange rate stability has likely led to a breach of the end-July PC and has made subsequent targets unattainable.

- The monetary program was broadly on track by end-July. However, the program envisaged significant monetary tightening from mid-2014, to curb the inflationary impact of the large currency depreciation and mop up the previously extended liquidity (as deposit withdrawals were expected to reverse). This will not be feasible anymore in view of larger-than-expected deposit withdrawals and the Government's and Naftogaz's higher financing needs in the face of curtailed market access.

11. A recent IMF safeguards assessment mission highlighted a number of risks. First, the NBU continues to face a pattern of fiscal dominance, and its balance sheet is under strain because of the increasing holdings of government securities and liquidity support to commercial banks. The proportion of government securities and loans to banks increased from 28 percent of NBU total assets at end-2010 to 56 percent at end-April 2014. Second, the NBU's financial autonomy has been undermined by advance profit distributions to the state budget, which were based on the annual state budget laws rather than permitted amounts under the NBU Law and have significantly eroded the NBU's financial position. Moreover, in February–May 2014 the government did not reimburse the NBU for repaying budget support received from the IMF in the context of the previous SBA arrangement.[2] Finally, from a governance perspective, the assessment found that the NBU Council's

[2] This led to accumulation of NBU claims on government of SDR 0.9 billion at end-May.

mandate is limited and substantial revisions to the NBU's legal framework are needed to establish sound oversight arrangements of its daily management.

12. The IMF Article VIII assessment mission in June found that Ukraine continued to maintain two multiple currency practices (MCPs). They arise from (i) the use of the official exchange rate for certain government transactions without establishing a mechanism to ensure that the official exchange rate does not deviate from the market exchange rate by more than 2 percent and (ii) the requirement to transfer the positive difference between the sale and purchase price of foreign exchange to the state budget if the purchased foreign exchange is not used within 10 days and is resold. In addition to these existing MCPs, staff identified two exchange restrictions inconsistent with Article VIII, Section 2(a) arising from (i) the imposition of absolute limits on the availability of foreign exchange for certain current international transactions and (ii) the imposition of a foreign exchange transaction tax that applies to both cash and non-cash purchases of foreign exchange. The identified exchange restrictions and MCPs were put in place prior to the approval of the current SBA and, therefore, have no implications on Ukraine observance of the continuous PCs on non-imposition and non-intensification of the exchange restrictions and non-introduction and non-modification of MCPs during the arrangement.

B. Policy Discussions

13. Although concerned about exchange rate depreciation, the authorities agreed to allow exchange rate flexibility as needed to meet the revised NIR path.

- The authorities were concerned about the potential impact on inflation and banks' balance sheets of a further weakening of the exchange rate following an already large depreciation. However, they concurred with staff's view that a flexible exchange rate was critical to restore competitiveness, help rebuild depleted international reserves—especially as buffers have now been exhausted—and provide an important shock absorber, while its impacts on banks and borrowers would remain manageable (¶19). In light of staff's recommendation to discontinue moral suasion on banks and limit NBU's sanctioning powers on the FX market (including withdrawal of licenses), the NBU agreed that administrative measures needed to be gradually rescinded at a pace consistent with macroeconomic and financial stability. It is preparing a plan to this effect, drawing from the advice of the IMF Article VIII mission in June.

- Even as local currency deposit withdrawals bottomed out by end-May and reversed in June, the FX deposit withdrawals continued through July. Staff and NBU concurred that some further reduction of FX deposits in Q3 2014 could be expected before their stabilization and recovery later in the year. The NBU believed that the earlier introduced restrictions on FX deposit withdrawals contributed to the loss of confidence in the banking sector ability to repay the deposits. It was agreed that the removal of FX deposit restrictions would be under a very gradual timeline and well-prepared plan. It should be contingent on stabilization of FX deposits, take into account the impact on the exchange rate and the reserve target, and envisage measures for coping with the potential one-off deposit outflows triggered by restrictions removal.

- The NIR/NDA targets were recalibrated in view of the unexpected balance of payment and public sector funding pressures. The revised NIR path allows a notable reduction in projected gross international reserves in 2014 to mitigate the impact of the current shock on the Hryvnia. However, to preserve minimally adequate reserve buffers, it was agreed that the NBU would accumulate at least US$1 billion through market purchases by end-2014. In this regard, by purchasing at least US$200 million, the NBU will achieve a level of NIR of at least US$7.675 billion as *a prior action*. Staff highlighted that the lower NIR targets would reduce the margins for maneuver in case of more acute or prolonged shock. In light of this, the NBU will strictly limit FX sales to Naftogaz and government to the amounts factored into the program projections; and the government will seek to roll over its maturing FX-denominated domestic debt liabilities by offering appropriate interest rates and maturities. This will help maintain the reserve accumulation flow objective in 2015 broadly unchanged compared to the program request. In view of the financing difficulties faced by the government and Naftogaz, there was agreement that some support from the NBU would be exceptionally needed to avoid severe funding disruptions. The revised NDA path therefore reflects additional monetization of these financing needs.

14. Policy interest rates—key tools to achieve the revised NDA targets—remain adequate, but vigilance is of the essence. The rapid inflation increase mainly reflected one-off impact of the exchange rate pass-through and administered price adjustments, the bulk of which has already occurred. However, to guide inflation expectations and enhance its ability to control its net domestic assets, the NBU agreed that it should keep its effective real policy rate positive on a forward-looking basis, particularly as inflation expectations have increased (Figure 2). Accordingly, the NBU increased its main policy interest rate by 300 basis points in mid-July (from 9½ percent to 12½ percent). Policy interest rates may be adjusted further as needed to meet the NDA targets.

15. While NBU liquidity support to banks has been critical in the face of large deposit outflows, steps should be taken to reduce the NBU's risk exposure. The mission probed to what extent the NBU's current level of liquidity support remained adequate (see also ¶20) and what modalities could be applied to sustain bank activity in the two troubled regions. It found that the banking sector's reliance on NBU liquidity has been necessary to bolster its resilience in the face of large households deposit outflows, particularly in the East. However, staff and the authorities agreed that proper procedures to monitor the quality of pledged loans, detect collateral quality deterioration, and seek its replacement by performing assets should be established in order to reduce the central bank's risk exposure.

16. Staff welcomed ongoing preparations for adopting inflation targeting (IT). Supported by IMF TA, the NBU has recently developed a time-bound action plan to implement the necessary technical preparations to adopt inflation targeting (MEFP ¶6). It envisages three stages of preparations for IT: (1) preparing background documents and decisions on the parameters and processes of the future regime; (2) putting in place all technical prerequisites for running IT policies; (3) testing the new framework and processes by taking de-facto IT policy decisions and communicating these decisions to the public. Staff welcomed the plan and highlighted that its

successful implementation would hinge on a change in the internal NBU structure to allow for the organizational separation of various functions. The Fund will provide extensive TA on the implementation of the plan. A successful implementation of IT will hinge on stabilizing the currency and financial market conditions, as well as phasing out government recourse to NBU borrowing.

17. The authorities are committed to strengthen the NBU's governance and financial autonomy to ensure adequate safeguards (MEFP ¶27). They have identified specific steps consistent with the recommendations of the IMF safeguards mission completed in May 2014. In particular, the NBU will prepare in consultation with Fund staff draft legislative amendments to the NBU Law (*structural benchmark* for end-December 2014), to strengthen the decision-making and oversight mandate of the Council as well as the autonomy of its members and the Deputy Governors, transform the Board into a smaller Executive Committee, and authorize the Council to establish special reserves before the profit distribution. NBU's internal controls will also be strengthened and the government will follow up on its commitment to settle its past IMF budget support-related obligations to the NBU by year-end. The authorities will also discontinue the practice of NBU making advanced profit transfers to the budget.

FINANCIAL SECTOR POLICY

The program aims at maintaining market confidence by strengthening banks' balance sheets and the financial infrastructure. Discussions focused on the ongoing bank diagnostics, strengthening supervision, and bolstering banks' balance sheets. The need to enhance the bank resolution and recapitalization framework was also addressed.

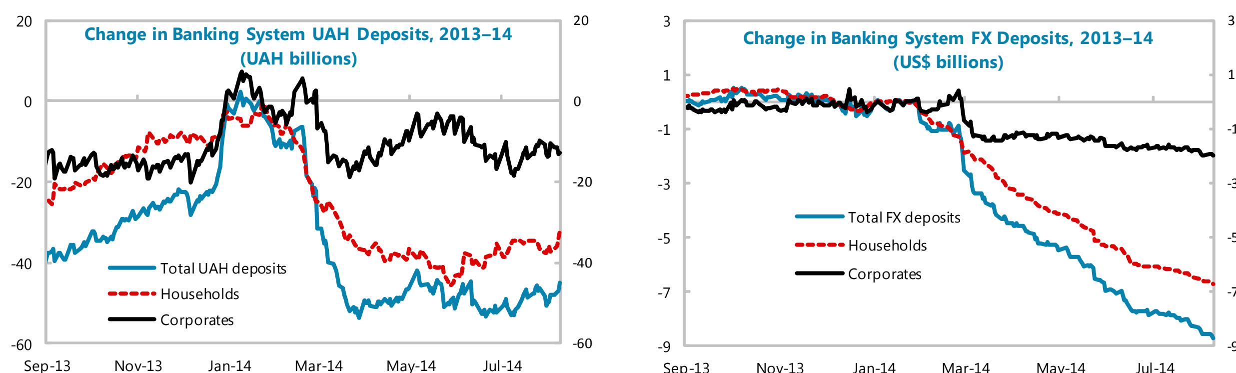
A. Recent Financial Developments

18. The banking system has shown resilience so far, but larger-than-expected exchange rate depreciation and deteriorating economic outlook are gradually taking their toll. All banks reported capital adequacy ratios above the regulatory minimum of 10 percent as of end-June, and the system's overall reported CAR remain high at 15–16 percent (Table 6). Reported bank operational losses have reversed by end-June, with return on assets increasing from -2 percent in January–May to 0.2 percent in January–June. Allowing banks to begin closing their negative foreign currency position since May 2014—after repealing the notorious Regulation 109—has somewhat reduced their exposure to exchange rate movements. Nevertheless, asset quality has deteriorated, with NPLs having increased from 12.9 percent at end-2013 to 14.6–14.7 percent in May–June 2014. Fifteen banks accounting for about 5 percent of the system deposits at end-2013 have failed since the beginning of the year and are in the process of being resolved.

19. Baseline assumptions for public sector resources allocated to bank restructuring were revised up. Based on reported bank data for May 2014, preliminary staff stress tests estimate that the system NPLs (under the NBU definition) would increase by half by end-2016 under the baseline (to 21.5 percent from 14.7 percent) and almost double under an adverse scenario (to 27.1 percent from 14.7 percent). Assuming that banks were to keep a provision ratio of 60 percent of NPLs, the

banking system would need to receive fresh resources in the range of 3.5–5 percent of GDP to meet capital targets of Tier I capital of 7 percent in the baseline and 4.5 percent under the adverse scenario.[3] This range raises the lower bound of the capital need, compared to earlier staff estimates of 1.6–5 percent of GDP. Accordingly, staff has revised its projected public sector resources allocated to support bank restructuring from 1 percent of GDP to a more conservative 2.8 percent of GDP over 2014–15, including 0.8 percent of GDP for the Deposit Guarantee Fund (DGF).[4]

20. NBU liquidity support has helped banks cope with large deposit outflows (Figure 5). By end-June, the banking system had lost about 17 percent of deposits since their peak in late January, or near 9 percent of GDP. Generally liquid after a strong deposit expansion in 2013, most banks have absorbed part of the loss so far. However, to support banks experiencing difficulties, the NBU had to extend liquidity support of about 5 percent of GDP or about 15 percent of total bank funding since February. As deposit withdrawals moderated by mid-April, the NBU scaled down its liquidity support. Withdrawals from household deposits in local currency bottomed out by end-May, reflecting the high interest rates offered by banks and liquidity support from the NBU that ensured smooth operations in Hryvnia. However, withdrawals from FX deposits of households continued into July because of perceptions of FX scarcity as well as high precautionary demand for cash FX holdings, which traditionally serve as a risk-free alternative to bank deposits in Ukraine.



Source: National authorities.

21. By early July, a problematic parliamentary legislative initiative to help indebted borrowers had been approved by Parliament in first reading. The proposal provided for forced conversion of household FX-denominated mortgages into Hryvnia at the pre-crisis exchange rate (some 30 percent below the current market rate). It also obliged banks to accept the mortgaged property in lieu of full payment of the outstanding loan at the discretion of the borrower. Furthermore, a law imposing moratorium on foreclosure of residential properties of borrowers in default had been passed with the view to be repealed once the legislation to convert FX-denominated mortgages into Hryvnia would have been approved.

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[3] The ongoing diagnostic studies are expected to estimate the capital shortfall more accurately.

[4] Based on the experience of the 2008–09 crisis, private shareholders are expected to provide about one half of the needed additional capital overall. In particular, foreign-owned banks should be fully supported by their parents.

B. Policy Discussions

22. The authorities reaffirmed their commitment to the financial sector reform program. Discussions focused on the following areas:

Updating the regulatory and supervisory framework

23. The monitoring of potentially weak institutions is being strengthened (MEFP ¶10). Staff welcomed the authorities' efforts to identify problematic banks early and adopt prompt corrective measures to prevent misbehavior of bank managers. In particular, banks have been classified with the view to identify those requiring special monitoring; and an NBU overseer was appointed to each bank in the latter group to follow their day to day activities and ensure that corrective actions prescribed by NBU are adopted. Discussions focused on the importance of keeping NBU board members informed about the situation of banks (especially those relying on liquidity support) and the use of a standardized approach to classify banks (such as CAMELS). There was agreement to benchmark early warning indicators and current tools to classify banks against best international practices.

Assessing financial resilience through bank diagnostics

24. The authorities are on track with their plans to diagnose and address weaknesses in the banking sector (MEFP ¶8 and 11). Agreement was reached on the criteria for using public funds to recapitalize or restructure undercapitalized or insolvent banks in the event that shareholders are unable or unwilling to inject new resources (*structural benchmark* for end-May). According to these criteria, banks accounting for at least 2 percent of the system deposit or assets may receive direct public recapitalization as long as the state is the controlling shareholder once bank shareholders equity participation has been wiped out, or diluted. Importantly, state capitalization will be preceded by thorough due diligence to protect public interest. Smaller institutions would be resolved by the DGF, following the least resolution cost method. It was also agreed that, in banks recapitalized by the state or resolved by the DGF, deposits related to shareholders, board members, and top managers would not be compensated. Separately, the diagnostic studies for the 15 largest banks are on track (*structural benchmark* for end-July). To monitor the process, the NBU has appointed a steering committee comprised of its senior supervisory staff.

Restructuring and recapitalizing financial institutions in need

25. Staff welcomed the progress made so far on crisis preparedness and urged the authorities to complete the review of the existing resolution framework (MEFP ¶12). Discussions focused on the following two important objectives to boost market confidence:

- *Enhancing DGF's legal and operational capacity*. Following parliamentary approval of the amendments to the DGF Law, the institution will have access to public financing if there is a significant risk of a decline of funds below its mandated coverage of 2.5 percent of insured deposits of the system. The amendments will help resolve banks—including by allowing the

creation of fully recapitalized bridge banks and by seeking the participation of the state in banks that meet the criteria described above. Going forward, staff stressed that it will be important to ensure that funds are made available to the DGF in due course to meet its mandate of quickly reimbursing insured deposits from failed banks, a prerequisite to ensure the credibility of the safety net system and financial stability.

- *Completing the review of the legal resolution framework.* Staff highlighted that the legal amendments under preparation should be fully in line with the banking strategy established in the program, especially concerning the criteria agreed on the use of public funds. In particular, staff urged the authorities to ensure that the NBU and the DGF have sufficient powers to wipe out or dilute the shareholders of failed banks before disbursing public support to them.

26. The authorities presented their plans to strengthen governance in restructured banks (MEFP ¶13). The government committed to create by end-September a specialized government unit to manage the state's financial sector shareholdings on the basis of an existing division at the Ministry of Finance. The current arrangement governing the relationship between banks and the Ministry of Finance will be aligned with best international practice. The authorities highlighted that the DGF had completed the filing of 112 potential cases of wrongdoing in the banks under its temporary administration. There was agreement that an independent, professional, and comprehensive assessment of the causes for bank failures was needed to identify and address potential governance issues. The DGF is now scheduled to complete by end-August 2014 an action plan to arrange comprehensive legal due diligence of banks and to launch the first two investigations by end-November 2014. The authorities also concurred that analyzing current practices to dispose assets from failed banks with the aim to maximize recovery value would be useful.

Enhancing banks' capacity to resolve bad loans

27. The authorities will work with banks on incentive schemes for voluntary debt restructuring. The Law forcing conversion of household FX mortgages into Hryvnia (¶21) entailed considerable risks for banks, potentially leading to losses of up to 1 percent of GDP. In particular, a poorly targeted approach could have led to demands for similar treatment of other segments of bank portfolios as well as generated perverse incentives for strategic loan default. In this context, staff stressed the importance of establishing an institutional framework that supports case-by-case voluntary restructurings consistent with best practices. The authorities agreed that the implemented scheme should aim to help borrowers in real need and preserve sound debt payment culture. To this end, they will work with Parliament to amend the draft law passed on first reading in line with these objectives and pass it by end-September *as a structural benchmark* (MEFP ¶14). The new Law will be supported by (i) a Code of Conduct to guide negotiations between borrowers in difficulty and banks, establish debt restructuring guidelines, and introduce an appeal process, and (ii) amendments to the tax code to allow banks to deduct losses stemming from the debt workouts while borrowers will not be required to recognize most of the associated income. Looking ahead, the authorities also committed to enhance the legal and regulatory framework associated with out-of-court arrangements and the insolvency law.

FISCAL POLICY

There was agreement that the fiscal revenue shortfall in 2014 could be partly accommodated to avoid undue strain on economic and social outcomes, while a tightening of the fiscal stance in 2015–16 relative to the original program targets would help contain adverse consequences on the debt dynamics and support external adjustment. Given the authorities' medium-term fiscal goals of stabilizing budget revenues and embarking on an expenditure-led fiscal consolidation path that distributes the burden of adjustment equitably, discussions also addressed reforms to achieve these objectives.

A. Recent Developments

28. The end-May general government deficit target was met comfortably supported by one-off factors. In January–May, tax revenue underperformed by ¼ percentage point of GDP relative to program projections, with the impact of revenue losses from the East being only partly offset by the tax policy measures adopted in April, breaking of fraudulent schemes of the previous regime, and the effect of higher than projected inflation and currency depreciation. However, the combination of the frontloading of the NBU profit transfer (UAH 22 billion in the first five months of the year compared to a UAH 22.8 billion budgeted for the full year) and under-execution of budgeted spending on goods and services and capital—in turn prompted by significant liquidity constraints—has kept the government deficit well below the end-May target. Financing constraints led to some accumulation of unpaid bills (¼ percent of GDP at end-May) and reduction in VAT refunds (by ¼ percent of GDP relative to January–May 2013); however, the deficit target would have still been met in the absence of these developments.

29. However, fiscal pressures stemming from the deterioration of the security situation and the weaker economic outlook would have opened a gap of about 1.6 percent of GDP relative to the program deficit target for 2014 in the absence of additional measures. The conflict in the East has weakened tax compliance, contributing to a rapid worsening in tax collections from that region. The end-July general government deficit target is still expected to have been met (although final data are not yet available), as spending is highly constrained under current financing strains. Nonetheless, in light of the tax collection underperformance to date and taking the revised macroeconomic projections into account, overall revenue would have underperformed by close to 1 percent of GDP, despite an unplanned EU grant (0.3 percent of GDP).[5] The authorities also indicated they saw a need for higher military spending to the tune of 0.6 percent of GDP—to be offset by other spending cuts (see below). Overall, the general government deficit would have exceeded its target by about 1.6 percent of GDP.

[5] Staff estimates that the effective separation of Crimea implies a deficit-neutral reduction of revenue and expenditure of about 1½ percent of GDP each.

30. In addition, higher bank restructuring costs and larger support for Naftogaz will add to general government debt. As described above, staff has revised its projections of government support for the banking system up, bringing the total amounts to 2.8 percent of GDP over 2014–15. At the same time, Naftogaz will need more financial assistance from the government to cover its increased deficit and repay external liabilities (see energy policy section), bringing the total Naftogaz financing bill to 7.6 percent of GDP in 2014—with support in 2015 unchanged (1.9 percent of GDP).

B. Policy Discussions

31. There was agreement to maintain the targeted structural adjustment in the short term and tighten the fiscal stance over the medium term to limit the worsening debt dynamics and support external adjustment. It was agreed that the 2014 headline general government deficit target would be revised upward while preserving the targeted structural adjustment. Nonetheless, in view of the need to limit the deterioration in the debt path (¶34), tight financing conditions, and balance of payments pressures, the headline deficit will be brought below the original program path already in 2015 (text table). Over the program period, the targeted structural adjustment over 2014–16 is now stronger than the one envisaged at the time of the program request. The combined deficit of the general government and Naftogaz has also been raised in 2014 to reflect this recalibration as well as a higher projected deficit for the gas company (see energy section), but will fall below the original program targets in the outer years.

Ukraine—General Government Balances

(percent of GDP)

	2013	2014		2015		2016	
		Prog. Request 1/	Rev. Prog.	Prog. Request 1/	Rev. Prog.	Prog. Request 1/	Rev. Prog.
General government balance	-4.8	-5.2	-5.8	-4.2	-3.9	-3.0	-2.7
Structural balance 2/	-4.6	-3.5	-3.5	-3.0	-2.3	-2.6	-2.0
Structural adjustment	-0.2	1.1	1.1	0.5	1.2	0.5	0.3
Combined general government and Naftogaz deficit	-6.7	-8.4	-10.1	-6.0	-5.8	-4.3	-4.0

Sources: National authorities; IMF staff estimates and projections.
1/ Ratios to GDP are calculated using the updated GDP estimates.
2/ The balance in 2014 treats part of the military spending and the EU grant as one-off operations.

32. To meet the revised budget deficit targets, the authorities have reiterated their earlier commitment to spending restraint and structural fiscal reforms; however, they also introduced some low-quality revenue and expenditure measures.

- To achieve this year's revised target, the government will maintain the nominal wage bill as budgeted and refrain from discretionary increases in pension and social assistance. In addition, the authorities will further reduce low-priority spending by 0.6 percent of GDP in the remainder of 2014 to offset higher military and reconstruction spending (MEFP¶17 and text table below). On the revenue side, the authorities adjusted the policy on VAT exemptions on grain exports and wood and eliminated the PIT exemption on deposit interest income, considering that the measure was of low risk to financial stability. A supplementary budget reflecting these new measures was adopted as a *prior action* for the review.

- However, the authorities also introduced several additional measures, with mixed positive and negative effects. Specifically, on a temporary basis until end-2014 they raised the royalties for extraction of oil and gas and introduced a PIT surcharge of 1.5 percent on all incomes. They also provided a grant to the city of Kyiv to settle its gas debt and set aside additional resources for reconstruction in the East once the conflict subsides. On the positive side, increased reconstruction spending is certainly important for a return to normal life and will support growth once the conflict ends. In the short run it is not inappropriate to finance it by a temporary, low-rate-broad base PIT hike, but next-year reconstruction spending needs to remain consistent with the program's fiscal strategy. On the other hand, the increase in transfers to Kyiv for settling debt obligations gives rise to moral hazard for Kyiv and may create an undesirable precedent for other local budgets. It would have been preferable if these obligations were settled through borrowing by the municipality. Moreover, the large increase in gas extraction royalties may delay investments in this strategically important sector of the economy, especially if expectations that it will be extended beyond 2014 take hold.

Ukraine—General Government

Compensatory Measures (percent of GDP)

Expenditure (net reduction)	0.3
Reduction	0.6
Goods and services	0.2
Transfers to households	0.1
Capital expenditures and net lending	0.2
Transfers to enterprises	0.1
Increase	0.3
Investment (reconstruction) in the East	0.1
Transfers to Kyiv city	0.1
Interest	0.1
Revenue (increase)	0.7
VAT exemptions	0.1
PIT	0.4
Subsoil royalties for extracting gas and	0.1
Total	1.0

Source: IMF staff estimates.

- Agreement was also reached on the measures necessary to achieve the tighter 2015 deficit objective (MEFP ¶18). Adjustment relative to the original program projections will mainly be based on reductions in: (i) the wage bill (0.7 percent of GDP, via limiting the wage increase to inflation indexation and further reduction in the number of employees); (ii) pension spending (0.8 percent of GDP, based on maintaining the pensions' real purchasing power—as opposed to the modest real increases built under the original program—and reforming privileged pensions), and (iii) goods and services (0.3 percent of GDP). These savings will be sufficiently large to offset: (i) the loss in revenue stemming from the weaker economy (0.5 percent of GDP); (ii) higher security spending (0.5 percent of GDP); (iii) higher interest costs brought by the rising debt (0.4 percent of GDP), and (iv) additional capital expenditure for post-conflict reconstruction needs (0.2 percent of GDP).[6]

33. Discussions also focused on reforms to underpin the achievement of the medium-term fiscal objectives. In keeping with the program objective of conducting a mainly expenditure-led consolidation and addressing underlying spending and revenue weaknesses (MEFP ¶18–19), the authorities committed to prepare by end-September a comprehensive reform plan, building on the

[6] The overall increase in capital spending between 2014 and 2015 is 0.6 percent of GDP, the bulk of which will go for reconstruction needs. Moreover, the authorities plan to ask for additional international assistance for this purpose.

recommendations of recent FAD TA missions and in consultation with the World Bank. The key elements of this plan will include:

- *Education reform*. The education system is overstaffed and oversupplied with buildings in spite of a declining student population. The authorities recognize the potential for large cost-efficiency gains in the sector. Reform options include increasing the teaching load of public school teachers, aligning class and school sizes with average European levels, reducing excessive staffing on the basis of performance reviews, and means-testing of free services provided to students while protecting vulnerable groups.

- *Reform of privileged pensions*. Recent reforms have addressed some shortcomings in Ukraine's pension system but will only generate savings in the medium term. In the meantime, given that about a quarter of pension spending is allocated to the so-called privileged pensions, further reform of these special regimes, which offer significantly higher benefits, could generate substantial savings while increasing equity. The authorities agreed to prepare legislative proposals to restrict eligibility for privileged pensions and reduce their cost, including by keeping at their current nominal levels the benefits paid to pensioners in these groups (except for those at the subsistence minimum) until end-2015, closing some of these systems for new entrants, and expanding taxation of high-income pensioners.

- *Reform of the agriculture VAT regime*. The authorities are working on a reform plan (*structural benchmark* for end-September) aimed at bringing the preferential VAT treatment of this sector closer to the general VAT regime.

- *Tax administration reform*. The authorities will take steps to: (i) improve administration of large taxpayers and largest tax debtors with a view to improve service and improve collections of current and past-due taxes; (ii) facilitate identification of under-declared wages by strengthening risk-based assessments and enabling the use of tax returns by the tax administration for that purpose.

34. Ukraine's public and publicly guaranteed debt remains sustainable, although its peak level and attendant risks have increased. Under the revised program scenario, debt rises to 68 percent of GDP in 2014 and peaks at 73 percent in 2015, 12 percentage points higher than originally programmed, reflecting mainly a weaker exchange rate and higher needs for government support to Naftogaz and banks. Thereafter, it declines toward 50 percent of GDP by 2019, under the targeted fiscal and quasi-fiscal adjustment. Gross financing needs of the public sector also increase by some six percentage points of GDP in 2014 relative to program before converging back as the temporarily higher liquidity needs dissipate. Although all standard shocks and scenario-based stress tests push debt above 75 percent of GDP in the short run, none of it produces unsustainable intrinsic dynamics (see Debt Sustainability Analysis in Annex I). The increase in public debt above 70 percent of GDP in 2015 causes the heat map to deteriorate relative to program, indicating that risks have increased. However, several factors mitigate risks to debt sustainability. First, the projected rise in the share of Hryvnia debt to 31 percent at end-2014 and 37 percent at end-2015 reduces risks related to exchange rate depreciation. Second, public debt includes all government-guaranteed

debt—including IMF lending to the NBU, which has been serviced out of resources outside the budget. Called guarantees—excluding Naftogaz, the support for which is fully accounted for— have historically been very low at about 1 percent of the total guaranteed debt. Finally, the NBU itself holds about a quarter of government debt, importantly mitigating rollover risks.

ENERGY POLICY

Reforms to modernize and restructure the energy sector are critical to enhance its efficiency and reduce its fiscal drag. Discussions for the first review focused on ways to address Naftogaz' large funding needs as well as next steps in the structural reform agenda.

A. Recent Developments

35. The dispute between Naftogaz and Gazprom has led to an interruption of gas flows to Ukraine. Despite intense negotiations and a US$786 million payment in late May, the parties failed to reach an agreement on the gas price after 2014:Q1 and full clearance of unpaid bills, and Gazprom stopped gas supply to Ukraine in June. Both companies filed claims in the arbitration court in Stockholm. Naftogaz claims US$6.3 billion for overcharges since 2011, while Gazprom is asking for US$4.5 billion for gas delivered and unpaid in 2013–14. Moreover, Naftogaz has requested revisions in the gas contract with Gazprom to make the price responsive to market developments and required import volumes reduced in line with Ukraine's current needs. The arbitration process could be protracted, but it is expected that under an emergency procedure the court will make a preliminary decision in the near future in order to allow the two parties to continue to do business with each other at an interim price until the final decision is made. Meanwhile, Naftogaz intends to purchase additional gas through reverse flows from EU countries to ensure sufficient gas supply through the heating season.

36. After raising the gas and heating prices as prior actions for the program approval, the authorities have made steady progress on the next steps of their energy sector reforms.

- The first cash flow audit of Naftogaz accounts for end-May was completed in early July, with a slight delay from the original schedule (*structural benchmark* for end-June). The audit verified the accuracy of Naftogaz's reporting of its financial results under the program.
- The law necessary to introduce mandatory distribution accounts in the district heating sector—and help improve collection of gas bills by Naftogaz—has been adopted by Parliament (end-June *structural benchmark*). Subsequently, a government resolution was adopted to ensure full implementation. The accounts should be operational by end-August.
- The government has launched the process of restructuring Naftogaz. A law expressing the intention to create two distinct companies for storage and transit of gas has recently been passed.

- The new targeted social assistance scheme to offset the tariff increases for the low-income households became operational on July 1. The Ministry of Social Policy held an information campaign about the introduction of the new scheme in June.[7]

37. However, Naftogaz' deficit and financing needs in 2014 have widened considerably relative to program projections. First, the more depreciated exchange rate will raise the deficit, as prices for households and heating companies would remain as originally programmed in 2014. Second, notwithstanding efforts to improve gas bill collections, lower sales volumes resulting from energy-saving measures will reduce the company's revenue, while costs will decline less than proportionately. Third, the need to pre-pay for gas imports vs. the usual post-delivery payment mode will add to the deficit on one-off basis in 2014. Fourth, these effects will be partly offset by the expected increase in transit revenue during the fourth quarter and other saving measures. Accordingly, Naftogaz' operational deficit for the year has been revised up to 4.3 percent of GDP, one percentage point higher than programmed. On the financing side, difficulties in collecting receivables from heating companies and industrial consumers, as well as potential repayment of external liabilities at the more depreciated exchange rate, are adding to Naftogaz's demands on financing from the state.[8] All told, Naftogaz is going to need 7.6 percent of GDP in financial support from the state in 2014 compared to 4 percent of GDP envisaged at the time of the program request.

Factors contributing to Naftogaz financing needs increase relative to program
(percent of GDP)

Exchange rate effect	0.7
Net sales shortfall	0.7
Pre-payment for gas	0.3
Transit revenue	-0.4
Other savings	-0.4
Total deficit increase	1.0
Increase in other financing needs, o/w:	2.5
- inability to collect domestic receivables	1.6
- repayment of external liabilities	0.9
Total financing need increase	**3.5**

Sources: Naftogaz and IMF staff estimates.

B. Policy Discussions

38. Discussions focused on steps to ensure Naftogaz' ability to meet its financial obligations both with government support and through its own efforts to collect revenue:

- Staff and the authorities agreed to accommodate the larger Naftogaz financing needs in 2014 on the condition that Naftogaz and the government take additional steps to strengthen the collection of current and past bills (MEFP ¶23).[9] To this end, a working group involving Naftogaz, the Ministry of Finance, and other stakeholders has been formed to assess the size of receivables and develop a monthly collection plan for September 2014–December 2015 (*structural*

[7] Between the existing and the newly-introduced scheme, 4.5 million families, about 27 percent of the total, will receive government assistance with their utility bills.

[8] Naftogaz is facing difficulties in collecting these bills, as receivables from heating companies stem from past underpayment of central government subsidies to compensate for the below-cost heating retail price. Moreover, a number of claims on companies are subject to court proceedings.

[9] This support will take the form of recapitalizing the company and thus would be recorded below the line.

benchmark). The plan will have targets by customer category to maximize the collection of arrears and make sure that customers remain current on their bills. The authorities will also identify and prepare the legal changes necessary to remove obstacles to more effective enforcement methods and debt rescheduling.

- As most of the deficit increase in 2014 is either exogenous or one-off, Naftogaz is targeting a return to the programmed deficit of 1.9 percent of GDP in 2015. Moreover, the authorities remain committed to eliminating the company's operational deficit by 2018. To this end: (i) the authorities will continue to adjust end-user gas and heating prices over the program period as needed to achieve the targeted deficit; (ii) the respective gas and heating market regulators will also continue to ensure that the component of the retail price received by Naftogaz gradually converges to its production and import cost, and (iii) prices for industrial and budget consumers will reflect movements in the exchange rate and gas import prices with a lag of one quarter.

- In order to ensure that the program is fully financed and not subject to financing risks stemming from the commercial dispute with Gazprom, Naftogaz has deposited US$3.1 billion in a restricted account with the NBU as a *prior action* for this review. Payments out of this account will only be channeled to settling gas bills and arrears with Gazprom, if and when such payments need to be made according to an interim or final arbitration decision or out of court settlement between the two companies.

39. Staff stressed the need to further advance structural reforms to increase transparency, modernize the energy sector, and attract investment. While the recent legislative steps taken by the authorities are encouraging, additional legislative action will still be necessary to allow foreign direct investments in the gas market. These steps will be important to foster transparency, attract fresh capital, and modernize the sector.

GOVERNANCE AND TRANSPARENCY

Reforms to address governance issues and improve the business climate are critical to generate high and sustainable growth. Discussions focused on designing a reform program to tackle corruption, streamline the regulatory environment for businesses, and strengthen the judiciary to ensure the enforcement of commercial claims.

A. Background

40. Notwithstanding the pushback from special interest groups, the new government has committed to improving the business climate and fighting corruption. The reform agenda will be developed gradually during the course of the program, as priorities move away from economic stabilization toward medium-term objectives. To this end, in consultation with IMF staff, the government conducted a diagnostic study on governance issues to identify areas for reforms, focusing on tackling corruption and improving business climate and the effectiveness of judiciary (*structural benchmark* for mid-July).

41. Other international partners are also supporting reforms in governance and the business climate.

- The *World Bank* does this through its Development Policy Loan (DPL) series. On governance, the first DPL (approved in May) supported policies to reform public procurement and preparation of legislation to establish external verification of financial disclosures by elected and senior public officials. Further actions, likely to form part of the second DPL in late 2014 will seek to strengthen the governance aspects of the public investment management framework, make the said legislation on verification of financial disclosures fully operational, and expand coverage of external audits of state budget revenue. In this context, the government has committed to strengthen the income and asset declaration, verification and publication framework as it applies to high-level pubic officials (MEFP ¶24). On the business climate, the DPL series aims to strengthen the regulatory framework and reduce costs of doing business. Here the policies include improving the transparency and ease of VAT refunds (consistent with the SBA's policies on the matter), easing business and property registration, and rationalizing the authorities' permit and licensing policies.

- Institutional reforms and reduction of endemic corruption are one of the key priorities of the *European Bank for Reconstruction and Development* (EBRD) in Ukraine, covering the strengthening of non-state institutions and advocacy for fair treatment of businesses, including through the establishment of an independent Business Ombudsperson.

- The *European Commission* has been recommending further improvements to Ukraine's anti-corruption legislation, including the strengthening of mechanisms for independent oversight on asset disclosure and the reform of rules on the immunity of members of parliament from criminal proceedings. Anti-corruption conditionality has also been included in recent EU initiatives (the EU State Building Contract for example, as well as the EU-Ukraine Visa Liberalization Action Plan).

- The *Council of Europe Anti-Corruption Group* (GRECO) has made recommendations on the composition of Ukraine's National Anti-Corruption Committee created in 2010 to analyze the corruption situation in Ukraine, to develop strategies against this phenomenon and to monitor their implementation. It underscored the importance of its independence, which should be broad-based and representative of society. The *Council of Europe Anti-Money Laundering Group* (MONEYVAL) has also recommended various improvements in the AML/CFT regime.

B. Policy Discussions

42. A strong push to improve governance, transparency and fairness would go a long way in helping Ukraine tap its large economic potential. Staff highlighted that this would require vigilance and strong political will to resist vested interests, as highlighted by recent efforts in Parliament to water down procurement rules. The authorities recognized this. In addition to the priorities highlighted below to tackle corruption, streamline business regulation and strengthen the effectiveness of the judiciary, they are committed to further improve governance, transparency and

fairness in tax administration, including through reforms to strengthen tax compliance of high income earners and those with foreign assets, and to address delays and weak transparency in granting VAT refunds (MEFP ¶26).

43. Building upon their recent diagnostic study conducted in consultation with Fund staff, the authorities have agreed to take specific steps to increase transparency and address corruption, including by strengthening the AML/CFT framework:

- An independent anti-corruption agency with broad investigative powers will be created (MEFP ¶24). The agency will detect and investigate corruption offences and acts of laundering of proceeds of corruption among high-level officials, as well as other corruption offences that constitute a particular danger to society and including those reflecting allegations received through a public hotline. It will also have powers of asset recovery related to its own investigations. Enabling legislation will be submitted to Parliament by September 1, 2014 (*structural benchmark*), for adoption by end-October (*structural benchmark*). In support of the agency's effectiveness, staff and the authorities agreed that designated prosecutors would be in charge of prosecuting the cases under the jurisdiction of the agency while reporting to the Prosecutor General. The exact arrangement will be a key topic of discussions for the second program review.

- Amendments to the AML law and the criminal code will be submitted to Parliament by September 1, 2014 (*structural benchmark*), for adoption by end-October (*structural benchmark*). The objective will be to introduce key elements of the FATF standard to support the government's anti-corruption effort.

44. Staff and the authorities also discussed the approach and timeline to streamlining the regulatory framework pertaining to economic activity. Staff stressed that a comprehensive strategy was needed to address the overbearing legislative and regulatory framework which affects the business climate, investment and growth. In view of the complex endeavor, it also highlighted that a clear and specific action plan, with high-level coordination would increase the chances of success. The government will take a formal decision (*prior action*) to establish by end-August a coordinating body subordinated to the Cabinet of Ministers to lead the regulatory simplification effort. One of this entity's first tasks will be to prepare an action plan to streamline, simplify and clarify the legislative and regulatory frameworks governing economic activity, which will be adopted by the government by end-October (*structural benchmark*).

45. A specific reform agenda to strengthen the effectiveness of the judiciary will be developed in the months ahead. The authorities concurred with staff's view that more should be done to ensure the enforcement of commercial claims. This will require a combination of reforms aimed at: (i) strengthening judicial independence; (ii) reinforcing institutional integrity; (iii) improving organization and procedure to enhance the effective and efficient processing of cases; and (iv) strengthening post-court enforcement.

PROGRAM FINANCING AND MODALITIES

46. The program remains adequately financed over the next 12 months. The bulk of committed external financing has arrived on time so far. However, relative to the programmed financing at the time of the SBA request, a shortfall of about US$1.1 billion and US$2.4 billion will materialize in 2014 and 2015, respectively—about US$1.1 billion over the next twelve months, as the shortfall in 2015 falls mainly late in the year. These reflect mainly revisions in projections for the speed of project implementation and the associated financing in the difficult political and security environment. To cover the shortfall in the next 12 months, the authorities plan to tap the sovereign debt market later in 2014. Efforts to secure further bilateral support from donors (some US$0.9 billion) for the remainder of the program period are ongoing, and there are good prospects for such additional financing.

47. The program continues to meet the criteria for exceptional access:

- **Criterion 1**: *The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account resulting in a need for Fund financing that cannot be met within the normal limits.* While the current account deficit is projected to shrink to sustainable levels by end-2014, Ukraine continues to experience exceptional balance of payments pressures emanating from the capital account. Official reserves continue to be at dangerously low levels, with significant payment obligations coming due this year. In addition, the conflict in the East and geopolitical tensions generate significant risks. Together, these factors continue to generate actual and potential financing needs beyond what can be financed within normal limits.

- **Criterion 2**: *A rigorous and systemic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over the period, exceptional access would be justified if there is a high risk of international systemic spillovers.* In staff's view, this criterion is met—there is a high probability that Ukraine's public debt is sustainable in the medium term. While the updated DSA now shows that the high-risk benchmark of 70 percent is breached under the baseline, this violation is projected to be short-lived, with the debt-to-GDP ratio rapidly converging towards 50 percent over the medium term under reasonable baseline assumptions. The efforts of the authorities and the international community to resolve the conflict appear to reduce the probability of protracted conflict and associated risks to debt sustainability described in Box 2. The DSA nonetheless indicates vulnerabilities and risks emanating from the gross financing needs and the debt profile. However, risks to debt sustainability are mitigated by: (i) the declining share of debt in foreign currencies, (ii) the fact that historically only a small fraction of government guaranteed debt has been called, while all guaranteed debt is included in the definition of public debt, and (iii) NBU holdings of a substantial share (25 percent) of public debt, which mitigates rollover risks.

- **Criterion 3**: *The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding*. Ukraine's loss of access to capital markets is linked largely to domestic vulnerabilities and policies, though geopolitical events have also played a role. Notwithstanding a worsening in the security situation and geopolitical tensions, Ukraine CDS and bond spreads have substantially improved since the program approval, indicating that prospects for regaining market access continue to improve. Staff anticipates that with a successful implementation of program measures, combined with support from the broader international community, Ukraine has good prospects of regaining greater access to private capital markets within the timeframe when Fund resources are outstanding.

- **Criterion 4**: *The policy program provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment*. Staff believes that this criterion continues to be met. Recent policy performance has been generally good and the program includes a new set of strong prior actions and additional structural conditionality. A more conservative macroeconomic and fiscal framework—including by incorporating the implications of events in the East—has also been adopted to reduce the risks to achieving program targets. The fiscal adjustment measures implemented in the context of this review and agreements reached on the 2015 budget will support the targeted adjustment in 2015 as well. Full implementation of critical structural reforms remains a key component of the program. In spite of the recent political events, the fact that the current government and Parliament will remain in place until the possible parliamentary elections provides assurance the authorities will undertake the agreed policies. The completion of the prior actions provides a welcome safeguard in this respect. Moreover, staff is seeking assurances from major political parties that they support the program's key objectives and policies (¶53). In addition, management has secured assurances from the European Union, Russia, and the United States that they are committed to working with all relevant parties to help restore peace and security within Ukraine as soon as possible, thereby laying the basis for economic stability and recovery.

48. Ukraine's capacity to repay the Fund remains adequate under the baseline, but is subject to exceptionally high risks. Under the revised program baseline, the Fund's exposure to Ukraine is projected to peak at 11.8 percent of GDP in 2015. Debt service is expected to gradually increase to 8.5 percent of exports of goods and services or 4 percent of GDP by 2019. Reserve buffers have been reduced markedly to accommodate the exogenous shock faced by the economy. However, renewed commitments to further adjustment in the face of this shock will help gradually improve Ukraine's balance of payments, rebuild these buffers, thus enhancing the country's capacity to service its external obligations. Ukraine's capacity to repay will also hinge on the international community's delivering on its financing commitments throughout the program period. For this to happen in a timely fashion, the authorities must continue to implement the program in full and meet applicable conditionality for disbursements of such assistance. While Ukraine's capacity to repay the Fund remains adequate in case of successful program implementation, the program's macroeconomic framework is subject to considerable downside risks. Should the adverse scenario materialize (Box 2), the risks to Fund repayments will become exceptionally high.

49. Rising public financing needs and restricted market access justify an allocation of additional Fund financing for the budget in 2014. International debt markets have not yet fully reopened to Ukraine in amounts necessary to cover the large public financing needs. Moreover, accommodating the increasing public sector financing needs related to Naftogaz external payments have necessitated a significant upward revision in the NBU budget financing for the rest of the year. In this situation, the authorities have requested that the domestic currency counterpart of SDR 0.650 billion (equivalent to about US$1 billion, 0.7 percent of GDP) out of the second purchase under the SBA be used to finance the budget deficit. Such use of Fund financing is consistent with the Fund's relevant policy framework.

50. Given the delay in completing the first program review, the program disbursements need to be rephased. Staff proposes to consolidate the third and fourth purchases originally linked to the second and third reviews and make the consolidated amount available in one purchase in mid-December 2014 subject to the completion of one single review (i.e., eliminate one program review) on the basis of the observance of the end-September and continuous performance criteria. This approach would keep the Fund's financing of the program unchanged in 2014—subject to successful program implementation—and thus be conducive to continuing timely provision of planned financing by Ukraine's other international partners. Staff will work with these partners to ensure that the program remains fully financed.

RISKS TO THE PROGRAM

51. Downside risks to the program remain very high. A number of geopolitical and economic developments could complicate program implementation significantly, by affecting confidence and weighing on economic activity, fiscal performance, and balance of payment flows:

- *Tensions in the East.* A further intensification of the conflict or its extension beyond the next few months could generate a deeper recession, larger fiscal pressures—stemming from both revenue underperformance and additional needs for military spending—and further capital outflows and international reserve losses. To illustrate these risks and attendant potential financing implications, staff has prepared an alternative scenario (Box 2) where the rapid drop in international reserves calls for a rethink of the current financing strategy, including significant additional external support needs. And given Ukraine's debt situation, new external loans may need to have a strong concessional element. An even more extreme scenario in which the central government loses effective economic control for purposes of implementing their economic policies in the East is also a risk.
- *Relations with Russia.* Lack of progress in improving bilateral relations with Russia could complicate the security situation, impede normalization of trade relations, and increase Ukraine's country risk premium. Russia has already imposed non-tariff restrictions on imports of various agricultural and food products from Ukraine. Moreover, there is a risk that, in response to Ukraine's signing of the Associated Agreement with the EU, Russia will cancel its free trade agreements with Ukraine and raise customs duties on Ukrainian imports to MFN levels, or up to

Box 2. Illustrative Adverse Scenario

To illustrate the risks and attendant potential financing implications of a prolonged conflict and confidence crisis, staff has prepared an adverse scenario. This scenario assumes that fighting in the East continues at the current level of intensity throughout 2015, as opposed to the baseline assumption that fighting tapers off in the coming months. Weaker confidence deepens the recession, entailing additional fiscal financing needs (that can only be met through monetization), and generates significant balance of payment pressures, even though all planned official financing is assumed to be disbursed as under the baseline. In order to assess the additional financing needs this scenario entails, external pressures are assumed to be met by central bank intervention and the exchange rate remains unchanged compared to the baseline, thereby opening a large financing gap if central bank reserves are to be maintained at the currently programmed level.

Real GDP growth is revised down from -6½ to -7¼ percent in 2014 and from 1 to -4¼ percent in 2015. Weaker consumer and business confidence leads to a much deeper contraction in private consumption and investment. Exports in 2014 are also falling much more than projected earlier as a result of rapidly deteriorating relations with Russia and disruptions in activity in the industrialized East. Exports rebound in 2015—from a low level—on the back of improved competitiveness and the free trade agreement with the EU, but at a slower pace than under the baseline.

On the **financial side**, hryvnia deposits are assumed to stabilize, but the downward trend in FX deposits continues. The pressures on banks require higher government recapitalization of banks and support for the DGF.

Notwithstanding a more favorable current account deficit path, the **balance of payments** is weaker than projected at the time of the program request—by over US$7½ billion in 2014 and US$11½ billion in 2015—reflecting reduced FDI, higher outflows from the banking system, much lower liability rollover rates for banks and corporates (and no external market access for the sovereign), and substantial capital flight. Meeting these external pressures while maintaining the programmed central bank gross international reserves would require additional external financing of about US$19 billion by end-2015 relative to the baseline.

Ukraine: Adverse Passive Scenario – Selected Indicators

	2014		2015	
	Rev. prog.	Adverse	Rev. prog.	Adverse
Real economy (percent change)				
Real GDP	-6.5	-7.3	1.0	-4.2
Public finance (percent of GDP)				
General government balance	-5.8	-7.3	-3.9	-8.3
Overall balance (including Naftogaz operational deficit)	-10.1	-11.6	-5.8	-10.3
Public debt (end of period)	67.6	68.9	73.4	83.2
Balance of payments (percent of GDP)				
Current account balance	-2.5	-0.6	-2.5	0.1
Gross reserves (end of period, billions of U.S. dollars)	16.2	8.6	23.4	4.4
Gap relative to the revised baseline		-7.6		-19.0

Source: IMF staff estimates and projections.

Budget execution is affected by much larger revenue underperformance resulting from weaker activity and compliance. In the absence of offsetting measures, this as well as higher military spending push the general government deficit up to about 7¼ and 8 percent of GDP, in 2014 and 2015 respectively—compared to 5.8 and 3.9 percent of GDP under the revised baseline.

Reflecting larger general government deficits and additional bank restructuring costs, **public debt** increases to about 69 and over 83¼ percent of GDP, in 2014 and 2015 respectively in the absence of additional measures—compared to 67½ and 73½ percent of GDP under the revised baseline.

These increased government/Naftogaz financing needs are not met by issuance in the domestic market, as the government faces a liquidity crisis, but by NBU's stepped up monetization, fueling further pressures on the reserves.

10 percent on average before any liberalization of trade with the EU has taken place. Since exports to Russia represent a quarter of Ukraine's exports, such a development would inevitably entail a significant cost for the economy and complicate program implementation.[10]

- *Gas dispute.* A protracted disruption of gas supply from Gazprom would risk affecting the operations of energy-intensive industries and lead to deeper-than-projected GDP and export drops. Increased "reverse-flow" gas imports from Central Europe and the government's program to save energy may alleviate this risk, however.

- *Financial sector risks.* Deteriorating loan quality, deposit outflows, and balance sheet losses caused by currency depreciation may result in larger-than-expected capital shortfalls, undercutting credit to economy. Moreover, absent prompt shareholder response, recapitalization or resolution of systemically important banks could require significantly higher budget outlays. The NBU may be called on to provide additional liquidity injections.

- *Program ownership, domestic politics, and other risks.* Possible parliamentary elections in the fall may undermine the authorities' resolve to implement much-needed policy adjustments and persevere with structural reforms. Slippages in program implementation, including those resulting from populist parliamentary initiatives and resistance to anti-corruption efforts may derail the macroeconomic adjustment, weaken confidence and hamper public support for reforms. Growing social tensions in response to rising inflation and unemployment could also exacerbate political risks.

- *Financing.* Should the risks noted above materialize, they could also trigger shortfalls in external financing. Higher political or economic uncertainty may generate difficulties with respect to the planned market access. Similarly, setbacks in program implementation could lead to delays in official financing. There is also a risk of continued shortfalls of private financial flows due to lower-than-expected rollover rates and higher outflows.

- Finally, even if the conflict does subside in a few months, and notwithstanding staff's more conservative assumptions, there are downside risks to the macroeconomic framework (for example financial sector or reconstruction-related investment needs may be larger than expected).

52. Some of these risks are mitigated by the authorities' strong program ownership. With policies implemented essentially as agreed and almost all program conditionality met, the authorities have signaled their resolute drive for reforms. This augurs well for continuing robust program implementation in the months ahead. In addition, management has secured assurances from the European Union, Russia, and the United States that they are committed to working with all

[10] Studies have assessed the impact of such action at a reduction in Ukrainian exports of up to 1.7 percent of GDP. See *Impact assessment of a possible change in Russia's trade regime vis-à-vis Ukraine,* German Advisory Group, Policy Briefing Series PB/04/2013, November 2013, p. 16.

relevant parties to help restore peace and security within Ukraine as soon as possible, thereby laying the basis for economic stability and recovery.

53. Possible early parliamentary elections are not expected to change the direction of economic policy. According to opinion polls, possible early parliamentary elections are likely to return a Parliament with a clear reformist majority, with the President's newfound party joining the Prime Minister's party and other reformist forces. Given that both the President and the Prime Minister—whose signatures are on the Letter of Intent—have expressed strong support for the Fund-supported program, staff does not expect that such an outcome will lead to a change in the thrust of economic policies. Nonetheless, staff is seeking assurances from the key political parties that they support the program's key objectives and policies.

STAFF APPRAISAL

54. Program implementation is off to a promising start. Policies have generally been implemented as planned, as the authorities have persisted in taking difficult and sometimes socially challenging measures despite the extremely volatile political situation. In view of implementation slippages that marred previous Fund-supported programs with Ukraine, the authorities' perseverance and determination are very welcome. This augurs well for their ability to continue to keep the program on track amid a much worse environment than hoped for when the program was approved.

55. However, the conflict in the East is beginning to take its toll on the economy and society. A number of downside risks highlighted at program inception—including an intensification of the conflict in the East and an escalation of the gas price and arrears dispute—have unfortunately already materialized. This is leading to a notable worsening in the economic outlook, budget performance, and balance of payment flows. In light of this, key program targets for end-2014 and beyond are now out of reach.

56. Compensatory measures are critical to bring the program back on track. Drawing down reserves and allowing a higher headline deficit in the short term will help avoid a vicious circle of lower growth, higher deficits, currency depreciation, and rising inflation. However, reserves will need to be rebuilt over time and the increase in public debt will have to be reversed. Specifically:

- **Efforts to accumulate reserves—including by allowing further exchange rate depreciation if needed—are paramount for program success**. As the program path for the NBU's international reserves has been revised downward, it is important to allow the exchange rate to adjust as needed to achieve the new reserve accumulation targets. In this context, steps to unwind deposit restrictions should be gradual and contingent on economic and financial stabilization.

- **Staff calls on the authorities to adhere to the revised fiscal strategy**. A larger budget deficit is appropriate this year to accommodate the temporary loss of revenue caused by the conflict

and avoid undue economic and social hardship. Nonetheless, staying the course of fiscal adjustment in 2015 and beyond is necessary in view of the deteriorating debt dynamics and the significant financing constraints. The targeted fiscal consolidation will also keep the external current account deficit from widening excessively once the economy rebounds. In this regard, incorporating the agreed expenditure and revenue measures in the 2015 budget while refraining from low-quality ad-hoc policies are critical for the success of the adjustment.

- **Stronger efforts are needed to put Naftogaz on a sound financial footing and limit the energy sector drag on public finances**. Given the large losses incurred by Naftogaz, the authorities need to step up efforts to improve collections of current and past gas bills. Beyond the short term, staff welcomes the authorities' commitment to continue adjusting gas and heating prices over time. These steps will contribute to reducing Naftogaz's operational deficit, increasing energy efficiency, promoting domestic production, and alleviating governance problems in the energy sector. The impact of these increases on the most vulnerable will be curbed through the existing and newly established social assistance programs covering over a quarter of the population. As regards the disputed arrears of Naftogaz to Gazprom, Naftogaz will set aside resources in a restricted account to address financial risks to the program stemming from the dispute. This ensures that the program is fully financed. However, staff urges Naftogaz to continue working on a timely resolution of the dispute given its potential impact on the economy.

57. Meanwhile, the authorities must not lose sight of the much-needed structural reforms and economic transformation needs. While it will be challenging to put in place such reforms in the midst of an acute conflict, the crisis and the potential emergency associated with it offers the opportunity to confront vested interests opposing reforms. The success of the program ultimately depends on the authorities' ability to make a decisive break with a past riddled with weak governance, widespread corruption, and abysmal business climate. Following through with the plans to create an effective anti-corruption agency and strengthen the AML framework, as well as steps to simplify the regulatory environment for business activity, will be a critical test of the authorities' willingness to address these issues.

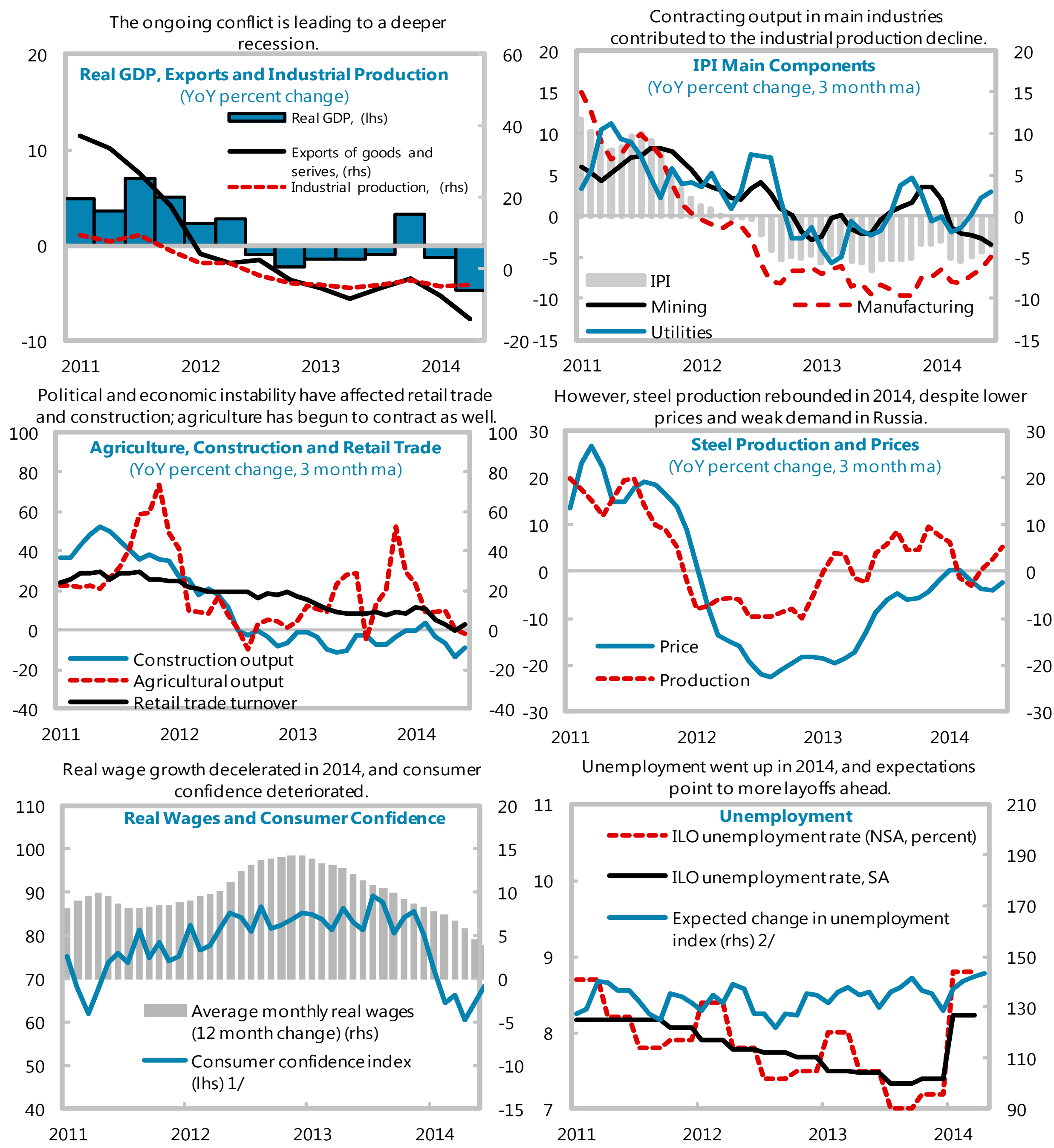
58. The program envisages additional external support. The program remains adequately funded for the next 12 months and there are good prospects for additional financing from Ukraine's international partners in the remainder of the program.

59. Overall, the program remains highly challenging and subject to notable risks. The program hinges crucially on the assumption that the conflict will begin to subside in the coming months. The assurances provided to management on the efforts of key powers to work towards restoring peace and security to Ukraine as soon as possible are critical to this assumption (see ¶52 above). Should the conflict not begin to subside soon, the program strategy would need to be reconsidered and viability would depend critically on the availability of significantly larger assistance from Ukraine's international partners. Further deterioration in relations between Ukraine and Russia—such as a prolongation of the gas dispute or a disruption in non-gas trade—could have

significant economic consequences. Strong policy performance and adherence to the planned reforms is therefore critical to support stabilization and growth.

60. Staff recommends completion of the first review, rephasing of the arrangement and granting the requested waivers for nonobservance and applicability of performance criteria. In particular, staff supports waivers for nonobservance of the end-July PCs on the NBU's NIR and the combined general government-Naftogaz deficit on the basis of the corrective actions put in place to avoid slippages on the Naftogaz deficit, boost reserves, and support the revised program targets. Notwithstanding the unavailability of the information necessary to assess observance of the end-July PCs on the ceiling on cash deficit of the general government, the ceiling on cumulative change in net domestic assets of the NBU and the ceiling on public guaranteed debt, staff recommends the granting of waivers of applicability for these since there is a good chance that they have been met and no clear evidence that they have been missed.

Figure 1. Ukraine: Real Sector Indicators, 2011–14



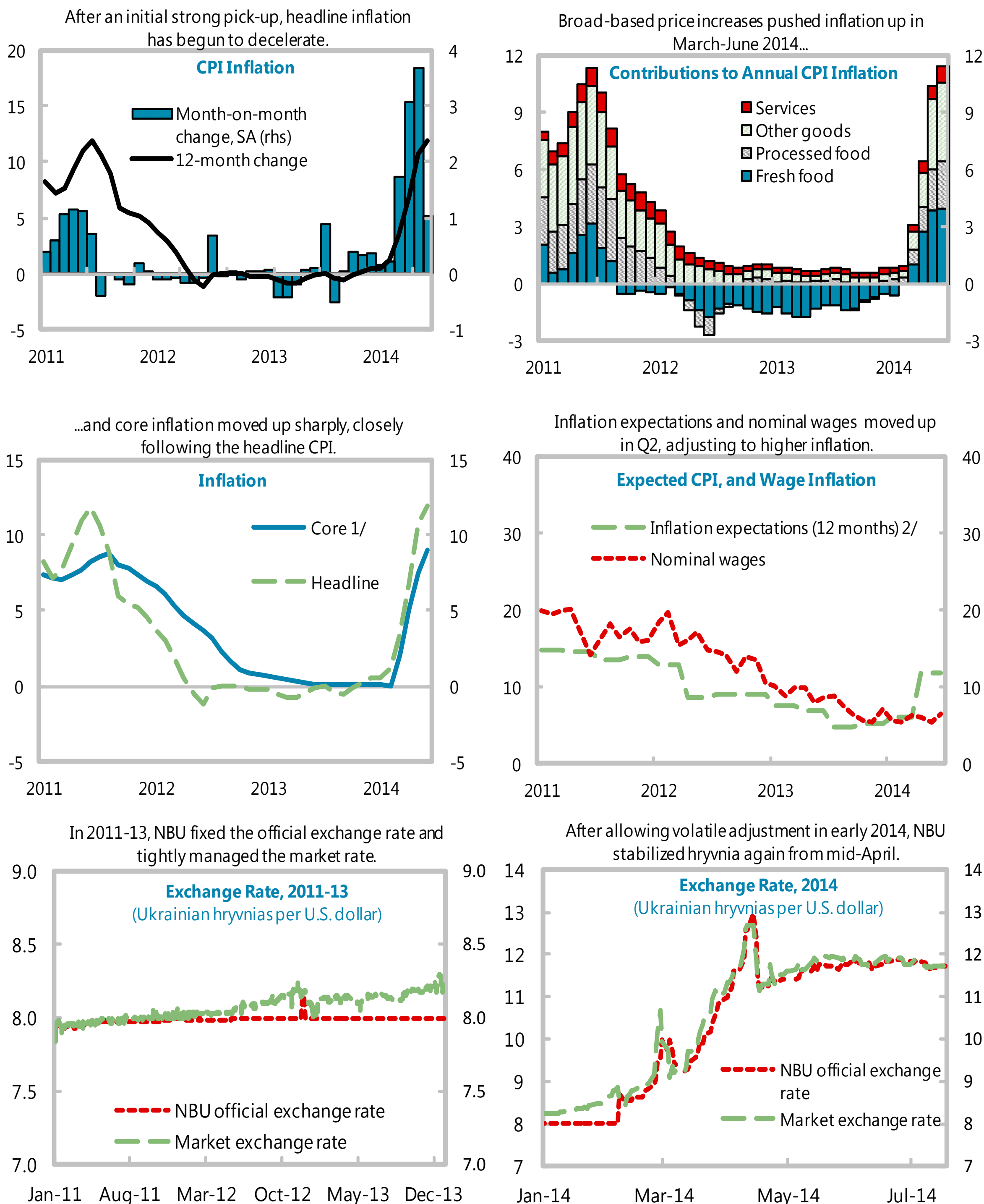
Sources: State Statistics Committee of Ukraine; Haver; Bloomberg; GFK Ukraine; International Centre for Policy Studies; and IMF staff calculations.

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 2. Ukraine: Inflation, Monetary, and Exchange Rate Developments, 2011–14

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



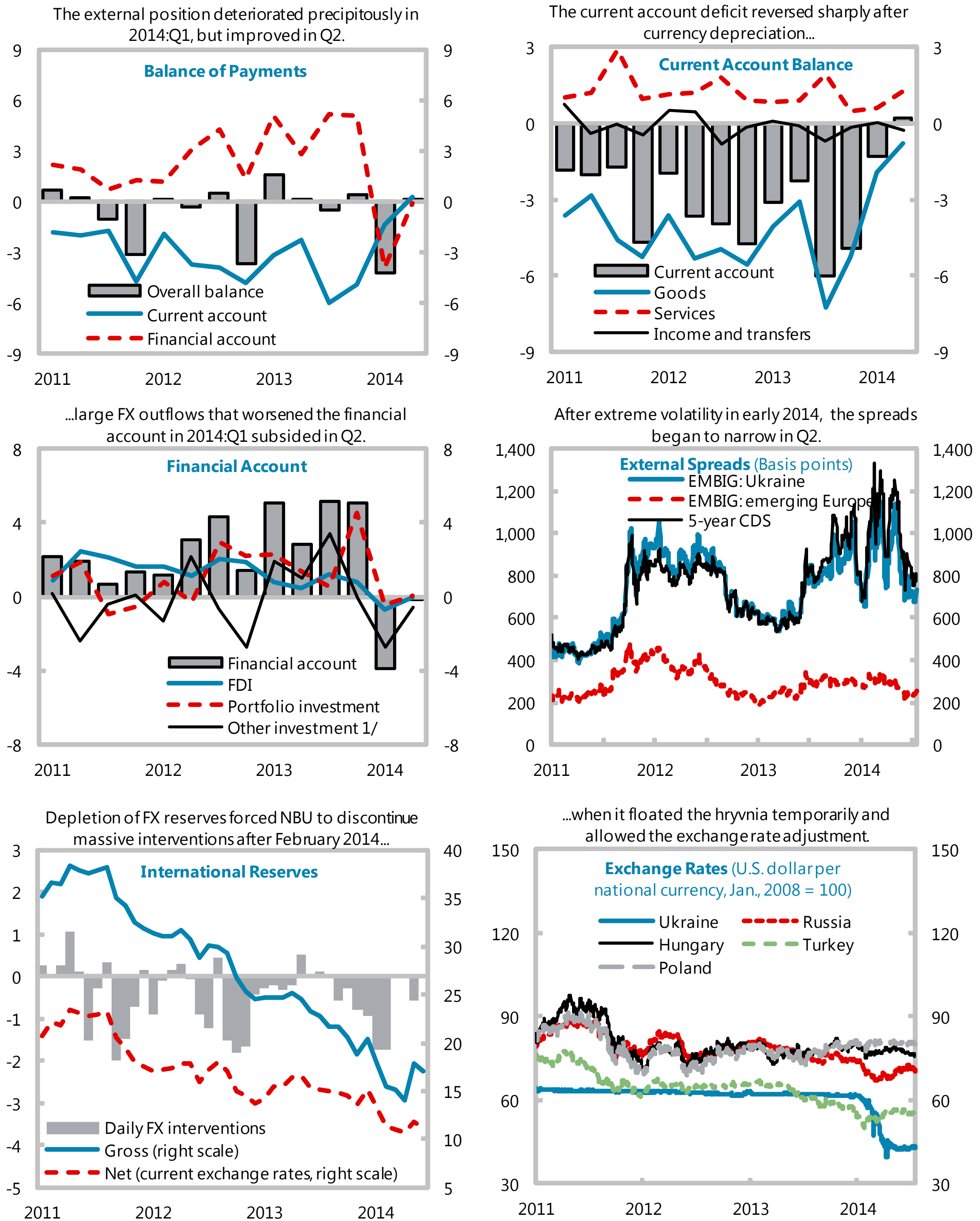
Sources: State Statistics Committee of Ukraine; International Centre for Policy Studies; National Bank of Ukraine; Bloomberg; and IMF staff calculations.

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

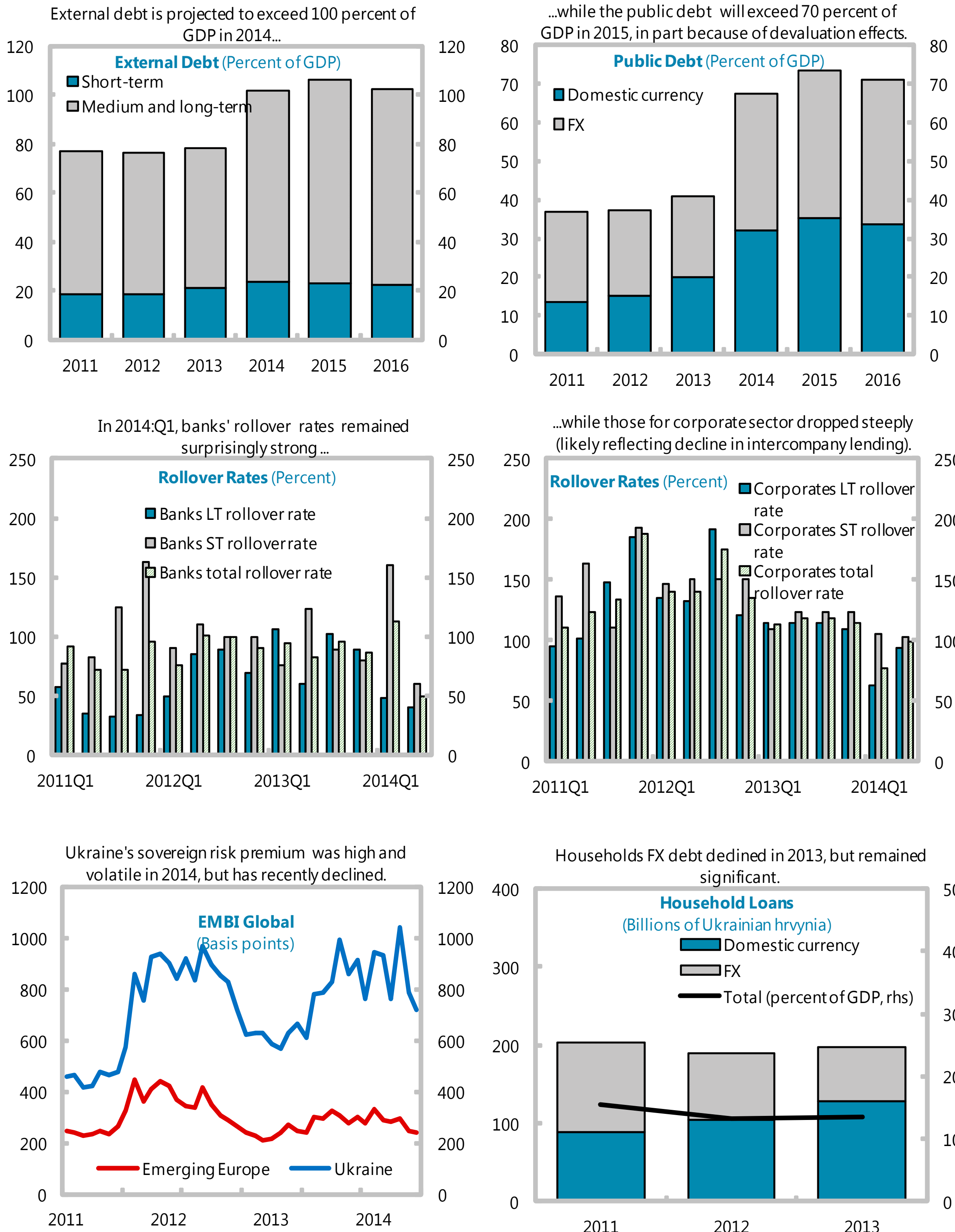
2/ Inflation expectations are surveyed and compiled by the NBU.

Figure 3. Ukraine: External Sector Developments, 2011–14

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



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.



Sources: National Bank of Ukraine; Bloomberg; Ministry of Finance; and IMF staff estimates.
1/ 2014–16 are projections.

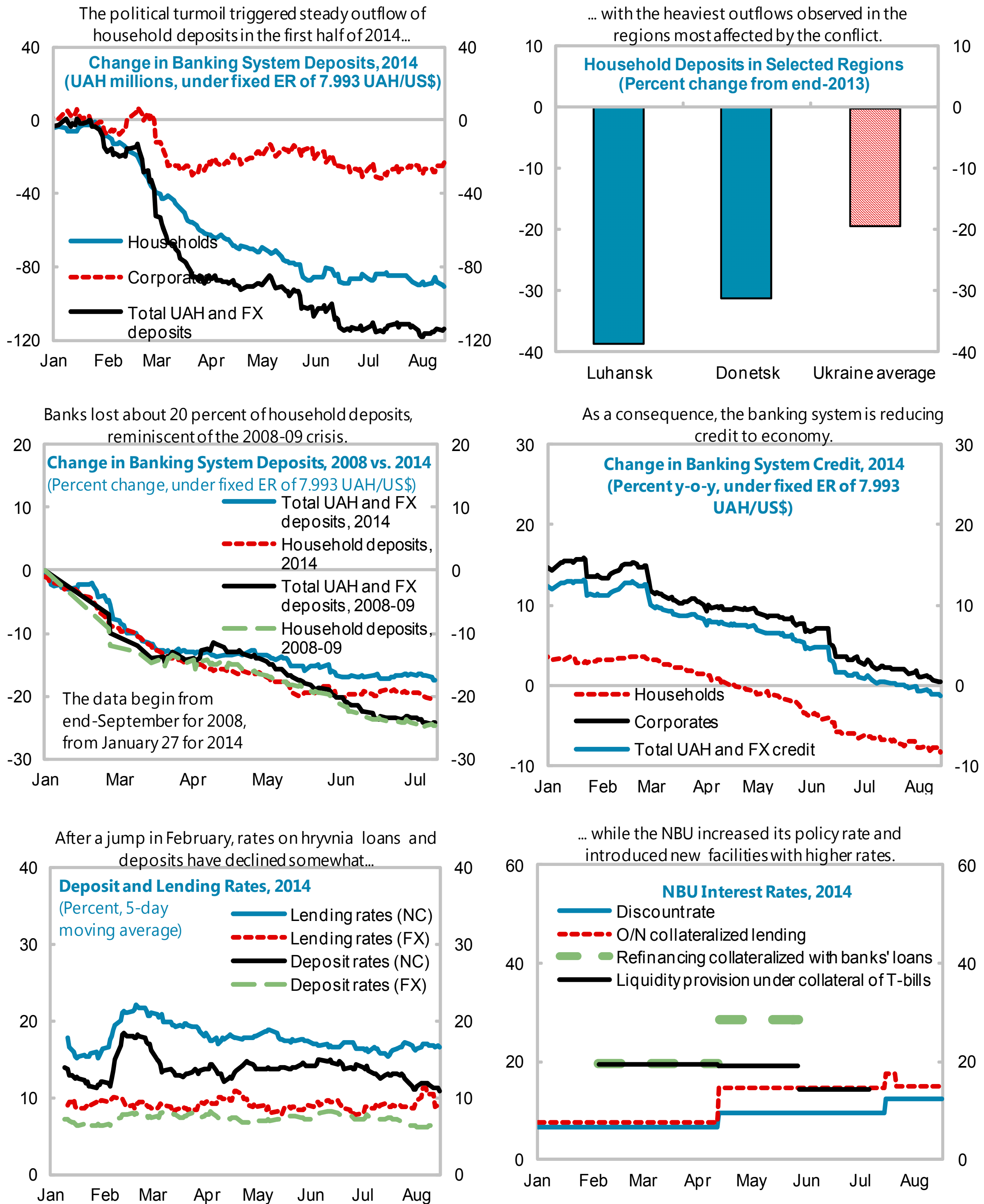
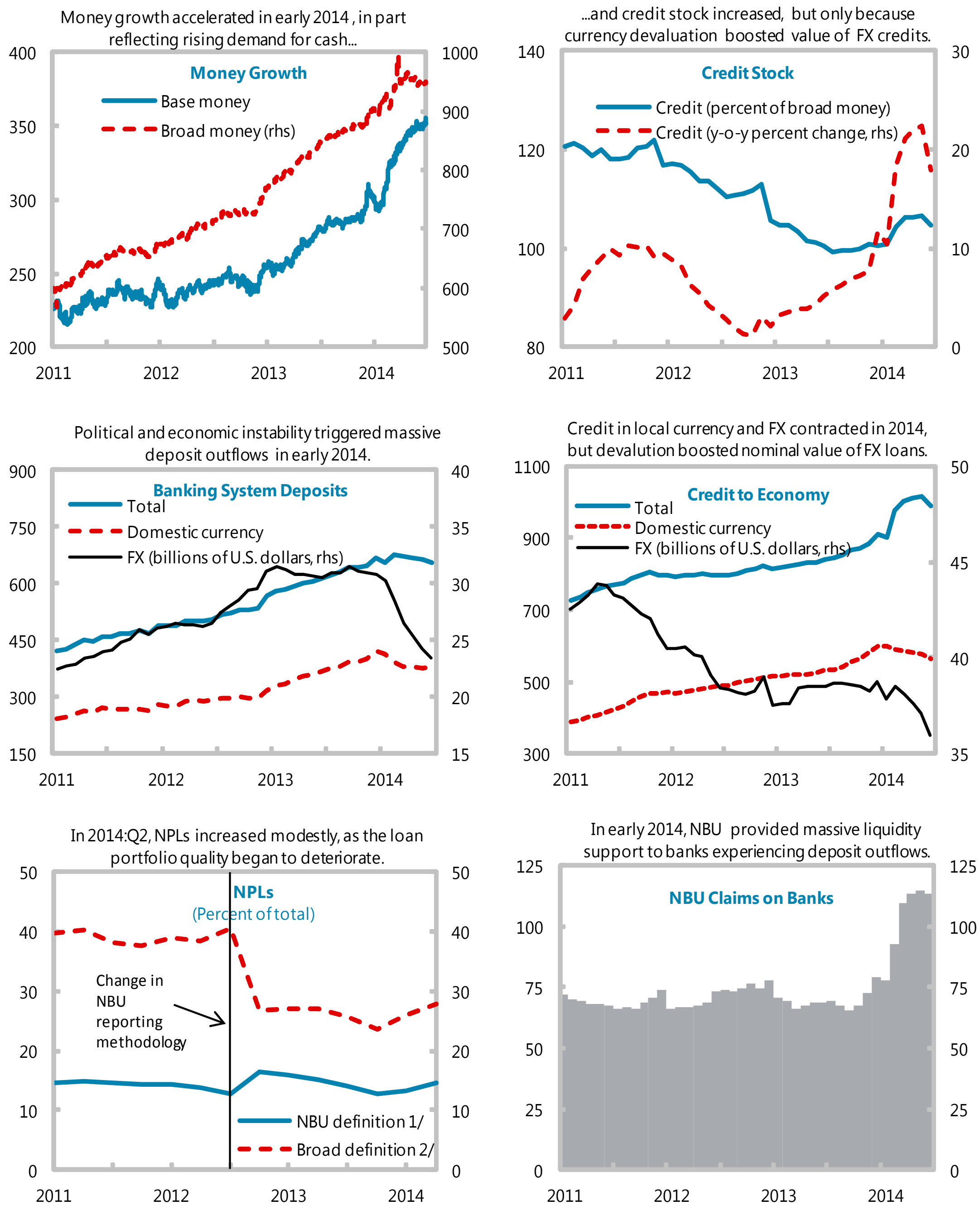


Figure 5. Ukraine: Banking Sector Deposits and Credit, 2014
The political turmoil triggered steady outflow of household deposits in the first half of 2014...
Change in Banking System Deposits, 2014
(UAH millions, under fixed ER of 7.993 UAH/US$)
Households
Corporates
Total UAH and FX deposits
Jan Feb Mar Apr May Jun Jul Aug
... with the heaviest outflows observed in the regions most affected by the conflict.
Household Deposits in Selected Regions
(Percent change from end-2013)
Luhansk
Donetsk
Ukraine average
Banks lost about 20 percent of household deposits, reminiscent of the 2008-09 crisis.
Change in Banking System Deposits, 2008 vs. 2014
(Percent change, under fixed ER of 7.993 UAH/US$)
Total UAH and FX deposits, 2014
Household deposits, 2014
Total UAH and FX deposits, 2008-09
Household deposits, 2008-09
The data begin from end-September for 2008, from January 27 for 2014
As a consequence, the banking system is reducing credit to economy.
Change in Banking System Credit, 2014
(Percent y-o-y, under fixed ER of 7.993 UAH/US$)
Households
Corporates
Total UAH and FX credit
After a jump in February, rates on hryvnia loans and deposits have declined somewhat...
Deposit and Lending Rates, 2014
(Percent, 5-day moving average)
Lending rates (NC)
Lending rates (FX)
Deposit rates (NC)
Deposit rates (FX)
... while the NBU increased its policy rate and introduced new facilities with higher rates.
NBU Interest Rates, 2014
Discount rate
O/N collateralized lending
Refinancing collateralized with banks' loans
Liquidity provision under collateral of T-bills
Sources: National authorities; and IMF staff estimates.

Figure 6. Ukraine: Financial Sector Indicators, 2011–14

(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.

Table 1. Ukraine: Program Scenario – Selected Economic and Social Indicators, 2013–16

	2013	2014		2015		2016
		Prog. Request	Rev. Program	Prog. Request	Rev. Program	Proj.
Real economy (percent change, unless otherwise indicated)						
Nominal GDP (billions of Ukrainian hryvnias)	1,455	1,506	1,524	1,736	1,756	1,978
Real GDP	0.0	-5.0	-6.5	2.0	1.0	4.0
Contributions:						
Domestic demand	0.9	-8.2	-12.4	2.0	-0.2	5.1
Private consumption	5.6	-3.7	-4.5	0.8	0.6	2.5
Public consumption	-0.5	-0.5	-1.6	-0.3	-0.4	-0.1
Investment	-4.1	-4.0	-6.3	1.5	-0.4	2.6
Net exports	-1.0	3.2	5.9	0.0	1.2	-1.1
GDP deflator	3.1	9.0	12.1	13.0	14.1	8.3
Output gap (percent of potential GDP)	-1.0	-3.2	-4.2	-2.3	-3.7	-1.6
Unemployment rate (ILO definition; percent)	7.2	8.5	10.0	8.0	9.8	9.3
Consumer prices (period average)	-0.3	8.3	11.4	12.9	14.0	7.0
Consumer prices (end of period)	0.5	16.2	19.0	7.4	9.0	6.9
Nominal monthly wages (average)	8.0	4.7	5.1	14.0	14.9	10.3
Real monthly wages (average)	8.3	-3.3	-5.7	1.0	0.8	3.1
Savings (percent of GDP)	6.5	5.0	5.6	7.1	5.2	8.5
Private	9.4	8.7	10.1	9.5	7.2	9.1
Public	-2.8	-3.7	-4.5	-2.4	-1.9	-0.5
Investment (percent of GDP)	15.7	9.5	8.2	11.4	7.8	11.2
Private	13.7	8.0	6.9	9.5	5.8	9.0
Public	2.0	1.5	1.3	1.9	2.0	2.2
Public finance (percent of GDP)						
General government balance 1/	-4.8	-5.2	-5.8	-4.2	-3.9	-2.7
Overall balance (including Naftogaz operational deficit)	-6.7	-8.5	-10.1	-6.1	-5.8	-4.0
Structural general government balance	-4.6	-3.6	-3.5	-3.1	-2.3	-2.0
Public debt (end of period) 2/	40.9	56.5	67.6	62.1	73.4	71.1
Money and credit (end of period, percent change)						
Base money	20.3	21.5	27.7	14.8	19.7	16.6
Broad money	17.6	11.8	12.0	17.6	16.4	13.2
At program exchange rate	15.7	2.9	-2.0	14.5	14.6	13.0
Credit to nongovernment	11.8	8.7	9.8	11.7	6.9	8.0
At program exchange rate	10.7	-1.8	-7.6	7.5	3.8	7.2
Velocity	1.6	1.5	1.5	1.5	1.5	1.5
Interbank overnight rate (annual average, percent) 3/	3.8	10.6	10.2	...	...	...
Balance of payments (percent of GDP)						
Current account balance	-9.2	-4.4	-2.5	-4.3	-2.5	-2.6
Foreign direct investment	1.8	2.0	0.1	2.5	1.4	1.3
Gross reserves (end of period, billions of U.S. dollars)	20.4	19.2	16.2	26.7	23.4	29.3
Months of next year's imports of goods and services	3.1	2.6	2.5	3.4	3.4	4.0
Percent of short-term debt (remaining maturity)	30.3	33.9	29.5	53.6	48.3	54.3
Percent of the IMF composite measure (float)	47.3	62.3	54.3	91.9	83.4	107.5
External debt (percent of GDP)	78.6	99.5	102.2	99.3	106.4	102.8
Goods exports (annual volume change in percent)	-6.7	-2.8	-8.4	6.5	4.8	4.9
Goods imports (annual volume change in percent)	-4.1	-13.8	-21.4	2.7	-1.2	6.1
Goods terms of trade (percent change)	0.9	-1.0	-1.2	-2.5	-3.4	-1.1
Exchange rate						
Hryvnia per U.S. dollar (end of period)	8.3	10.5	12.5	11.5	13.3	13.4
Hryvnia per U.S. dollar (period average)	8.2	10.6	11.3	11.6	12.9	13.3
Real effective rate (CPI-based, percent change)	-3.7	-18.0	-20.6	1.5	-2.2	1.4
Memorandum items:						
Per capita GDP / Population (2013): US$3,928 / 45.4 million						
Literacy / Poverty rate: 100 percent / 2.9 percent						

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

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

2/ Government and government-guaranteed debt.

3/ For 2014, average of rates for January–August.

Table 2. Ukraine: Program Scenario – General Government Finances, 2014–16 1/

(Billions of Ukrainian hryvnia)

	2014			2015			2016
	Prog. Request	Prog. Request excl. Crimea	Rev. Prog.	Prog. Request	Prog. Request excl. Crimea	Rev. Prog.	Proj.
Revenue	677.3	654.4	649.8	781.2	754.7	748.5	844.7
Tax revenue	601.9	580.9	573.2	692.5	668.2	661.0	748.3
Tax on income, profits, and capital gains	125.6	122.5	117.3	146.2	142.6	132.2	149.4
Personal income tax	74.3	72.5	76.4	85.2	83.0	85.0	94.3
Corporate profit tax	51.3	50.0	40.9	61.1	59.6	47.1	55.1
Payroll tax	200.2	189.1	187.0	229.3	216.5	215.2	238.6
Property tax	14.0	13.6	11.1	16.1	15.7	12.8	14.4
Tax on goods and services	205.2	200.1	200.0	235.7	229.8	234.4	271.6
VAT	146.1	142.5	145.0	166.9	162.7	167.2	189.3
Excise	46.8	45.6	44.6	55.0	53.6	53.2	66.8
Other	12.3	12.0	10.4	13.8	13.5	14.0	15.5
Tax on international trade	24.0	23.4	15.8	27.2	26.5	18.1	19.8
Other tax	33.0	32.2	41.9	38.0	37.1	48.2	54.6
Nontax revenue	75.4	73.5	76.7	88.6	86.5	87.5	96.4
Expenditure	755.3	731.9	737.8	854.4	827.3	817.6	898.4
Current	718.8	695.9	694.1	819.8	793.4	771.9	841.3
Compensation of employees	174.6	169.5	169.1	197.1	191.2	178.6	184.1
Goods and services	110.0	106.2	103.4	119.1	114.7	109.0	114.6
Interest	51.5	51.4	52.0	74.6	74.5	80.3	101.1
Subsidies to corporations and enterprises	31.7	32.0	32.0	35.1	35.5	35.6	39.5
Social benefits	350.8	336.6	337.4	393.6	377.3	368.2	401.8
Social programs (on budget)	63.9	61.3	61.3	69.4	66.5	70.2	79.1
Pensions	260.2	249.0	249.0	294.0	281.1	267.0	289.1
Unemployment, disability, and accident insurance	26.7	26.3	27.1	30.2	29.7	31.0	33.5
Other current expenditures	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital	22.2	21.7	19.6	32.5	31.9	34.9	43.2
Net lending	5.9	5.9	4.0	0.6	0.5	0.5	2.5
Discrepancy / reserve fund	8.4	8.4	20.0	1.5	1.5	10.3	11.4
Overall balance	-78.0	-77.5	-88.0	-73.2	-72.6	-69.1	-53.7
Naftogaz balance	-50.4	-50.4	-65.3	-32.7	-32.7	-33.0	-24.8
General government and Naftogaz balance	-128.4	-127.9	-153.3	-105.9	-105.9	-102.1	-78.5
General government financing	78.0	77.5	88.0	73.2	73.2	69.1	53.7
External	56.9	56.9	62.9	4.4	4.4	-8.8	53.0
Disbursements	102.6	102.6	119.6	73.9	73.9	68.7	91.3
Amortizations	-45.8	-45.8	-56.7	-69.4	-69.4	-77.4	-38.3
Domestic (net)	21.1	20.6	25.1	68.8	68.8	77.9	0.7
Bond financing	6.9	6.4	24.0	54.8	54.8	63.9	-13.3
Direct bank borrowing	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Deposit finance	4.5	4.5	0.0	0.0	0.0	0.0	0.0
Privatization	9.7	9.7	1.0	14.0	14.0	14.0	14.0
Discrepancy							
Other financing	15.0	15.0	30.5	0.0	0.0	22.5	0.0
Bank recapitalization	15.0	15.0	23.5	0.0	0.0	22.5	0.0
VAT bonds	0.0	0.0	7.0	0.0	0.0	0.0	0.0
Naftogaz financing	50.4	50.4	65.3	32.7	32.7	33.0	24.8
Government financing 2/	61.6	61.6	115.2	32.7	32.7	36.2	22.8
Accumulation of arrears	-16.1	-16.1	-20.1	0.0	0.0	0.0	0.0
Other 3/	4.9	4.9	-29.8	0.0	0.0	-3.2	2.0
Total financing	143.4	142.9	183.8	105.9	105.9	124.6	78.5
Memorandum items:							
Public sector debt 4/	850.7	850.7	1,030.6	1,078.3	...	1,289.3	1,406.8
Of which: In foreign currency	485.5	485.5	638.5	584.3	...	791.0	869.3
Domestic	386.5	386.5	489.1	480.3	...	625.8	673.7
External	464.2	464.2	541.5	598.0	...	663.5	733.1
Nominal GDP (billions of Ukrainian hryvnia)	1,524	1,524	1,524	1,756	1,756	1,756	1,978

Table 2. Ukraine: Program Scenario – General Government Finances, 2014–16 (concluded) 1/

(Percent of GDP)

	2014			2015			2016
	Prog. Request	Prog. Request excl. Crimea	Rev. Prog.	Prog. Request	Prog. Request excl. Crimea	Rev. Prog.	Proj.
Revenue	44.4	42.9	42.6	44.5	43.0	42.6	42.7
Tax revenue	39.5	38.1	37.6	39.4	38.1	37.6	37.8
Tax on income, profits, and capital gains	8.2	8.0	7.7	8.3	8.1	7.5	7.6
Personal income tax	4.9	4.8	5.0	4.8	4.7	4.8	4.8
Corporate profit tax	3.4	3.3	2.7	3.5	3.4	2.7	2.8
Payroll tax	13.1	12.4	12.3	13.1	12.3	12.3	12.1
Property tax	0.9	0.9	0.7	0.9	0.9	0.7	0.7
Tax on goods and services	13.5	13.1	13.1	13.4	13.1	13.3	13.7
VAT	9.6	9.3	9.5	9.5	9.3	9.5	9.6
Excise	3.1	3.0	2.9	3.1	3.1	3.0	3.4
Other	0.8	0.8	0.7	0.8	0.8	0.8	0.8
Tax on international trade	1.6	1.5	1.0	1.5	1.5	1.0	1.0
Other tax	2.2	2.1	2.7	2.2	2.1	2.7	2.8
Nontax revenue	4.9	4.8	5.0	5.0	4.9	5.0	4.9
Expenditure	49.6	48.0	48.4	48.7	47.1	46.6	45.4
Current	47.2	45.7	45.5	46.7	45.2	44.0	42.5
Compensation of employees	11.5	11.1	11.1	11.2	10.9	10.2	9.3
Goods and services	7.2	7.0	6.8	6.8	6.5	6.2	5.8
Interest	3.4	3.4	3.4	4.2	4.2	4.6	5.1
Subsidies to corporations and enterprises	2.1	2.1	2.1	2.0	2.0	2.0	2.0
Social benefits	23.0	22.1	22.1	22.4	21.5	21.0	20.3
Social programs (on budget)	4.2	4.0	4.0	4.0	3.8	4.0	4.0
Pensions	17.1	16.3	16.3	16.7	16.0	15.2	14.6
Unemployment, disability, and accident insurance	1.8	1.7	1.8	1.7	1.7	1.8	1.7
Other current expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital	1.5	1.4	1.3	1.9	1.8	2.0	2.2
Net lending	0.4	0.4	0.3	0.0	0.0	0.0	0.1
Discrepancy / reserve fund	0.5	0.5	1.3	0.1	0.1	0.6	0.6
Overall balance	-5.2	-5.2	-5.8	-4.2	-4.1	-3.9	-2.7
Naftogaz balance	-3.3	-3.3	-4.3	-1.9	-1.9	-1.9	-1.3
General government and Naftogaz balance	-8.4	-8.4	-10.1	-6.0	-6.0	-5.8	-4.0
General government financing	5.2	5.2	5.8	4.2	4.2	3.9	2.7
External	3.7	3.7	4.1	0.3	0.3	-0.5	2.7
Disbursements	6.7	6.7	7.8	4.2	4.2	3.9	4.6
Amortizations	-3.0	-3.0	-3.7	-4.0	-4.0	-4.4	-1.9
Domestic (net)	1.4	1.4	1.6	3.9	3.9	4.4	0.0
Bond financing	0.5	0.4	1.6	3.1	3.1	3.6	-0.7
Direct bank borrowing	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit finance	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Privatization	0.6	0.6	0.1	0.8	0.8	0.8	0.7
Discrepancy							
Other financing	1.0	1.0	2.0	0.0	0.0	1.3	0.0
Bank recapitalization	1.0	1.0	1.5	0.0	0.0	1.3	0.0
VAT bonds	0.0	0.0	0.5	0.0	0.0	0.0	0.0
Naftogaz financing	3.3	3.3	4.3	1.9	1.9	1.9	1.3
Government financing 2/	4.0	4.0	7.6	1.9	1.9	2.1	1.2
Accumulation of arrears	-1.1	-1.1	-1.3	0.0	0.0	0.0	0.0
Other 3/	0.3	0.3	-2.0	0.0	0.0	-0.2	0.1
Total financing	9.4	9.4	12.1	6.0	6.0	7.1	4.0
Memorandum items:							
Cyclically-adjusted general government balance	-3.5	-3.5	-3.8	-3.0	-3.0	-2.2	-2.0
Structural general government balance 5/	-3.5	-3.5	-3.5	-3.0	-3.0	-2.3	-2.0
Structural general government primary balance 5/	-0.2	-0.2	-0.2	1.1	1.1	2.1	3.0
Government deposits at NBU	0.8	0.8	0.8	0.7	0.7	0.7	0.6
Public sector debt 4/	55.8	55.8	67.6	61.4	61.4	73.4	71.1
Of which: In foreign currency	31.9	31.9	41.9	33.3	33.3	45.0	44.0
Domestic	25.4	25.4	32.1	27.4	27.4	35.6	34.1
External	30.5	30.5	35.5	34.0	34.0	37.8	37.1
Nominal GDP (billions of Ukrainian hryvnia)	1,524	1,524	1,524	1,756	1,756	1,756	1,978

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

1/ National methodology, cash basis.

2/ Government spending for Naftogaz financing, including through recapitalization bonds. In 2014, includes repayment of a US$1.6 billion Eurobond.

3/ Includes external and domestic net disbursements, trade credits, deposit drawdowns, as well as company receivables.

4/ Government and government-guaranteed debt.

5/ The balance in 2014 treats part of the military spending and the EU grant as one-off operations.

Table 3. Ukraine: Program Scenario – Balance of Payments, 2013–16

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

	2013	2014		2015		2016
		Prog. Request	Rev. Prog.	Prog. Request	Rev. Prog.	Proj.
Current account balance	-16.3	-6.3	-3.4	-6.4	-3.4	-3.9
Goods and services trade balance	-15.5	-5.0	-2.4	-4.8	-1.1	-3.5
Merchandise trade balance	-19.6	-10.4	-7.7	-10.1	-6.3	-8.0
Exports, f.o.b.	65.0	62.5	58.5	65.8	60.4	62.5
Imports, f.o.b. 1/	-84.6	-72.9	-66.2	-75.9	-66.7	-70.5
Of which: gas	-9.9	-9.0	-8.6	-9.9	-9.7	-9.7
Services (net)	4.1	5.4	5.3	5.3	5.2	4.6
Receipts	20.4	18.8	17.4	18.7	16.9	16.4
Payments	-16.2	-13.4	-12.0	-13.4	-11.6	-11.8
Income (net)	-3.0	-3.6	-3.3	-4.2	-5.0	-3.1
Current transfers (net)	2.1	2.3	2.3	2.6	2.6	2.7
Capital and financial account balance	15.8	-5.0	-10.7	1.4	-0.3	5.9
Capital account	-0.1	0.0	0.0	0.0	0.0	0.0
Financial account	15.8	-5.0	-10.7	1.4	-0.3	5.9
Direct investment (net)	3.3	2.8	0.2	3.7	1.9	2.0
Portfolio investment (net)	8.7	0.4	1.8	-2.4	-2.2	1.6
Of which: general government	4.2	0.1	2.2	-3.0	-2.9	0.9
Other investment (net)	3.9	-8.2	-12.7	0.1	-0.1	2.4
Medium and long-term loans	0.8	-4.2	-5.5	0.5	0.6	0.6
Official	-0.5	-2.1	-2.5	-0.6	-0.6	-0.6
Disbursements 2/	...	...	...	...	...	...
Repayments 3/	-0.5	-2.1	-2.5	-0.6	-0.6	-0.6
Banks	-0.4	-0.5	-0.2	0.4	0.4	1.0
Other sectors	1.7	-1.6	-2.8	0.7	0.8	0.2
Short-term loans	3.5	-3.4	-6.3	-0.6	-0.7	1.6
Banks	-0.1	-0.5	-1.0	0.3	0.3	0.2
Other sectors 4/	3.6	-3.0	-5.2	-0.9	-1.0	1.4
Currency and deposits	-0.4	-0.5	-1.0	0.2	0.1	0.2
Banks	2.3	-0.5	2.5	0.2	0.2	0.2
Other sectors 5/	-2.7	0.0	-3.5	0.0	-0.1	0.0
Errors and omissions	-0.2	0.0	0.9	0.0	0.0	0.0
Overall balance	-0.8	-11.3	-13.2	-5.0	-3.8	2.0
Official financing	2.3	6.4	5.3	5.4	3.9	2.8
World Bank	0.3	1.9	1.7	1.6	1.3	0.7
EU	0.1	2.2	2.6	0.6	0.8	0.1
EBRD/EIB/Others	2.0	2.3	1.0	3.1	1.8	1.9
Financing	-1.5	4.9	7.9	-0.4	-0.2	-4.8
Gross official reserves (increase: -)	4.1	1.2	4.2	-7.5	-7.2	-5.9
Net use of IMF resources	-5.6	3.7	3.7	7.1	7.1	1.1
Of which: Prospective Fund purchases	...	7.4	7.4	8.6	8.6	1.1
Memorandum items:						
Total external debt	140.1	141.5	137.8	149.1	144.7	152.7
Total external debt (percent of GDP)	78.6	99.5	102.2	99.3	106.4	102.8
Current account balance (percent of GDP)	-9.2	-4.4	-2.5	-4.3	-2.5	-2.6
Goods and services trade balance (percent of GDP)	-8.7	-3.5	-1.7	-3.2	-0.8	-2.3
Gross international reserves	20.4	19.2	16.2	26.7	23.4	29.3
Months of next year's imports of goods and services	3.1	2.6	2.5	3.4	3.4	4.0
Percent of short-term debt (remaining maturity)	30.3	33.9	29.5	53.6	48.3	54.3
Percent of the IMF composite measure (float)	47.3	62.3	54.3	91.9	83.4	107.5
Merchandise export value (percent change)	-7.5	-3.8	-9.9	5.3	3.2	3.4
Merchandise import value (percent change)	-5.7	-13.8	-21.7	4.0	0.7	5.7
Merchandise export volume (percent change)	-6.7	-2.8	-8.4	6.5	4.8	4.9
Merchandise import volume (percent change)	-4.1	-13.8	-21.4	2.7	-1.2	6.1
Goods terms of trade (percent change)	0.9	-1.0	-1.2	-2.5	-3.4	-1.1
Gross domestic product (current prices)	178.3	142.3	134.9	150.2	136.1	148.5

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

1/ Gas import prices for 2012 and 2013 were US$427 and US$371 per tcm, respectively. For 2014, the price of US$357 per tcm is projected. For 2015–19, projected gas prices are: $385, $366, $354, $347, $341, respectively. Naftogaz is currently disputing the arrears to Gazprom. For program financing and risk assessment considerations the potential liability to Gazprom was estimated using US$385.5 per tcm. This price is used for accounting purpose only, and does not constitute an expression of a view by Fund staff on what the gas price should be.

2/ Financing from World Bank, EU, and EBRD is recorded below the line.

3/ Includes repayment of Naftogaz Eurobond in September 2014.

4/ Includes trade credit and arrears, including those related to Naftogaz potential arrears to Gazprom.

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

Table 4. Ukraine: Program Scenario – Gross External Financing Requirements, 2013–16

(Billions of U.S. dollars)

	2013	2014		2015		2016
		Prog. Request	Rev. Prog.	Prog. Request	Rev. Prog.	Proj.
Total financing requirements	73.7	63.0	63.3	58.0	53.4	50.7
Current account deficit	16.3	6.3	3.4	6.4	3.4	3.9
Portfolio investment	7.5	2.2	2.7	5.7	5.6	3.5
Private	5.4	1.2	1.7	1.2	1.2	1.2
Public	2.0	1.0	1.0	4.5	4.4	2.3
Medium and long-term debt	18.0	17.5	17.9	11.9	11.9	11.9
Private	17.5	15.4	15.4	11.3	11.3	11.3
Banks	4.7	5.3	5.3	5.3	5.3	5.3
Corporates	12.8	10.1	10.1	6.0	6.0	6.0
Public /1	0.5	2.1	2.5	0.6	0.6	0.6
Short-term debt (including deposits)	12.8	12.1	12.1	11.9	11.8	12.0
Other net capital outflows 2/	-1.9	0.0	2.3	0.0	0.5	0.0
Trade credit	21.2	24.9	24.9	22.1	20.2	19.4
Total financing sources	73.0	51.7	49.2	53.1	49.6	52.7
Capital transfers	-0.1	0.0	0.0	0.0	0.0	0.0
Direct investment, net	3.3	2.8	0.2	3.7	1.9	2.0
Portfolio investment	16.1	2.6	4.5	3.3	3.4	5.0
Private	9.9	1.5	1.3	1.8	1.9	1.9
Public	6.3	1.1	3.2	1.5	1.5	3.1
Medium and long-term debt	18.8	13.3	13.0	12.4	12.4	12.5
Private	18.8	13.3	13.0	12.4	12.4	12.5
Banks	4.3	4.8	5.1	5.7	5.7	6.3
Corporates	14.5	8.5	7.8	6.7	6.8	6.2
Public 3/	…	…	…	…	…	…
Short-term debt (including deposits)	13.8	10.9	11.3	12.7	12.4	13.3
Trade credit	21.1	22.1	20.2	21.0	19.4	19.9
Increase in gross reserves	-4.1	-1.2	-4.2	7.5	7.2	5.9
Errors and omissions	-0.1	0.0	0.9	0.0	0.0	0.0
Total financing needs	-3.3	10.1	9.0	12.5	11.0	3.8
Official financing	-3.3	10.1	9.0	12.5	11.0	3.8
IMF	-5.6	3.7	3.7	7.1	7.1	1.1
Prospective purchases	…	7.4	7.4	8.6	8.6	1.1
Repurchases	5.6	3.7	3.7	1.5	1.5	0.0
Official creditors	2.3	6.4	5.3	5.4	3.9	2.8
World Bank	0.3	1.9	1.7	1.6	1.3	0.7
EU	0.1	2.2	2.6	0.6	0.8	0.1
EBRD/EIB/Others	2.0	2.3	1.0	3.1	1.8	1.9
Memorandum items:						
Gross international reserves	20.4	19.2	16.2	26.7	23.4	29.3
Percent of short-term debt (remaining maturity)	30.3	33.9	29.5	53.6	48.3	54.3
Months of next year's imports of goods and services	3.1	2.6	2.5	3.4	3.4	4.0
Percent of the IMF composite measure (float) 4/	47.3	62.3	54.3	91.9	83.4	107.5
Loan rollover rate (percent)						
Banks	90.1	85.4	94.1	107.5	107.5	112.8
Corporates	116.2	89.2	84.4	108.2	107.9	109.0
Total	107.6	87.7	88.2	107.9	107.7	110.7

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

1/ Includes repayment of Naftogaz Eurobond in September 2014.

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

3/ For the projection period (2014–19), financing from official sources is recorded below the line.

4/ 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. For Ukraine "fixed weights are used until 2013, and "floating" weights are used from 2014 onwards.

Table 5. Ukraine: Program Scenario – Monetary Accounts, 2013–16

	2013	2014						2015	2016
		Mar.	Apr.	May	Jun.	Sep.	Dec.		
					Est.	Projection		Rev. Prog.	Proj.
	(Billions of Ukrainian hryvnias unless otherwise noted)								
Monetary survey									
Net foreign assets	51	8	-1	7	11	-35	-41	-51	-4
(In billions of US dollars)	6.4	0.7	-0.1	0.6	1.0	-2.9	-3.3	-3.9	-0.3
Foreign assets	273	255	253	298	292	...	...	...	...
Foreign liabilities	222	247	254	291	281	...	...	...	...
Net domestic assets	858	937	952	946	938	1,011	1,059	1,236	1,345
Domestic credit	1,198	1,338	1,363	1,337	1,321	1,366	1,445	1,630	1,750
Net claims on government	248	294	310	279	290	339	401	514	546
Credit to the economy	911	1,002	1,011	1,016	990	988	1,000	1,069	1,154
Domestic currency	601	585	582	579	565	562	577	576	607
Foreign currency	310	417	429	437	425	426	423	493	547
(In billions of US dollars)	38.8	38.1	36.9	37.5	35.9	35.5	33.9	37.2	40.8
Other items, net	-340	-401	-411	-391	-383	-356	-386	-394	-406
Broad money	909	945	952	954	949	975	1,018	1,185	1,341
Currency in circulation	238	269	277	287	290	308	326	390	460
Total deposits	668	671	670	663	656	664	689	790	877
Domestic currency deposits	422	380	379	377	379	389	393	445	492
Foreign currency deposits	246	291	290	285	277	275	295	346	385
(In billions of US dollars)	30.8	26.6	25.0	24.5	23.4	22.9	23.6	26.1	28.8
Accounts of the NBU									
Net foreign assets	124	120	125	140	132	88	83	89	153
(In billions of US dollars)	15.5	11.0	10.8	12.1	11.2	7.3	6.7	6.7	11.4
Net international reserves	114	117	121	134	123	78	81	87	151
(In billions of US dollars)	14.2	10.6	10.4	11.5	10.4	6.5	6.5	6.6	11.3
Reserve assets	157	162	160	206	193	156	192	298	379
(In billions of US dollars)	19.6	14.8	13.8	17.6	16.3	13.0	15.4	22.5	28.3
Reserve liabilities	43	46	39	71	70	78	111	211	228
Net domestic assets	183	209	214	202	218	283	309	380	394
Net domestic credit	218	286	304	269	284	348	415	500	519
Net claims on government	145	183	198	165	178	246	314	418	447
Claims on government	149	199	210	209	210	302	317	422	451
Liabilities to government	4	17	12	44	33	56	4	4	4
Net claims on banks	72	103	106	104	106	102	101	82	71
Other items, net	-35	-78	-91	-66	-66	-64	-106	-120	-125
Base money	307	329	339	343	351	371	392	469	547
Currency in circulation	238	269	277	287	290	308	326	390	460
Banks' reserves	69	60	62	56	61	63	66	79	88
Cash in vault	24	22	24	22	23	23	25	28	32
Required reserves	27	32	36	36	35	36	35	40	44
Excess reserves	18	7	1	-2	3	4	6	10	12
Deposit money banks									
Net foreign assets	-73	-112	-126	-133	-121	-123	-125	-140	-157
(In billions of US dollars)	-9.2	-10.2	-10.8	-11.4	-10.2	-10.3	-10.0	-10.6	-11.7
Foreign assets	106	89	89	86	88	...	...	...	...
(In billions of US dollars)	13.3	8.1	7.6	7.4	7.5	...	...	...	...
Foreign liabilities	179	201	215	219	210	...	...	...	...
Net domestic assets	740	782	794	794	775	787	813	931	1,034
Domestic credit	1,048	1,111	1,119	1,122	1,096	1,091	1,099	1,209	1,316
Net claims on government	103	111	111	114	112	93	88	96	99
Credit to the economy	910	1,001	1,011	1,016	990	987	1,000	1,069	1,154
Other claims on the economy	40	42	42	42	41	41	40	40	41
Net claims on NBU	-4	-44	-45	-50	-47	-31	-29	3	23
Of which: Refinancing loans	79	110	113	114	114	102	101	81	71
Other items, net	-308	-329	-325	-328	-320	-304	-286	-278	-282
Banks' liabilities	667	669	668	661	654	664	689	790	877
Demand deposits	197	207	207	209	212	...	...	...	...
Time deposits	470	462	461	452	442	...	...	...	...
Memorandum items:	(Year-on-year percent change, unless otherwise indicated)								
Base money	20.3	28.5	26.8	26.7	27.3	30.5	27.7	19.7	16.6
Broad money	17.6	18.0	16.3	16.1	13.4	11.9	12.0	16.4	13.2
At program exchange rate	15.7	5.9	3.4	2.3	0.1	-1.4	-2.0	14.6	13.0
Credit to the economy	11.8	21.2	21.9	22.4	18.0	14.2	9.8	6.9	8.0
At program exchange rate	10.7	6.5	5.4	4.4	0.6	-2.9	-7.6	3.8	7.2
Velocity of broad money, ratio	1.60	1.55	...	...	1.55	1.55	1.50	1.48	1.48
Money multiplier, ratio	2.96	2.87	2.81	2.78	2.70	2.63	2.59	2.52	2.45
Hryvnia per U.S. dollar, market rate	8.30	11.44	11.63	11.66	11.82	12.00	12.50	13.25	13.38
Hryvnia per U.S. dollar, official rate	7.99	10.95	11.63	11.66	11.82	12.00	12.50	13.25	13.38

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

Table 6. Ukraine: Financial Soundness Indicators for the Banking Sector, 2009–14

(Percent, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	
						Mar.	Jun.
Ownership							
Number of banks, *of which*	182	176	176	176	180	181	174
Private	180	174	174	171	173	174	167
Domestic	129	119	121	118	124	123	116
Foreign	51	55	53	53	49	51	51
Of which: 100% foreign-owned	18	20	22	22	19	19	19
State-owned	2	2	2	2	3	3	3
Foreign-owned banks' share in statutory capital	35.8	40.6	41.9	39.5	34.0	33.6	32.3
Concentration							
Share of assets of largest 10 banks	52.8	53.9	52.8	52.7	54.3	55.5	57.3
Share of assets of largest 25 banks	76.5	75.9	74.6	74.7	76.0	77.2	79.5
Number of bank with assets less than $150 million	107	92	81	75	77	95	95
Capital Adequacy							
Regulatory capital to risk-weighted assets	18.1	20.8	18.9	18.1	18.3	14.8	15.9
Capital to total assets	13.1	14.6	14.8	15.0	14.0	12.8	12.6
Asset Quality							
Credit growth (year-over-year percent change) 1/	-2.3	1.1	9.5	2.2	11.8	21.2	18.0
Credit to GDP ratio 1/	78.9	67.3	61.2	57.8	62.6	68.4	67.1
NPLs to total loans (NBU definition) 2/	13.1	14.9	14.3	16.5	12.9	13.3	14.6
NPLs to total loans (broad definition) 3/	37.6	40.3	37.7	26.7	23.5	26.1	27.7
NPLs net of provisions to capital 2/	32.0	29.2	25.8	36.0	30.7	37.6	47.0
Specific provisions (percent of NPLs, NBU definition)	65.1	66.6	68.3	63.9	80.4	79.4	72.3
Specific provisions (percent of total loans)	8.9	10.2	10.1	12.7	13.6	13.8	13.7
Foreign Exchange Rate Risk							
Loans in foreign currency to total loans 1/	51.2	46.5	40.6	36.9	34.1	41.7	43.0
Deposits in foreign currency to total deposits	47.2	42.1	42.6	43.8	36.9	43.5	42.3
Foreign currency loans to foreign currency deposits 1/	239.2	194.8	155.7	121.1	126.0	143.4	153.5
Net open FX position to regulatory capital (NBU definition) 4/	28.5	21.6	8.4	2.5	6.9	13.4	14.6
Net open FX position to regulatory capital (staff estimate) 4/	-23.6	-36.9	-40.0	-28.9	-15.1	-18.3	…
Liquidity Risk							
Liquid assets to total assets	11.5	18.8	18.7	22.2	20.6	21.6	…
Customer deposits to total loans to the economy 1/	45.3	56.7	61.2	69.6	73.3	66.9	66.1
Earnings and Profitability							
Return on assets (after tax; end-of-period)	-4.4	-1.5	-0.8	0.5	0.1	-0.6	0.2
Return on equity (after tax; end-of-period)	-32.5	-10.2	-5.3	3.0	0.8	-4.2	1.4
Net interest margin to total assets	6.2	5.8	5.3	4.5	4.1	4.6	4.4
Interest rate spreads (percentage points; end-of-period)							
Between loans and deposits in domestic currency	5.6	7.6	6.6	4.3	4.8	7.4	4.5
Between loans and deposits in foreign currency	0.7	4.7	2.8	4.5	2.4	1.9	2.3
Between loans in domestic and foreign currency	9.4	5.3	9.4	9.1	8.9	11.4	8.4
Between deposits in domestic and foreign currency	4.5	2.4	5.6	9.4	6.5	5.9	6.2
Number of banks not complying with banking regulations							
Not meeting capital adequacy requirements for Tier I capital	12	3	2	2	0	6	5
Not meeting prudential regulations	22	8	11	6	6	28	25
Not meeting reserve requirements	15	5	5	9	8	37	27

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.

3/ Includes 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 did 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: Indicators of Fund Credit, 2013–19

	2013	2014	2015	2016	2017	2018	2019
		Projection					
Stock of existing and prospective Fund credit 1/ 2/							
Millions of SDRs	3,359	5,771	10,290	10,976	10,347	6,917	2,144
Percent of quota	245	421	750	800	754	504	156
Percent of GDP	2.9	6.6	11.8	11.6	10.0	6.2	1.8
Percent of exports of goods and services	6.1	11.8	20.9	22.0	19.9	12.7	3.8
Percent of gross reserves	25.3	55.3	68.9	58.0	50.0	31.7	10.6
Existing Fund credit 1/ 2/							
Millions of SDRs	3,359	3,027	2,058	2,058	1,544	515	0
Percent of quota	245	221	150	150	113	38	0
Percent of GDP	2.9	3.5	2	2	1	0	0
Percent of exports of goods and services	6.1	6.2	4	4	3	1	0
Percent of gross reserves	25.3	29.0	14	11	7	2	0
Prospective Fund credit 1/ 2/							
Millions of SDRs	0	2,744	8,232	8,918	8,804	6,403	2,144
Percent of quota	0	200	600	650	642	467	156
Percent of GDP	0	3.2	9.5	9.5	8.5	5.7	1.8
Percent of exports of goods and services	0	5.6	16.7	17.8	17.0	11.8	3.8
Percent of gross reserves	0	26.3	55.1	47.1	42.5	29.4	10.6
Obligations to the Fund from existing and prospective drawings 2/							
Millions of SDRs	3,768	865	1,123	247	882	3,685	4,877
Percent of quota	275	63	82	18	64	269	355
Percent of GDP	3.3	1.0	1.3	0.3	0.9	3.3	4.0
Percent of exports of goods and services	6.7	1.7	2.2	0.5	1.7	6.7	8.5
Percent of gross reserves	28.4	8.3	7.5	1.3	4.3	16.9	24.1
Obligations to the Fund from existing drawings 2/							
Millions of SDRs	3,768	849	998	23	537	1,042	518
Percent of quota	275	62	73	2	39	76	38
Percent of GDP	3.3	1.0	1.1	0	1	1	0
Percent of exports of goods and services	6.7	1.7	2.0	0	1	2	1
Percent of gross reserves	28.4	8.1	6.7	0	3	5	3
Obligations to the Fund from prospective drawings 2/							
Millions of SDRs	0	16	124	224	346	2,642	4,359
Percent of quota	0	1	9	16	25	193	318
Percent of GDP	0	0.0	0.1	0.2	0.3	2.4	3.6
Percent of exports of goods and services	0	0.0	0.3	0.4	0.7	4.9	7.6
Percent of gross reserves	0	0.2	0.8	1.2	1.7	12.1	21.5

Source: IMF staff estimates.

1/ End of period.

2/ Repayment schedule based on repurchase obligations.

Table 8. Ukraine: Access and Phasing Under the Stand-By Arrangement

	Amount of purchase		
Date	Millions of SDRs	Percent of quota	Conditions
April 30, 2014 1/	2,058.00	150.00	Board approval of arrangement
July 25, 2014 2/	914.67	66.67	First review and end-May 2014 performance criteria
December 15, 2014	1,829.33	133.33	Second review and end-September 2014 performance criteria
March 15, 2015	1,372.00	100.00	Third review and end-December 2014 performance criteria
June 15, 2015	1,372.00	100.00	Fourth review and end-March 2015 performance criteria
September 15, 2015	1,372.00	100.00	Fifth review and end-June 2015 performance criteria
December 15, 2015	1,372.00	100.00	Sixth review and end-September 2015 performance criteria
March 15, 2016	686.00	50.00	Seventh review and end-December 2015 performance criteria
Total	10,976	800.0	

Source: IMF staff estimates.

1/ Of which SDR1,290 million for budget support.

2/ Of which SDR650 million for budget support.

Annex. Public Debt Sustainability Analysis

Ukraine's public debt sustainability has deteriorated since the SBA approval but is still deemed to remain sustainable with high probability under the baseline, which assumes that the conflict will begin to subside in the coming months. In light of the deeper exchange rate depreciation and additional fiscal and quasi-fiscal financing needs, public debt is projected to peak at 73.4 percent of GDP in 2015, above the 70 percent of GDP high-risk threshold used in the debt sustainability framework. Debt is projected to decline thereafter—reaching 51 percent of GDP by 2019—driven by fiscal adjustment and the elimination of quasi-fiscal losses in the energy sector and as the effects of the stabilization and improved economic performance become entrenched. The baseline public debt path is subject to considerable risks, particularly from lower growth, real exchange rate, and contingent liabilities shocks. Gross financing needs are forecast to peak at 23 percent of GDP in 2014, but will average 13.7 percent of GDP over the medium term, pointing to a reduction of rollover risks over the program period.

Macroeconomic and fiscal assumptions: The assumptions underpinning the DSA are those of the baseline program scenario. Relative to the SBA request near-term real GDP growth is projected to be lower registering -6.5 percent in 2014 and 1 percent in 2015, rising gradually to 4.5 percent in the medium term. Inflation (measured by the GDP deflator) is projected to rise to 12.1 percent on average in 2014 and peak at 14.1 percent in 2015, as the effects of the significant exchange rate depreciation in 2014 are fully transmitted. The general government fiscal deficit is projected to reach 5.8 percent of GDP in 2014 and then decline to 3.9 percent, in light of a more backloaded adjustment, reaching 2.5 percent by 2019. 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 (includes domestic debt held by the NBU amounting to 10¼ percent of GDP at end-2013); (ii) government guarantees on loans extended to state enterprises (including for the state-owned gas company, Naftogaz); (iii) debt of local governments; historic and projected public financing for Naftogaz provided through recapitalization bonds, and (iv) National Bank of Ukraine's (NBU's) liabilities to the IMF.

The DSA framework suggests that Ukraine's public debt will continue to rise rapidly until 2015 and will temporarily breach the high-risk benchmark before starting to decline. The DSA suggests that debt will reach 67.6 percent of GDP at end-2014, a jump of over 26 percentage points from 2013, driven by large financing needs under past unsustainable policies, as well as significant exchange rate depreciation. This ratio is about 10 percent of GDP higher than at the time of the SBA request in light of additional exchange rate depreciation as well as higher fiscal and quasi-fiscal financing needs related to Naftogaz and banking sector support. The higher 2014 base for debt will imply that public debt will peak in 2015 at 73.4 percent of GDP, as disbursements by the IMF and other donors, including to the NBU, come into full force but will then steadily decline reaching 51.5 percent of GDP in 2019.

Under some shock scenarios envisaged in the DSA, the debt-to-GDP ratio temporarily breaches the 70 percent threshold. These shocks pertain to a historical scenario where key variables remain at their 10-year historical average, and one-time shocks to the primary balance and the real interest rate. These shocks lead to temporary increases in the debt trajectory in the medium term relative to the baseline.

Other shocks breach the high risk threshold for more persistent periods. Additional scenarios pertaining to a growth shock, a constant primary balance shock, a combined macro-fiscal shock, a contingent liability shock, and a real exchange rate shock lead to persistent breaches of the high risk threshold. Under a growth shock, entailing a cumulative growth decline of over 9 percent in 2015–16 in addition to the projected 2014 decline of 6.5 percent, the debt-to-GDP ratio reaches 99 percent in 2016. The constant primary balance shock entails the debt peaking at 84 percent in 2017. 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 shocks, sending debt to 134 percent of GDP in 2016. The contingent liabilities shock is designed to highlight risks from implicit guarantees to the banking sector. This shock would be capturing additional government needs to support the banking sector over and above the UAH 23.5 and UAH 22.5 billion already incorporated in the baseline framework in 2014–15. This shock includes an associated shock to growth and resulting deterioration in the primary balance together with an increase in interest rates and decrease in inflation. Under this shock debt peaks at 98 percent of GDP in 2016. The real exchange rate shock includes deterioration in inflation, interest rates, and the primary balance. Under this shock debt reaches nearly 93 percent of GDP in 2015. On the latter, the rise in the projected share of hryvnia debt from 25 percent under the SBA request to 31 percent at end-2014 and from 30 percent to 37 percent at end-2015 mitigates exchange rate depreciation risks.

A customized adverse shock scenario that assumes drawn-out armed hostilities in the East points to additional risks to the debt path. Under this scenario fighting in the East will continue at the current level of intensity through the end of 2015 with real GDP contracting by an additional 4.25 percent while the improvements in the primary balance are smaller in magnitude. The debt to GDP ratio would peak at 92 percent in 2015 before starting to decline and reach the 70 percent threshold by the end of the period.

The baseline and shocks scenarios highlight the considerable risks related to the large financing needs of the budget and Naftogaz in the short term. Under the baseline, gross financing needs are about 23 percent of GDP in 2014 (above the high-risk indicative threshold of 15 percent), but they decline steadily over the program period and beyond and drop below the high risk threshold by 2016. The gross financing needs are higher by nearly 6 percent of GDP in 2014 relative to the DSA at the time of the program request in light of the higher exchange rate depreciation and higher Naftogaz and banking sector government support. As at the time of the program request, the gross financing needs are magnified under the various shocks, especially under the growth shock, the contingent liability shock, and the combined macro-fiscal shock.

Risks to the debt profile are mixed. Public perceptions of risk as captured by EMBIG spreads are high, but they have substantially improved since the program approval. The share of public debt held by non-residents is high, but this is shifting from private to official creditors reducing somewhat the implied risks. On the other hand, short-term debt ratios are very low, and the share of external debt is projected to decline in the coming years mitigating rollover and exchange rate risks.

The DSA concludes that Ukraine's public debt is sustainable with high probability under the baseline, which assumes that the conflict will begin to subside in the coming months. This conclusion stems from the observation that no single-shock and scenario-based stress test produce unsustainable intrinsic dynamics. Inclusion of government guaranteed debt in the definition of public debt provides an additional buffer given that historically called guarantees have been very low (less than one percent of total guarantees) and NBU debt to the IMF, which is government guaranteed and not serviced from the budget, is projected to amount to around 10 percent of GDP by 2015, implying that public debt excluding IMF lending to the NBU would be well below the 70 percent high-risk benchmark. Although higher in its level, the revised debt path gradually converges back to the programmed path as delayed fiscal adjustment kicks in. The risks highlighted in the DSA point to the critical role of the SBA-supported program in restoring stability, entrenching fiscal adjustment and implementing reforms that lead to sustainable and durable economic growth.

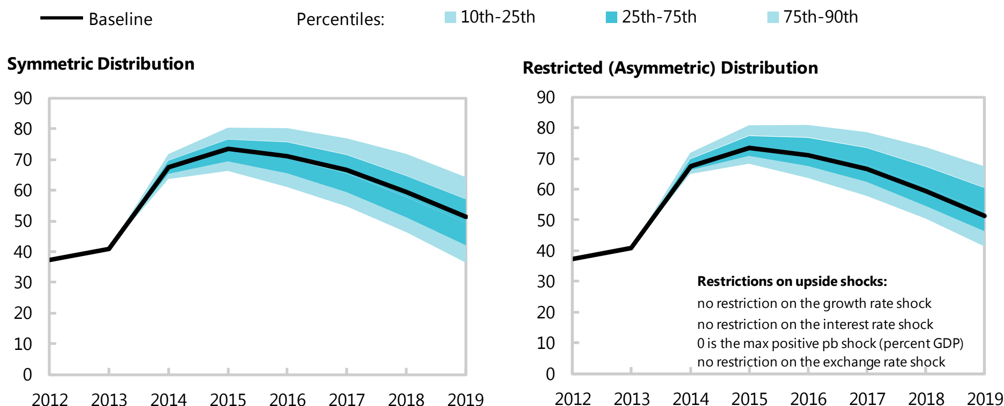
Ukraine Public DSA Risk Assessment

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

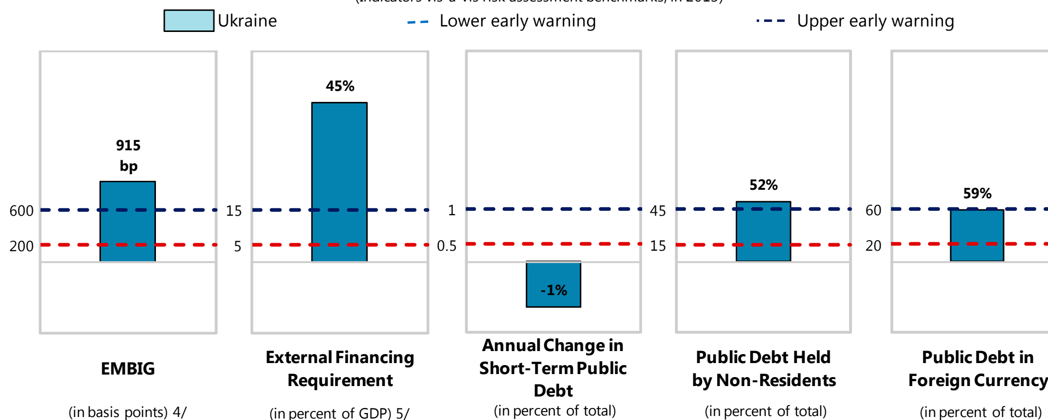
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



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:

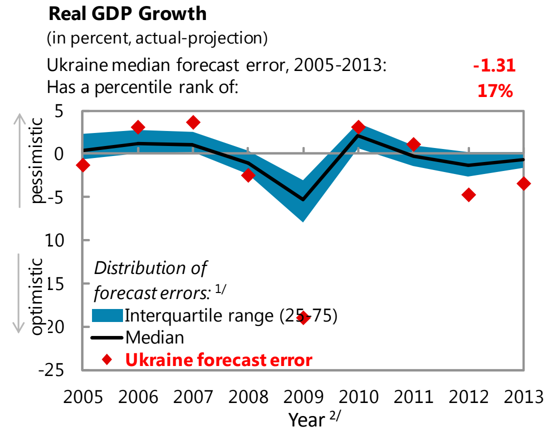
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

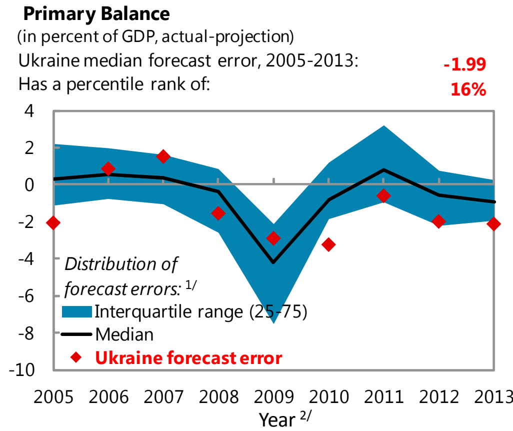
4/ EMBIG, an average over the last 3 months, 25-Apr-14 through 24-Jul-14.

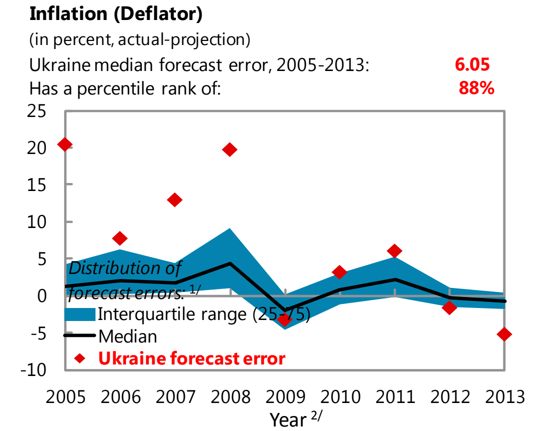
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Ukraine Public DSA - Realism of Baseline Assumptions

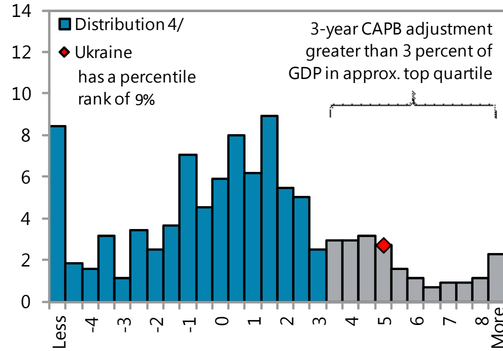
Forecast Track Record, versus all countries

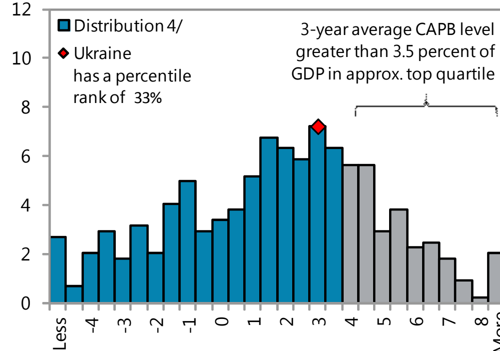






Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/

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, as it meets neither the positive output gap criterion nor the private credit growth criterion.

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)

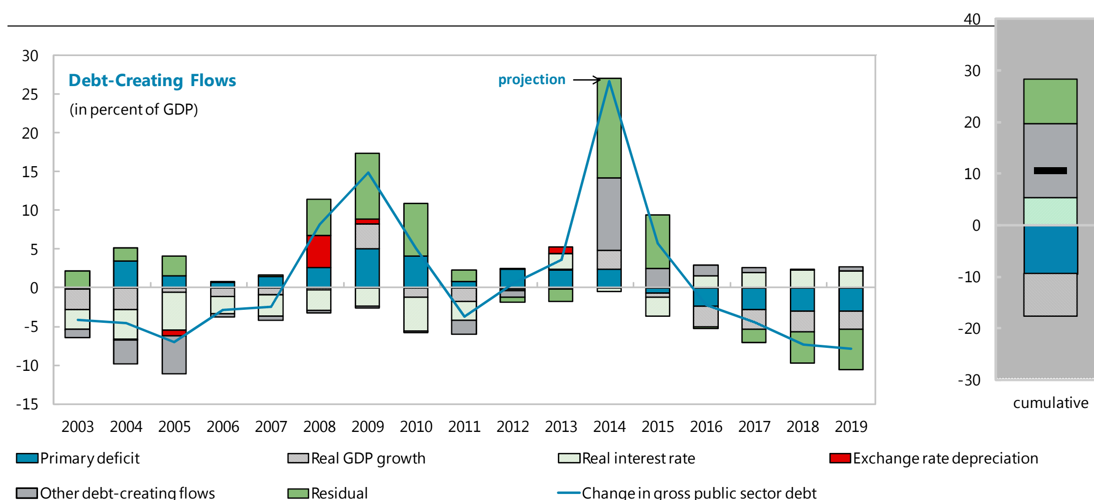
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	25.8	37.4	40.9	67.6	73.4	71.1	66.6	59.3	51.5
Of which: guarantees	5.9	8.2	7.2	11.2	16.2	15.4	13.2	8.9	3.4
Public gross financing needs	5.5	9.3	9.9	23.1	18.0	11.7	14.0	12.4	12.2
Real GDP growth (in percent)	4.1	0.3	0.0	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation (GDP deflator, in percent)	17.2	8.1	3.1	12.1	14.1	8.3	7.6	6.6	6.0
Nominal GDP growth (in percent)	22.0	8.4	3.1	4.8	15.2	12.6	12.0	11.4	10.8
Effective interest rate (in percent) [4/]	6.1	7.4	8.7	10.2	10.1	11.0	11.0	10.7	10.5

As of July 26, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		925
5Y CDS (bp)		786
Ratings	Foreign	Local
Moody's	Caa3	Caa3
S&Ps	CCC	B-
Fitch	CCC	B-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	primary balance [9/]
Change in gross public sector debt	0.4	0.6	3.6	26.7	5.8	-2.3	-4.5	-7.3	-7.8	10.5	0.3
Identified debt-creating flows	-2.8	1.1	5.2	13.8	-1.1	-2.0	-2.7	-3.3	-2.7	1.9	
Primary deficit	2.2	2.4	2.4	2.4	-0.7	-2.4	-2.8	-3.0	-3.0	-9.5	
Primary (noninterest) revenue and grants	41.6	44.5	43.6	42.3	42.5	42.5	42.3	41.9	41.6	253.2	
Primary (noninterest) expenditure	43.8	46.8	46.0	44.7	41.8	40.2	39.5	38.9	38.7	243.8	
Automatic debt dynamics [5/]	-3.6	-0.3	3.0	2.1	-3.0	-1.1	-0.6	-0.4	-0.2	-3.1	
Interest rate/growth differential [6/]	-4.0	-0.3	2.1	2.1	-3.0	-1.1	-0.6	-0.4	-0.2	-3.1	
Of which: real interest rate	-3.1	-0.2	2.0	-0.4	-2.4	1.5	2.0	2.3	2.2	5.2	
Of which: real GDP growth	-0.9	-0.1	0.0	2.5	-0.6	-2.6	-2.5	-2.7	-2.4	-8.3	
Exchange rate depreciation [7/]	0.4	0.0	0.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.4	-0.9	-0.1	9.3	2.5	1.5	0.6	0.1	0.4	14.4	
General Government: Net Privatization Procee	-1.4	-0.9	-0.1	-0.1	-0.8	-0.7	-0.5	-0.5	-0.4	-3.0	
Contingent liabilities	0.0	0.0	0.0	9.1	3.3	1.2	0.5	0.1	0.0	14.2	
Other adjustments	0.0	0.0	0.0	0.3	-0.1	1.0	0.7	0.5	0.9	3.3	
Residual, including asset changes [8/]	3.1	-0.6	-1.6	12.9	6.9	-0.3	-1.7	-4.0	-5.1	8.6	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as Assumed 1 percent of GDP each year in projection period allocated and assumed called.

2/ Based on available data.

3/ EMBIG.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; 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 numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

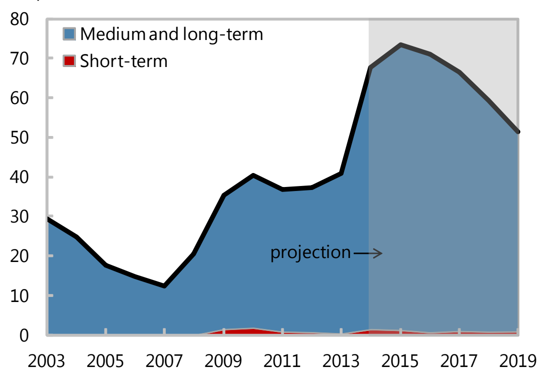
8/ Includes changes in the stock of guarantees (including IMF financing to NBU), and asset changes. For projections, includes exchange rate changes during the projection period.

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.

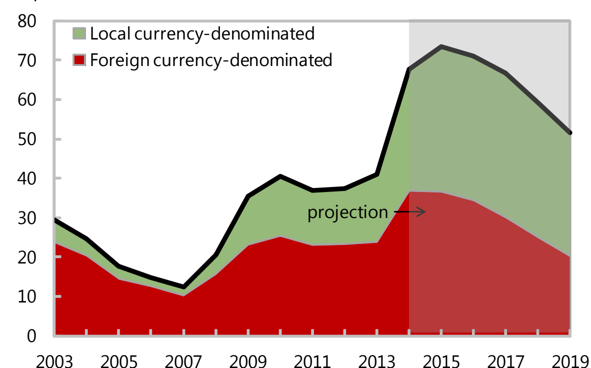
Ukraine Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



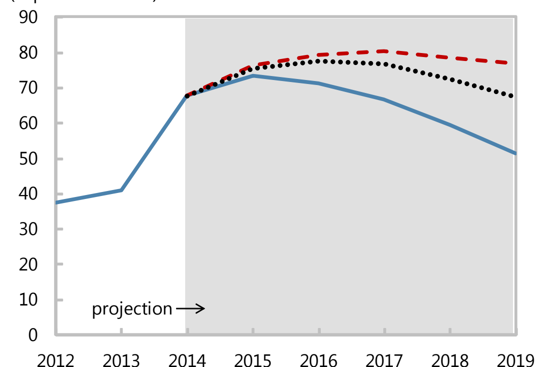
By Currency
(in percent of GDP)



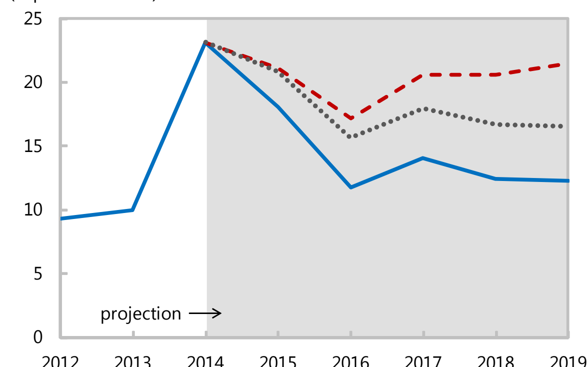
Alternative Scenarios

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)

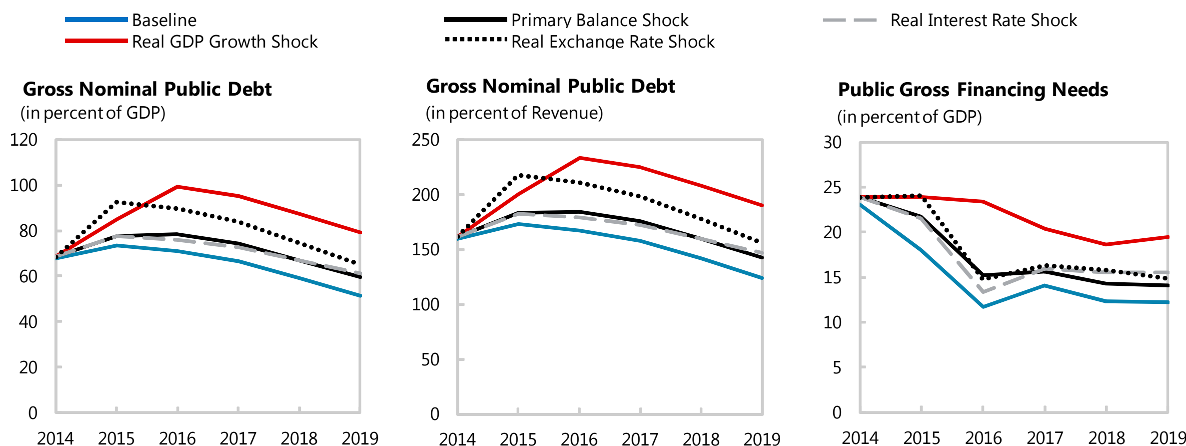
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation	12.1	14.1	8.3	7.6	6.6	6.0
Primary Balance	-2.4	0.7	2.4	2.8	3.0	3.0
Effective interest rate	10.2	10.1	11.0	11.0	10.7	10.5
Constant Primary Balance Scenario						
Real GDP growth	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation	12.1	14.1	8.3	7.6	6.6	6.0
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	10.2	10.1	11.0	10.9	10.6	10.3

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-6.5	2.7	2.7	2.7	2.7	2.7
Inflation	12.1	14.1	8.3	7.6	6.6	6.0
Primary Balance	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	10.2	10.1	8.0	6.4	4.3	3.1

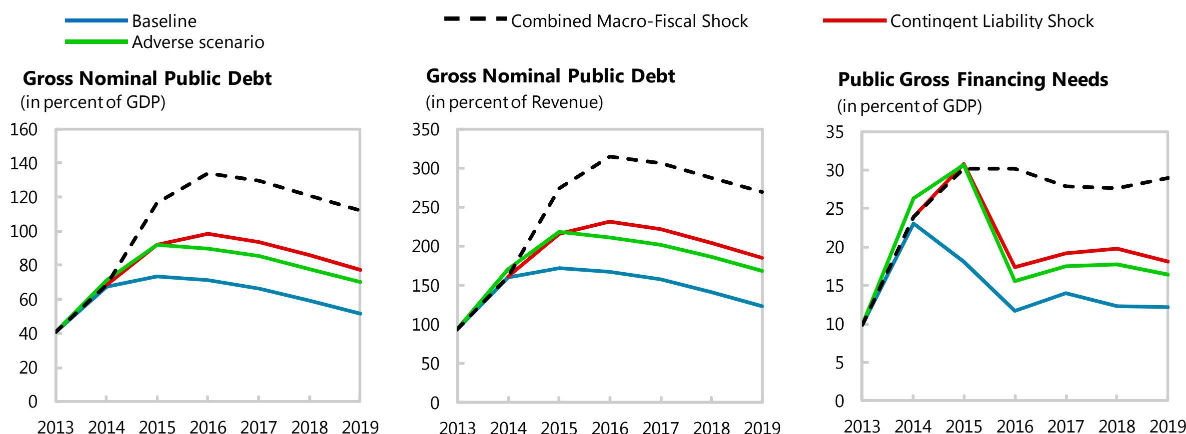
Source: IMF staff.

Ukraine Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2014	2015	2016	2017	2018	2019
Primary Balance Shock						
Real GDP growth	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation	12.1	14.1	8.3	7.6	6.6	6.0
Primary balance	-3.2	-2.9	-0.1	2.6	2.9	3.0
Effective interest rate	10.2	10.1	11.0	11.1	10.8	10.5
Real Interest Rate Shock						
Real GDP growth	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation	12.1	14.1	8.3	7.6	6.6	6.0
Primary balance	-3.2	-2.6	2.4	2.8	3.0	3.0
Effective interest rate	10.2	10.1	12.4	13.0	13.5	13.6
Combined Shock						
Real GDP growth	-6.5	-6.2	-3.2	4.0	4.5	4.5
Inflation	12.1	12.3	6.5	7.6	6.6	6.0
Primary balance	-3.2	-3.2	-5.4	2.6	2.9	3.0
Effective interest rate	10.2	12.4	10.5	11.5	12.3	12.9

	2014	2015	2016	2017	2018	2019
Real GDP Growth Shock						
Real GDP growth	-6.5	-6.2	-3.2	4.0	4.5	4.5
Inflation	12.1	12.3	6.5	7.6	6.6	6.0
Primary balance	-3.2	-3.2	-5.4	2.8	3.0	3.0
Effective interest rate	10.2	10.1	11.0	11.5	11.1	10.8
Real Exchange Rate Shock						
Real GDP growth	-6.5	1.0	4.0	4.0	4.5	4.5
Inflation	12.1	31.6	8.3	7.6	6.6	6.0
Primary balance	-3.2	-2.6	2.4	2.8	3.0	3.0
Effective interest rate	10.2	12.4	10.4	10.6	10.5	10.3
Contingent Liability Shock						
Real GDP growth	-6.5	-6.2	-3.2	4.0	4.5	4.5
Inflation	12.1	12.3	6.5	7.6	6.6	6.0
Primary balance	-3.2	-9.6	2.4	2.8	3.0	3.0
Effective interest rate	10.2	11.1	11.1	11.0	10.7	10.4

Source: IMF staff.

Appendix. Letter of Intent

Kyiv, August 18, 2014

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC, 20431

Dear Ms. Lagarde:

1. Our economic reform program aims at restoring macroeconomic stability, strengthening economic governance and transparency, and generating sound and sustainable economic growth, while protecting the most vulnerable. The attached Memorandum of Economic and Financial Policies (MEFP) updates the MEFP of April 22, 2014 to account for recent macroeconomic developments and introduce policy adjustments to continue the process of macroeconomic stabilization.

2. The economy continues to adjust, but a number of challenges have emerged since the inception of the program. The conflict in the East has intensified and is weighing heavily on confidence and the economic outlook. A dispute between Naftogaz and Gazprom over gas import prices, which has led to the cut of gas supplies by Gazprom, has added to the uncertainty. These developments are affecting economic activity, fiscal revenue performance, and balance of payment flows, making it difficult to meet the initial program targets for the months ahead.

3. We have been steadily implementing the policies under the program. All structural benchmarks for this review have been implemented, although some of them with delay. Despite the adverse impact of the continuing conflict in the Eastern part of the country on the economic situation, we have met all but one of the performance criteria (PCs) for end-May. With joint efforts of the NBU and the Ministry of Finance, we met the end-May PC on Net International Reserves (NIR). Strict control of budget expenditure allowed us to meet the PC on the general government deficit. However, since program approval, Naftogaz imported and stored more gas than initially assumed, which, together with a more depreciated exchange rate, led to a wider Naftogaz deficit. In light of this, the end-May PC on the combined general government/Naftogaz deficit was missed.

4. Similarly, we estimate that the end-July PCs on the general government deficit, guaranteed debt, and net domestic assets (NDA) have been met. However, reflecting the developments described above, the NIR and combined general government and Naftogaz deficit at end-July are estimated to have been missed. We are taking corrective actions to boost our reserve position and

to strengthen payment discipline and compliance, to partly offset these developments and ensure that future targets will be met.

5. In light of the existing economic pressures, we have recalibrated the fiscal deficit and international reserve paths targeted under the program, in a way that seeks to re-establish macroeconomic stability while avoiding undue strains on economic and social outcomes.

6. We remain determined to employ all the necessary measures to stabilize the economy, address structural weaknesses, and ensure sustainable growth. To ensure that the program remains fully financed and not subject to financing risks stemming from settling past gas import bills with Gazprom, we have set aside a substantial amount of funds to settle these bills, if and when such payments need to be made. Looking ahead, we will proceed with the implementation of the energy sector reform and restoration of the viability of Naftogaz finances. To this end, we will intensify our actions to improve collection of both current and past gas bills and make sure Naftogaz gets its fair share of customer payments in the heating sector. We are also committed to maintain a flexible exchange rate and introduce inflation targeting after careful preparation. Fiscal consolidation will continue, at a pace consistent with the economy's recovery trajectory. Simultaneously, we will work to preserve financial stability and continue strengthening our financial regulatory and supervisory framework. Structural reforms to address corruption, improve the business climate, and enhance the effectiveness of the judiciary will remain a key part of our reform agenda.

7. In light of our program implementation record, as well as the corrective actions put in place to avoid slippages on the Naftogaz deficit, boost reserves, and support the revised program targets, we request waivers of nonobservance of the end-July PCs on NIR and the combined general government/Naftogaz deficit and waivers of applicability of the end-July PCs on the ceiling on cash deficit of the general government, the ceiling on cumulative change in net domestic assets of the NBU and the ceiling on public guaranteed debt,—since final data to assess these are not yet available and we estimate they will have been met. On this basis, we also request the completion of the first review of the program under the Stand-By Arrangement and the associated disbursement of SDR 914.67 million. The domestic currency counterpart of Fund purchases in the amount of SDR 650 million will be used to finance the budget deficit. Given the delay in completing the first program review, we request the rephasing of disbursements under the Stand-By Arrangement. We request that the third and fourth purchases originally linked to the second and third reviews be consolidated and that the consolidated amount be made available in one purchase in mid-December 2014 subject to the completion of the second review on the basis of the observance of the end-September and continuous performance criteria.

8. We remain confident that the policies described in the current and previous MEFP are adequate to achieve the macroeconomic and financial objectives under the program. Nonetheless, we stand ready to take additional measures should they be needed to meet these objectives and will consult with the IMF, in accordance with the Fund's policies, on any necessary revisions to the policies contained in this letter and the attached MEFP. We will provide Fund staff with the data and information it requests for the purpose of monitoring program implementation. Reaffirming commitment to our policy of transparency, we consent to the IMF's publication of this letter, the attached MEFP, the Technical Memorandum of Understanding (TMU), and the accompanying Executive Board documents.

Yours sincerely,

/s/
Petro Poroshenko
President

/s/
Arsenii Yatseniuk
Prime Minister

/s/
Oleksandr Shlapak
Minister of Finance

/s/
Valeria Gontareva
Governor
National Bank of Ukraine

Attachment I. Memorandum of Economic and Financial Policies

I. Macroeconomic Framework

1. **Economic activity has been weakening, and escalation of the conflict in the East adds to the uncertainty**. In 2014:Q1, GDP dropped by a mild 1.1 percent, but high-frequency indicators point to a deepening recession. Although agricultural production is expanding, industrial production and construction have continued to decline and retail trade growth has decelerated. Accordingly, we revised our projections of the economic contraction in 2014 to -6.5 percent, from -5 percent expected at the time of our program request. In 2015, after the economy has stabilized, a rebound in exports, followed by private consumption and investment will lead to a modest recovery of 1 percent.

2. **The current account deficit is shrinking fast, but the overall balance of payments is not as good as expected**. While measures introduced by the NBU and the arrival of international financial assistance have reduced hryvnia volatility in April–July, recent intensification in security tensions have led to renewed exchange rate pressures. As a result, the exchange rate depreciated by about 55 percent by mid-August relative to end-2013. In light of this and the fall in domestic demand, imports have contracted rapidly. The current account deficit is in turn improving at a rapid pace and is now projected to reach 2.5 percent of GDP this year, compared to 4.4 percent at the time of the program request. Rollover rates for banks and corporate entities during the first five months of 2014 have been more robust than expected at the time of the program request. However, this has been more than offset by weaker FDI and larger than anticipated outflows of foreign currency from the banking system. On balance, these effects imply a lower than expected pace for accumulation of reserves under the program (Table 2).

3. **Consumer price inflation has accelerated, reflecting rapid pass-through from the currency depreciation and increases in administered prices**. The hryvnia exchange rate has been weaker than initially foreseen. As a result, we expect inflation to reach 19 percent by end-2014. In 2015, inflation should decelerate to about 9 percent, driven by a successful implementation of our stabilization policies.

II. Revised Policies under the program

A. Exchange Rate and Monetary Policy

4. **We remain committed to maintaining a flexible exchange rate**. To this end:

a. ***We will facilitate the unobstructed functioning of the FX market, and will make all regulations, rules, and procedures known and transparent to all market participants***. We have restored the temporarily suspended FX trading licenses to 22 banks in April–May 2014. We will resist pressures to modify legislation to widen the NBU's sanctioning powers with regard to the FX and money market, as this would create uncertainty among market participants and hamper the functioning of these markets.

b. ***We will gradually rescind existing restrictions and MCPs***. In May, we phased out the requirement to deposit hryvnia in a special account for several days before purchasing FX from the market. Once market pressures stemming from the current security tensions subside, we will formulate a plan for staged removal of the remaining restrictive measures, including exchange restrictions and multiple currency practices.

5. ***We remain committed to the objectives of maintaining adequate international reserves and controlling monetary aggregates***. In light of the less favorable BOP flows, we have revised the programmed NIR path (Table 2). To support the revised path, the NBU will accumulate at least US$1 billion through market purchases by end-2014. In this regard, by purchasing at least US$200 million, the NBU will achieve a level of NIR of at least US$7.675 billion as **a prior action**. To save reserves, the NBU will seek to limit FX sales to the central government and Naftogaz to the strictly necessary amounts factored into the program projections for 2014, and will not meet ad hoc demands for FX coming from local governments and other entities. Instead, the NBU will advise them to buy FX in the open market, as will Naftogaz—without restrictions—except for the one-off programmed purchases specified in the TMU (Table C). On its side, the Ministry of Finance will seek to roll over maturing domestic debt liabilities, both in hryvnia and FX by offering an appropriate interest rate and an expanded range of maturities. These policies will be followed throughout the program period. To secure achievement of NIR targets, the Debt Management Unit of the Ministry of Finance and the NBU Monetary Policy Department will step up coordination of their operations through the establishment of a high level coordinating committee. NBU liquidity provision and other operations with its counterparties will be based on a policy framework and regulations that are known and transparent to all market participants. To guide inflation expectations and enhance its

ability to control its net domestic assets as needed, the NBU will maintain its effective policy rate positive in real terms on a 12-month forward-looking basis.

6. **We will continue preparations for adopting inflation targeting (IT) in line with a detailed plan agreed with the IMF**. To this end, we will prepare a strategy to reform the central bank and monetary policy during both the transition phase and the steady state—when full-fledged inflation targeting will be in place**.**

a. ***A new monetary policy framework is currently being prepared***. This would mainly require an increase in the NBU policy and operational independence, building internal capacity, and establishing appropriate internal processes. Furthermore, the NBU will develop and use its own inflation projections and will no longer be obliged to follow the projections developed by the Ministry of Economy. To this end, the law on National Bank of Ukraine will be modified by end-November 2014.

b. ***Starting in July 2014, we will begin implementing changes in the internal NBU structure***. Specifically, we will set up a Monetary Policy Committee (MPC), and ensure a clear organizational and operational separation of the monetary policy formulation function in the Economics Department from the monetary policy implementation function in the context of the overall reorganization of the NBU structure based on the IMF TA Mission recommendations.

c. ***From July 2014 on, we will deploy a new communication strategy to convey to the public how the NBU operates***. The NBU will provide a clear public explanation of its monetary policy and operations, following the best practices established by other central banks.

d. ***The practice of NBU making advanced profit transfers to the budget will be discontinued from July 2014***. The NBU will not transfer profits during the second half of 2014, after the remaining amount of UAH 806 million from the 2013 profit will have been transferred. We will discontinue the practice of overriding the profit distribution rules included in the NBU Law by provisions in the annual Budget Laws and accordingly discontinue advance profit transfers from the NBU to the budget during the current fiscal year. To this end, we will enact legal amendments as needed.

e. ***Benefitting from the IMF technical assistance (TA), the NBU will move ahead with adopting market instruments for interest rate management and control***. As the outflow of deposits from the banking system is bottoming out, since end-July the liquidity support will mainly be focused at the standard monetary mechanisms and its cost will be closely linked to the policy rate.

f. ***By mid-2015, we plan to have in place all technical prerequisites for IT***. In particular, we will implement a transparent policy framework based on controlling money-market interest rates through open market operations using a key policy rate, supplemented by standing lending and deposit facilities.

B. Financial Sector Policies

7. **Despite the economic recession and political events in the Eastern provinces, the banking system has remained resilient**. All banks continue reporting capital adequacy ratios above the regulatory minimum of 10 percent as of end-June, and NPL levels have remained at about 14–15 percent since last May. Demand for fresh NBU liquidity support has eased in recent weeks, although 74 institutions are yet to reimburse NBU liquidity support. The Deposit Guarantee Fund has taken over 15 mainly small banks and has begun the process of paying out the insured deposits.

8. **We have already taken important steps towards maintaining banks' resilience, as envisaged in the program**. Specifically, (i) we reached agreement with IMF and WB staff on the terms of reference for the banks' diagnostic studies and, on this basis, launched the studies for the 15 largest banks in May 2014; (ii) we have amended the DGF Law to enhance its legal and operational capability to restructure banks; and (iii) the NBU and Ministry of Finance have agreed with IMF and WB staff on the criteria for using public funds in recapitalizing or restructuring eligible banks (structural benchmark for end-May, met with delay).

9. **We will continue making progress towards strengthening financial stability with a view to supporting economic growth**. This will be achieved by:

Updating the regulatory and supervisory framework

10. **We are working towards further enhancing our monitoring of banks**. While the bank diagnostics are being completed, the NBU' supervisory teams are actively monitoring and analyzing banking condition with the aim of identifying risks and banks in difficulties, classifying them in three categories (banks under ordinary regime, problematic, and insolvent) to decide on the supervisory strategy for each institution. Prudential supervision over problematic banks is performed on a daily basis, and this analysis together with detailed information on specific institution (including liquidity and cash flows analysis and quality and availability of collateral) is being reported to the NBU board weekly and serve as basis for the Board decision on disbursement of funds for new liquidity support or possible renewal of liquidity support loans. Importantly, with technical assistance from the IMF, we will complete by end-November 2014 a review of the NBU tools to identify problem banks early, by benchmarking them against best international practices. Finally, with the view to improve our

analysis and monitoring of systemic risks, by end-October we will enhance our set of modeling instruments for macro stress-testing.

Assessing financial resilience through bank diagnostics

11. **We will continue implementing diagnostic studies of banks**. By August 31, the NBU board will complete the review of the results of the diagnostic studies performed by external auditing firms on the largest fifteen banks and send letters to banks requiring recapitalization and submission of restructuring plans as a result of these studies (after taking into consideration recommendations provided by the Steering Committee responsible for controlling the quality of bank diagnostics). On July 15, 2014, the diagnostic studies of the 20 next largest banks have begun. By end-August, with technical assistance provided by IMF and WB, the NBU will prepare an outline of a standardized restructuring plan and a set of criteria to assess the credibility and sustainability of banks' recapitalization and restructuring plans.

Restructuring and recapitalizing financial institutions in need

12. **We are enhancing our preparedness to deal with eventual capital needs while preserving financial stability**. To this end, we are working on three fronts:

- **Enhancing the DGF framework and financial position**. We amended the DGF law to enhance its legal and operational capability to resolve banks by making more explicit the conditions of its access to public loans and direct recapitalization of the state in extreme circumstances. On funding, the amendments also allow the DGF to issue securities and exchange them with government securities to cover gaps between assets and liabilities that are being transferred from insolvent to solvent institutions. Moreover, on July 10, 2014 a cabinet resolution has been passed to rule on DGF funding activities. On the basis of estimates provided by the DGF and reviewed by the NBU and the Ministry of Finance, the latter will lend the DGF sufficient resources in line with the DGF Law to support its capability to pay out the insured deposits in the small banks it has taken over. By end-September 2014, in close coordination with IMF and WB staff we will issue the needed implementing by-laws to address new features introduced by the new DGF law.

- **Ensuring availability of contingent public funds**. With the advice of the Fund and WB, we have completed the criteria to use public funds to recapitalize and restructure systemically important banks. As in 2014, the government will continue to seek authorization to provide adequate public funds for this purpose in the 2015 budget.

- **Improving legal bank restructuring tools**. In close consultation with IMF and WB staff, we will submit by end-August draft legislation to Parliament to address legal weaknesses that may impede the effective implementation of the banking strategy agreed in the current program.

- **Enhancing coordination between NBU and DGF**. On the basis of their recently revised memorandum of understanding, the coordination between the two institutions has improved significantly. NBU and DGF staff are monitoring closely not only banks deemed to be insolvent but also problematic institutions.

13. **We will continue to ensure proper governance in restructuring banks**. We will take action in three fronts:

- **Monitoring state ownership in recapitalized banks**. We are working towards establishing a specialized unit to manage the state's financial sector shareholdings by end-September 2014. To this end, we will assess whether the current specialized division at the MoF, responsible for managing corporate rights, needs to be reorganized, enhancing its organizational relevance within the ministry, and provided with adequate budgetary resources to hire experienced staff. If action is needed, we will adopt the necessary measures by end-September 2014. Furthermore, while we believe the specialized division' current terms of reference could serve as the basis to define the relationship between banks and the Ministry of Finance and ensure no political interference, by end-August 2014, in coordination with Fund staff, we will revise our existing arrangement with the aim to identify any eventual deviation from international best practices.

- **Ensuring that due investigation is initialed**. The DGF has completed the filing of 112 potential cases of wrongdoing in the banks under its temporary administration, mostly associated with lack of control of bank assets and documentation. Furthermore, to enhance our work on governance, we will ensure that the DGF, in line with existing legislation and consultation with the IMF and WB staff, will complete by end-September 2014 terms of reference and an action plan to arrange comprehensive legal due diligence by independent firms of banks under temporary administration to identify whether wrongdoing or bad banking practices led the bank into insolvency. The tender process for the selection of the firms responsible for the due diligence of the first two cases of the action plan will be initiated by end-September 2014 with the view to launch the two such investigations by end-November 2014.

- **Managing the assets left in banks under liquidation**. With technical assistance from the IMF and WB, by end-November 2014 we will complete an assessment of options currently available and strategy to dispose assets with the aim to identify areas that may deserve further

enhancement and help to maximize recovery value. This assessment will also include tools available to collect related party loans and means of cooperation from NBU (for example, NBU would ensure that in assessing these borrowers' creditworthiness the operating banks factor in past due loans held by banks under liquidation and also ensure these exposures are reported to the credit register set to be created at NBU). On this basis, we will amend the Law on banks and banking.

Enhancing banks' capacity to resolve bad loans

14. **We remain fully committed to ensuring that banks have the tools and motivation to successfully address their NPLs and proactively seek to prevent new ones**. To this end, we are working on four fronts:

- We will support the approval of legislation by end-September that would guide the restructuring of foreign currency denominated mortgage loans serviced by struggling but still performing borrowers without interfering in bilateral negotiations between borrowers and banks ***(structural benchmark)***. To this end, we will amend the draft law already passed by Parliament on first reading. This law will aim to: (i) protect the rights and interests of individuals that can demonstrate to be in financial difficulties; (ii) target borrowers with loans that do not exceed UAH 1 million as of end-December 2013 (about US$125,000) and who live in the mortgaged properties; (iii) establish a voluntary process where eligible borrowers would apply to banks for restructuring and can prove their difficult financial situation; (iv) guide banks to restructure loans on the basis of the borrowers' financial condition and capacity to pay. After considering reasonable living expenses, the banks will make a proposal to borrowers that may include debt conversion and interest and principal reduction; and (v) require banks to establish an independent and credible panel under NBU monitoring to deal with customers' complaints. This process will also be guided by the Code of Conduct discussed below. Should a materially different law be passed, the President will veto its enactment. Simultaneously, we will also lift the moratorium on collateral foreclosure imposed in June as it will be replicated for eligible borrowers by the procedures under the Code of Conduct.

- On the basis of NBU existing guidelines on loan in arrears and international best practice, with technical assistance from the IMF, the NBU will issue a Code of Conduct by mid-September 2014 to guide negotiations between borrowers in difficulty and banks, establish debt restructuring guidelines, and an appeal process. The Code will seek to induce fair and balanced negotiations between banks and borrowers. The launch of such negotiations will lead to immediate standstill on collateral foreclosure on residential property for eligible borrowers. The resulting agreements

on debt workouts should aim to help borrowers in real need while maintaining a high level of debt servicing discipline.

- Supporting the introduction of the Code of Conduct, we will seek to amend the Tax Code by end-September 2014 to allow banks to deduct losses stemming from such debt workouts, while borrowers should not be required to recognize income associated with interest, penalties, and exchange rate differences stemming from debt restructuring.

- Going forward we also plan to enhance our current legal and regulatory framework associated with out of court arrangements and insolvency law, and ensure banks' readiness to deal with troubled borrowers, with technical assistance from the IMF.

C. Fiscal Policy

15. **The end-May general government deficit target was met, but pressures are emerging in light of the deterioration of the security situation**. Despite the positive effects of the measures implemented under the program and the depreciation of the hryvnia, tax revenues have been underperforming. Frontloading of the NBU profit transfer and expenditure restraint have helped meet the end-May target for the budget deficit with a wide margin. However, some accumulation of unpaid bills and reduction in VAT refunds could not be avoided. In addition, the deterioration of the security situation in the East is contributing to the recent weakness in tax revenue performance and creating upward pressures on military expenditure.

16. **In light of the shocks facing the economy, we are recalibrating our general government deficit path to maintain the targeted structural adjustment in the fiscal and quasi-fiscal deficit**. The recalibration aims at a larger structural fiscal adjustment of 2.6 percent of GDP during 2014–16, compared to the original program target of 2 percent, to compensate for the widening in Naftogaz's deficit (see section D). Given the weaker economy and the one-off nature of some of our military spending, this translates into headline general government deficits of 5.8 percent of GDP in 2014 (0.6 percent of GDP wider than envisaged at the time of the program request), 3.9 percent of GDP in 2015 (0.3 percent of GDP tighter than originally envisaged), and 2.7 percent of GDP in 2016 (0.4 percent of GDP tighter than originally envisaged). Since Naftogaz's projected operational deficit for 2014 also needs to be revised upwards (see below), this will be consistent with combined deficits of the general government and Naftogaz of 10.1 percent of GDP in 2014, 5.8 percent of GDP in 2015, and 4.0 percent of GDP in 2016. Revised ***quantitative performance criteria*** and indicative targets are set in Table 2.

17. **Notwithstanding the loosening of the 2014 general government deficit target, meeting the revised objective requires continuing spending restraint and additional policy measures**. First, we will maintain the expenditure policies described in the MEFP dated April 22—including refraining from discretionary wage, pension, and social assistance hikes as well as completing the significant cuts in administrative civil service staff (27,000 staff) to correct for an unaffordable expansion in previous years. Second, we will offset a UAH 9.7 billion increase in military and reconstruction spending planned in 2014 by reducing spending on goods and services, transfers, subsidies, and other expenditure by the same amount, including by locking in savings from the first half of the year. Third, we will implement additional revenue measures yielding UAH 5½ billion in the remainder of the year to partly compensate for the revenue shortfall driven by the deterioration of security in the East. To this end, in addition to the recently adopted tax on deposit interest income, we will extend the VAT exemption on grain exports from October to the end of 2014 and eliminate VAT exemptions for the wood-processing industry. A new supplementary budget reflecting these policy adjustments will be passed as ***a prior action***.

18. **Over the medium-term, we are aiming at a gradual expenditure-based fiscal consolidation to build confidence and reduce imbalances**. High levels of public spending relative to GDP call for an expenditure-led consolidation. We plan to implement a number of structural fiscal measures needed to meet our consolidation targets for 2015–16 and create fiscal space for growth-enhancing fiscal spending. Specifically:

- In 2015, we will continue our efforts to put expenditure on sustainable footing by further structural fiscal reforms while keeping discretionary spending in check. After a freeze in 2014, we plan to index public sector wages to expected inflation, while reducing the number of employees in the budgetary sector by 3 percent to limit the wage bill to 10.2 percent of GDP. Similarly, we will aim to maintain the purchasing power of pensions unchanged in real terms and target overall Pension Fund spending of 15.2 percent of GDP. Energy-saving measures and strict expenditure control will allow us to reduce spending on goods and services to 6.2 percent of GDP. These policies will allow us to expand public investment by almost half to 2 percent of GDP to support growth and cover reconstruction costs in the East.

- Building on the advice of the IMF technical assistance mission on expenditure rationalization, we will review by end-September 2014 the education spending and develop measures needed to enhance cost-efficiency in the sector, including by (i) exploring the possibility of raising class and school sizes toward the average European levels; and (ii) reducing excessive staffing on the basis of performance reviews. From July 1, 2015 we will also increase the teaching load of primary and secondary school teachers from 18 to 20 hours, followed by a further increase to 22 hours from

July 1, 2016. In addition, by end-September 2014 we will prepare a plan to introduce means-testing in providing benefits to students in secondary schools while protecting vulnerable groups as per our current plans.

- We have already begun to reform privileged pensions. From May 1, 2014, we reduced the replacement ratio used for calculating such pensions in the civil service from 80 to 70 percent and expanded the base of the pension to include the average wage of the last 5 years (as opposed to the last 2 years before). By end-September, we will prepare and present to IMF staff a plan of measures and legislative proposals to restrict eligibility for privileged pensions and reduce their cost over time. Specifically, we will keep privileged pensions at their current nominal levels until end-2015, except for inflation indexation of pensions that are at the subsistence minimum, and consider closing some of these systems for new entrants as part of the reform. The plan will also include expanding taxation of high-income pensioners in 2015. All these measures are expected to save the budget ¼ percent of GDP.

19. **Notwithstanding the priority given to the reduction in government spending in the years ahead, revenue reforms will also be necessary to achieve our fiscal objectives**.

- Drawing on recommendations of the recent FAD TA mission on tax administration, we will submit a law to Parliament by September 1, 2014 to be passed by end-October 2014 that will:

a. Eliminate discretion for large taxpayers to choose a tax office to manage their tax affairs and transfer all taxpayers meeting large taxpayer criteria to the Large Taxpayer Office;

b. Review the management of the largest debtors to the budget and assign the cases to a centralized and separate function starting from January 1, 2015.

- We will improve detection of under-declared wages, a pervasive problem, through strengthening risk-based assessment of taxpayers. To this end, we will assign the responsibility for improving compliance with payroll and PIT taxation to one deputy head in each local tax inspectorate. This person will lead the work to identify high-risk taxpayers—based on a set of indicators including a suspiciously high share of employees receiving minimum wage—and communicate this information to the tax police. Moreover, we will change the internal procedures of the fiscal service to enable the use of tax returns for identification of under-declared wages.

- After discussion within government and with the private sector, we will prepare by end-September 2014 a proposal for the reform of VAT in the agricultural sector in view of

bringing the VAT treatment of this sector closer to the general VAT regime (***structural benchmark***). In this context, in consultation with producers we will reduce the VAT exemptions for agriculture in 2015. We are discussing with agricultural producers the most appropriate form of taxation taking into account the recommendations of IMF and World Bank technical assistance missions and the needs of the sector.

D. Energy Sector Policy

20. **Higher-than-planned gas imports and exchange rate depreciation have led to a sharper-than-expected deterioration of the Naftogaz deficit**. Naftogaz has imported and put in storage more gas than assumed at the time of the program request, which, together with the more depreciated exchange rate, has led to a wider deficit. Accordingly, and notwithstanding our full commitment to improve collections across all customer groups to ensure that future targets are met, we have had to revise the 2014 combined general government/Naftogaz deficit target upward, based on a projected deficit for Naftogaz of 4.3 percent of GDP versus 3.3 percent targeted earlier. In addition to the impact of the higher deficit, the company will need more support from the government than expected at the time of the program request (an additional 3.5 percent of GDP in 2014) to offset large shortfalls in the collection of past receivables due to inability of heating companies and some industrial companies to pay their bills. We are taking measures to address this problem (¶23).

21. **A gas price dispute with Gazprom led to accumulation of payment arrears in 2014:Q2, interruption of gas supplies in June, and an arbitration process under way in Stockholm**. Naftogaz has cleared its arrears for January–March 2014, leaving arrears for gas delivered in November and December 2013 outstanding. However, as the gas price is in dispute since April, Naftogaz did not pay for imported gas in April–June. Despite intensive negotiations, a solution was not found, and Gazprom stopped gas deliveries to Ukraine on June 16, 2014. Both companies filed arbitration claims, with Naftogaz claiming overpayment of US$6 billion for 2010–13 as a result of the gas prices charged by Gazprom then; the arbitrator's decision may affect the amount of arrears outstanding from 2013. More generally, Naftogaz is asking for revisions to the 2009 contract to reflect current economic conditions on the gas market and in Ukraine.

22. **We have made several important steps towards reforming the energy sector**.

- Household gas and heating tariffs were raised effective May 1 and July 1, 2014; industrial gas tariffs were adjusted in April and May to reflect exchange rate changes. The utility regulator

NURC remains committed to keeping the share flowing to Naftogaz constant rather that reducing it for the benefit of transportation and distribution companies.

- The new targeted social assistance scheme to offset the tariff increases for low income households became operational on July 1. Between the new and the existing schemes, about 27 percent of the population will receive assistance to cope with the energy bills.

- The audit company BDO was selected to conduct the quarterly cash flow audits of Naftogaz accounts and prepared the end-May cash flow audit on July 8 (a structural benchmark for end-June, met with delay).

- The process of making mandatory distribution accounts in the district heating sector fully operational is under way. These distribution accounts are critical for increasing the share of revenues channeled to Naftogaz from district heating companies once they collect revenues from consumers. The law on the creation of distribution accounts has been passed (a structural benchmark for end-June) and the Cabinet of Ministers resolution was published in early July. District heating companies are expected to open special bank accounts where households will deposit their bill payments within one month from the publication of the resolution. We expect that by the start of the heating season, the distribution accounts will be channeling to Naftogaz funds commensurate with the share of the gas price in the heating tariffs.

- In addition, as part of the reform in the energy sector, on June 4, 2014, we reiterated our objective to restructure Naftogaz by establishing separate companies that will perform the transit and storage of natural gas. This unbundling would put Ukraine in compliance with the Third Package of the Energy Community Treaty and would help attract investors for the modernization and operation of the gas transport system. In the coming months Parliament is expected to consider a number of legislative amendments to put this process into its implementation stage. A working group consisting of the European Commission and the World Bank is working with Naftogaz and the Ministry of Fuel and Energy in reforming the gas sector.

23. **Going forward, we remain committed to our energy sector reform strategy**:

a. ***In 2014, the main objective will be to contain Naftogaz's deficit to 4.3 percent of GDP***. We will reduce it to 1.9 percent of GDP in 2015 and aim to eliminate it by 2018.

b. ***To ensure that the program is not subject to financing risks stemming from settling past gas import bills with Gazprom, we have earmarked a substantial amount of funds for this purpose***. Specifically, after the completion of Naftogaz's recapitalization procedure, the

company will deposit US$3.1 billion in a restricted account with the NBU (***prior action***). Naftogaz will make payments out of this account only with the agreement of the Ministry of Finance and the NBU for the purpose of settling gas bills with Gazprom upon a decision by the arbitrator in the dispute with Gazprom or if out of court settlement between Naftogaz and Gazprom is reached. In the event the funds in the account exceed the amounts needed to pay Gazprom under the arbitrator's decision or the settlement between the two companies, the funds will be used to pay for gas imports going forward.

c. ***In response to the developments noted above, the government will step up its financial support to Naftogaz***. In addition to the budget allocation of UAH 33 billion already put in place, Naftogaz will need UAH 82 billion to finance its deficit and its debt payment obligations. To this aim we amended the 2014 budget on July 31 to provide additional funds for Naftogaz recapitalization in the amount of UAH 70 billion, including UAH 7.3 billion to cover cancellation of arrears to Naftogaz related to tariff differences. In addition to enhancing its collection efforts, Naftogaz is in the process of rolling over domestic debt obligations coming due this year.

d. ***We will continue to adjust on a quarterly basis gas prices to industrial and budget consumers in line with the actual gas imports costs***, taking into account new gas import prices and exchange rate movements.

e. ***We will strengthen our efforts to collect Naftogaz receivables from clients, which is critical for improving Naftogaz finances***. To this end we have set up a working group involving the Ministry of Energy, Naftogaz, and the Ministry of Finance to review existing Naftogaz receivables and develop by end-August 2014 a monthly collection plan for September 2014–December 2015 (**structural benchmark**). The plan will have targets by customer category to maximize the collection of arrears and make sure that customers remain current with their bills. A department within Naftogaz will be tasked with assessing the stock of accounts receivable that are truly collectible, soliciting bill payments from collectible accounts, assessing the accounts on which a haircut is warranted in order to ensure at least a portion of the funds flows to Naftogaz, and blocking bank accounts and pursuing asset seizure if repayment or a plan for repayment is not agreed with customers. We will identify the necessary legal changes to remove obstacles, if any, to these collection methods by end-August 2014 and propose the necessary legislation amendments by September 15. Furthermore, Naftogaz will publish on its website the list of entities (private and public) with overdue bills payable for gas delivered to them. The list will be updated on a monthly basis.

f. ***We will continue to pursue our objectives of restructuring Naftogaz and attracting new investments in the gas sector***. We will amend relevant laws so as to allow FDI in companies operating in the gas transport and storage business. Furthermore, the statutes for the creation of two independent companies out of a Naftogaz subsidiary that will handle gas transport and storage services will be developed. Once these companies are operational, the procedures for setting tariffs for gas transport and storage will also be changed to reflect international best practice.

E. Governance, Transparency and the Business Climate

24. **Strengthening governance and the transparency of government operations and improving the business climate remain key reform priorities**. We have conducted jointly with Fund experts a diagnostic study (structural benchmark for July 15) to identify major areas for reforms. Based on the recommendations of the diagnostic study we will:

a. ***Improve governance and AML/CFT framework***. To this end we will:

- **Submit to Parliament by September 1, 2014 (*structural benchmark*) and adopt by end-October, 2014 (*structural benchmark*) enabling legislation for the establishment of an independent anti-corruption agency with broad investigative powers**. The agency will detect and investigate corruption offences and acts of the laundering of proceeds of corruption among high-level officials, as well as other corruption offences that constitute a particular danger to society and including those reflecting allegations received through a public hotline. The agency will prepare semi-annual public reports of its activities, including summary and data on its investigations and their outcomes. The agency will have powers of asset recovery (freezing, seizing and executing confiscation orders of assets) related to its own investigations. In particular, we will ensure that the agency will be: (i) operationally and institutionally independent from any external influence guaranteed and realized; (ii) accountable and transparent; (iii) adequately resourced in terms of budget, staffing and expertise; and (iv) able to obtain all relevant information domestically and to engage in international cooperation with regard to its area of competency. Institutional and operational independence from any external influence will be guaranteed and realized, in particular, through appropriate procedures for appointment; term limits and dismissal of the head of the agency; the power to recruit and dismiss its own staff; special procedures for budgetary allocations; and competitive remuneration for the head and staff of the agency. Prosecuting authorities will designate prosecutors to be in charge of prosecuting the cases under the jurisdiction of the agency; they will report to the Prosecutor General. Going forward, we will also implement reforms to strengthen the income and asset

declaration, verification, and publication framework as it applies to high-level pubic officials. We will discuss this area of reforms with Fund staff at the time of subsequent reviews.

- **Submit to Parliament by September 1, 2014 (*structural benchmark*) and adopt by end-October, 2014 (*structural benchmark*) amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort**. The key elements are as follows: (i) financial institutions will be required to conduct enhanced due diligence on business relationships with domestic politically exposed persons; (ii) the laundering of the proceeds of tax crimes will be criminalized and made a predicate offence to money laundering; (iii) the respective provisions of the Criminal Code of Ukraine pertaining to illicit enrichment will be brought in line with the UN Anticorruption Convention; (iv) financial institutions will be allowed to end a business relationship with a customer when institutions are unable to perform customer due diligence requirements; and (v) pecuniary administrative sanctions for non-compliance with AML requirements are effective, proportionate, and dissuasive.

b. ***Streamline the regulatory framework pertaining to economic activity***. To this end:

- **As a *prior action* for the review, the government will take a formal decision to establish by end-August an authorized body accountable to the Cabinet of Ministers to coordinate the effort to simplify regulations**. The head of the body will report directly to the Prime Minister to ensure adequate high-level coordination (both within the government and among government, civil society and business) as well as effective monitoring and reporting of progress toward regulatory simplification.

- **The government will adopt by end-October an action plan to streamline, simplify and clarify the legislative and regulatory frameworks governing economic activity (*structural benchmark*)**. The plan will be prepared by the coordinating body. Individual ministries and agencies will provide their input to the action plan based on their areas of competency. We will involve the business community and the civil society in a public consultative process. The action plan will include a census of existing legislative and regulatory requirements and specify those that will be eliminated, streamlined, simplified or clarified, with appropriate prioritization in terms of substantive impact and timelines. We will publish quarterly reports indicating the progress made on the action plan.

25. **Strengthen the effectiveness of the judiciary to ensure the enforcement of commercial claims**. Our reform agenda is based on four broad objectives: (i) enhancing judicial independence,

(ii) ensuring institutional integrity, (iii) streamlining organization and procedure, and (iv) strengthening post-court enforcement. We will develop, in consultation with Fund staff, specifics and timeline for reforms in these areas at the time of subsequent reviews. In the meantime, to lay the ground work, the relevant judicial entities (the State Judicial Administration and the High Council of Judges) and the State Enforcement Service have undertaken to conduct and complete by September 1, 2014, in consultation with IMF staff, reports on the following: (i) the number and processing time of court cases and post-court enforcement cases; (ii) the current court fee system (with revenue streams per jurisdiction) with proposals for changing court fees in line with cross-country developments; and (iii) the internal supervision system over judges and enforcement agents.

26. **Other steps to improve governance, transparency and fairness include**: (i) preparing, in consultation with the IMF and other international partners, a strategy by end-September 2014 and an implementation plan by end-November 2014 for strengthening tax compliance of high income earners and those with foreign assets; and (ii) continuing to address delays and weak transparency in granting VAT refunds, a long-standing problem that has given rise to governance issues. Regarding the VAT refunds, we remain committed to the specific measures outlined in MEFP of April 22, 2014. In particular, in order to step up VAT refunds, particularly those provided through the automated mechanism, we will reconsider the eligibility rule based on the level of average wages and will enhance the risk-based audit system. Appropriate amendments to the Tax Code will be introduced to this effect by end-October, following the recommendations of working groups established at the Ministry of Finance and involving representatives of the business community. Consistent with the Tax Code, the practice of requesting CIT advance payments in exchange for VAT refunds will be also prohibited—the State Tax Service will issue instructions to all tax offices to confirm this by end-July 2014.

III. Safeguards

27. **We will ensure that adequate safeguards are in place**. To this end, we will implement the recommendations of the IMF safeguards mission completed in May 2014 to improve the NBU governance and financial autonomy.

a. *The NBU will prepare in consultation with Fund staff draft legislative amendments to the NBU Law* (**structural benchmark for end-December 2014**). These will (i) strengthen the decision-making and oversight mandate of the Council; (ii) transform the Board into a smaller Executive Committee, composed of the Governor and Deputy Governors that would be charged with the residual powers of the NBU, which are powers not explicitly assigned to the Council or the Governor; (iii) strengthen the personal autonomy of Council members and Deputy Governors by enhancing appointment procedures and mitigating conflicts of interest through developing a

Code of Conduct; and (iv) authorize the Council to establish special reserves before the profit distribution rules kick in.

b. *We will strengthen internal controls of the NBU.* On May 8, 2014, the government and the NBU signed an Agreement concerning the servicing of future financial obligations related to the budget support under the current program and provided a copy of this Agreement to the Fund. We will resume the quarterly data audits introduced during the 2008 Fund-supported program and communicate the results to the Fund within six weeks of each test date. By October 2014 the NBU will establish a senior level Credit Committee to oversee the liquidity lending operations. In addition, the NBU will, in the medium term, shift the origination and management of these operations to a function outside of banking supervision.

c. *The government will settle its obligations to the NBU* which were accumulated (starting from February 2014) as the National Bank repaid out of its reserves the government obligations coming due to the IMF. These obligations covered by the NBU originated from budget support disbursements in the context of the 2010 SBA arrangement with the Fund. While repaying these obligations in full and on schedule, the NBU did not receive the corresponding payments from the Ministry of Finance (SDR 913 million in total). As per the Agreement signed between Ministry of Finance and the NBU in June 2014, the government will fully reimburse the NBU by end-2014.

IV. Program Monitoring

28. **Program implementation will be monitored through prior actions, quarterly reviews, quantitative performance criteria and indicative targets, and structural benchmarks**. The second review is now set for mid-December 2014 based on end-September 2014 quantitative targets and taking into consideration structural benchmarks through end-October 2014. For all reviews, quantitative performance criteria will include: a ceiling on the cash deficit of the general government; a ceiling on the combined deficits of the general government and Naftogaz; a ceiling on publicly guaranteed debt; a floor on cumulative change in the NIR; a ceiling on cumulative change in the NBU's NDA; and non-accumulation of external debt payments arrears by the general government. The **prior actions** and **structural benchmarks** are set out in Table 1. The quantitative targets for target dates through end-December 2014, along with a **continuous quantitative performance criterion** are set out in Table 2. The understandings between the Ukrainian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this memorandum are further specified in the Technical Memorandum of Understanding (TMU) attached to this memorandum.

Table 1. Ukraine: Prior Actions and Structural Benchmarks

Prior actions	**Status**	**Completion date**
Parliament will pass a supplementary budget, reflecting: (i) the new tax policy and expenditure measures (¶17) and (ii) the funds necessary to recapitalize Naftogaz (¶23).	Met	July 31, 2014
The NBU will achieve a level of NIR of at least US$7.675 billion by accumulating at least US$200 million through market purchases (¶5).		
After the completion of Naftogaz's recapitalization procedure, the company will deposit US$3.1 billion in a restricted account with the NBU (¶23).		
The government will take a formal decision to establish by end-August an authorized body accountable to the Cabinet of Ministers to coordinate the effort to simplify regulations (¶24).		
Structural benchmarks	**Status**	**Completion date**
To strengthen payment discipline for the heating sector, Parliament will pass legislation that will make distribution accounts fully operational and mandatory for utility payments.	Met	June 30, 2014
If existing fit and proper shareholders are unwilling or incapable of recapitalizing in full a weak bank, public funds could be used to bring it back into solvency, according to strict criteria. Government and the NBU will reach agreement with IMF staff on these criteria.	Met with delay on July 4, 2014	May 31, 2014
To provide an accurate picture of Naftogaz finances, Naftogaz will launch a tender by April 3 to conduct audits of Naftogaz operations, led by an external auditor. The auditor will be in place within 60 days of the tender. The results of the audits will be shared with the IMF within 30 days of each period, initially on a monthly basis beginning with data for end-May 2014, and then on a quarterly basis for end-September data forward.	Met with delay on July 8, 2014	June 30, 2014 and then monthly through October; then quarterly
Complete a comprehensive diagnostic study in close consultation with IMF staff that will cover the anti-corruption framework, the design and implementation of key laws and regulations that may have impact on business climate, the effectiveness of the judiciary, and tax administration, as described in ¶24.	Met	July 15, 2014
Complete diagnostic studies and review of business plans for the 15 largest banks.	Met	July 31, 2014
The government should be prepared to manage its financial sector shareholdings in the event that it is called on to use public funds—and to this end, a specialized unit will be set up at the Finance Ministry.	In progress	September 30, 2014
After discussion within government and with the private sector, we will prepare a proposal for the reform of VAT in agriculture with a view to bringing the regime in this sector closer to the general VAT regime.	In progress	September 30, 2014

Table 1. Ukraine: Prior Actions and Structural Benchmarks (concluded)

Structural benchmarks	**Status**	**Completion date**
Prepare a monthly collection plan for Naftogaz's receivables for September 2014–December 2015, with targets by customer group.	**New SB**	End-August, 2014
Parliament will adopt a law to facilitate NPL resolution and help prevent new NPLs, as described in ¶14.	**New SB**	End-September, 2014
Submit to Parliament draft law for the establishment of an independent anti-corruption agency with broad investigative powers	**New SB**	September 1, 2014
Adopt enabling legislation for the establishment of an independent anti-corruption agency with broad investigative powers.	**New SB**	End-October, 2014
Submit to Parliament amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	**New SB**	September 1, 2014
Adopt amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	**New SB**	End-October, 2014
The government will adopt an action plan to eliminate, streamline, simplify and clarify the legislative and regulatory frameworks governing economic activity.	**New SB**	End-October, 2014
The NBU will prepare draft legislative amendments to the NBU Law to strengthen the governance and autonomy framework of the NBU, in line with the recommendations of the safeguards assessment mission.	**New SB**	End-December, 2014

Table 2. Ukraine: Quantitative Program Targets and Projected Performance 1/

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

	2014										
	March	May			July			September		December	
		PC	Adj. PC		PC	Adj. PC	Est.	IT	PC	IT	PC
I. Quantitative performance criteria											
Ceiling on the cash deficit of the general government (- implies a surplus) 2/	4,732	31,000	25,211	5,193	47,500	36,252	34,000	59,000	64,000	78,000	88,000
Ceiling on the cash deficit of the general government and Naftogaz (- implies a surplus) 2/	4,685	44,700	10,371	14,791	69,200	3,895	48,700	94,800	130,305	128,500	153,349
Floor on cumulative change in net international reserves (in millions of U.S. dollars) 3/ 4/	10,998	-1,273	849.0	849.0	1,096	311	-223	266	-3,780	-687	-3,755
Ceiling on cumulative change in net domestic assets of the NBU 3/ 4/	208,588	36,383	14,523	4,611	21,292	39,379	31,082	29,685	83,638	51,527	104,349
Ceiling on publicly guaranteed debt 2/	0	25,000		0	25,000		0	25,000	25,000	25,000	25,000
II. Continuous performance criterion											
Non-accumulation of new external debt payments arrears by the general government 2/	0	0		0	0		0	0	0	0	0
III. Indicative Targets											
Ceiling on cumulative change in base money 3/	329,061	22,438		13,912	33,303	38,503	28,645	32,593	42,233	44,003	63,211
Ceiling on net accumulation of VAT refund arrears 5/	8,545	0		2,150	0			-2,500	-5,000	-5,000	-10,695
IV. Memorandum Items											
External project financing 2/	317	2,800		414	5,000		1,300	15,500	2,300	31,400	4,700
NBU loans to DGF and operations with Government bonds issued for DGF financing or banks recapitalization 3/	0	0		0	0		5,200	0	5,200	15,000	28,700
Government bonds issued for banks recapitalization and DGF financing 3/	0	0		0	0		0	0	0	15,000	23,500
Stock of budgetary arrears on social payments 2/	0	0		21	0		0	0	0	0	0
Programmed disbursements of international assistance except IMF (millions of U.S. dollars) 3/ 4/	29	1,150		1,898	4,746		2,587	5,786	5,544	6,286	6,826
Percent of it applied to adjustment	...	100		100	100		100	75	100	75	100
Naftogaz purchases of foreign exchange from the NBU for the purposes and in the event of paying gas supply bills and repaying currently disputed arrears to Gazprom as well as the Eurobond issue maturing in September 2014 (millions of US dollars) 3/	813	2,160		786	2,160		786	3,830	5,556	4,830	6,935
NBU purchases of T-bonds Issued by Government for Naftogaz recapitalization 3/	11,100	23,662		10,000	23,662		12,900	41,956	75,100	52,911	104,400
Financing by multilateral institutions and official bilateral creditors disbursed to Naftogaz for investment projects 2/	0	0		0	0		0	0	0	0	0
Net transfers made by Gazprom (advance transit fee) 2/	0	0		0	0		0	0	0	0	0
Estimated arrears to Gazprom for gas imports (millions of U.S. dollars) 6/ 7/	2,238	0		2,449	0		4,469	0	4,469	0	0
Ceiling on bonds issued to pay VAT refund arrears (VAT bonds) 2/	0	16,700		0	16,700		5,800	16,700	16,700	16,700	16,700
Program exchange rate, Hryvnia per U.S. dollar	10.9546	10.9546		10.9546	10.9546		10.9546	10.9546	10.9546	10.9546	10.9546

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

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

2/ Targets and projections are cumulative flows from end-December, 2013. Data for March are flows from end-December, 2013.

3/ Targets and projections are cumulative flows from April 1, 2014. Data for March are stocks as of end-March, 2014.

4/ Calculated using program exchange rates specified in the TMU.

5/ Data for March is a stock as of the end of the month. The flows for May and July are cumulative from end-March 2014. Targets for September and December are cumulative flows from end-May 2014.

6/ Naftogaz is currently disputing the arrears to Gazprom. The estimates of potential liabilities arising from such disputed arrears are provided solely for the purpose of accounting for program financing and risk assessment considerations.

7/ Arrears stock data for end-March, end-May, end-July include arrears for gas imports in 2013 and for imports up to end-March 2014, end-April, and end-June respectively. Arrears for end-September program targets are the sum of unpaid bills from January 2014 (US$3.759 billion).

Attachment II. Technical Memorandum of Understanding

August 18, 2014

1. This Technical Memorandum of Understanding (TMU) replaces the TMU of April 22, 2014 and sets out the understandings between the Ukrainian authorities and IMF staff regarding the definitions of the variables subject to quantitative targets (performance criteria and indicative targets) for the economic program supported under the Stand-By Arrangement, as described in the authorities' Letter of Intent (LOI) dated August 18, 2014 and the attached Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in the LOI, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

2. The quantitative performance criteria are shown in Table 2 of the MEFP. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. Prior actions and structural benchmarks are listed in Table 1 of the MEFP, with corresponding definitions in Section I below. The official exchange rate is defined in Section II. Reporting requirements are specified in Section III.

3. For the purposes of the program, all exchange rates used to evaluate reserve levels and monetary aggregates are (i) the official exchange rate of the Ukrainian hryvnia to the U.S. dollar of 10.9546 set by the NBU as of March 31, 2014, and (ii) reference exchange rates of foreign currencies reported by the European Central Bank (ECB) on its web site as of March 28, 2014, which the NBU used to set official exchange rates of hryvnia to those currencies. In particular, the Swiss Franc is valued at 0.8857 per dollar, the Euro is valued at 1.3759 dollars, Pound Sterling is valued at1.6633 dollars, Australian dollar is valued at 0.9243 U.S. dollars, and the Japanese yen is valued at 102.41 per dollar. The accounting exchange rate for the SDR will be 0.647773 per dollar. Official gold holdings were valued at 1,295.75 dollars per fine ounce. These program exchange rates are kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing monetary aggregates does not imply that there is any target exchange rate for policy purposes.

4. For the purpose of the program, gross domestic product is compiled as per the System of National Accounts 1993 (SNA'93). The State Statistics Service has indicated that they plan to change to the System of National Accounts 2008 and discontinue the series based on SNA'93 at some point in 2014. We will reach agreement with the Fund before making any modifications in GDP compilation used for purposes of the program.

I. Quantitative Performance Criteria, Indicative Ceilings, and Continuous Performance Criteria

A. Floor on Cumulative Change in Net International Reserves (Performance Criterion)

Definition

5. Net international reserves (NIR) of the NBU are defined as the dollar value of the difference between usable gross international reserve assets and reserve-related liabilities to nonresidents, evaluated at program exchange rates.

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

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

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

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

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

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

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

- the stock of IMF credit outstanding;

- the nominal value of all derivative positions[1] (including swaps, options, forwards, and futures) of the NBU and general government, implying the sale of foreign currency or other reserve assets against domestic currency; and

- all foreign exchange liabilities of the NBU to resident entities (e.g., claims in foreign exchange of domestic banks, and NBU credits in foreign exchange from domestic market) excluding foreign exchange liabilities to the general government, or related to deposit guarantees.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability[2]	NBU Balance Sheet and memorandum Accounts
1. **International reserves**	
Monetary gold	1100, 1107
Foreign exchange in cash	1011, 1017
Demand deposits at foreign banks	1201, 1202,
Short-term time deposits at foreign banks	1211,
Long-term deposits at foreign banksSDR holdings and Reserve	1212
Position in the IMF	IMF, Finance Department[3]
Securities issued by nonresidents	1300, 1305, 1307, 1308, minus 1306
Settlement of foreign securities	2746, minus 4746
2. **Short-term liabilities to nonresidents** *(in convertible currencies)*	
Correspondent accounts of nonresident banks	3201
Short-term deposits of nonresident banks	3211
Operations with nonresident customersUse of IMF credit	3230, 3232, 3233IMF, Finance Department

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

[2] The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on March 31, 2014. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

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

Adjustment mechanism

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

- NIR targets will be adjusted upward by the full amount of the cumulative shortfall in Naftogaz purchases of foreign exchange from the NBU for the purposes and in the event of paying gas supply bills and repaying currently disputed arrears to Gazprom (including by depositing funds in a restricted account) as well as the Eurobond issue maturing in September 2014 relative to the baseline projection (Table C). [4]

- NIR targets will be adjusted upward by the full amount of the cumulative shortfall in government purchases of foreign exchange from the NBU for the purpose and in the event of early repayment of government-guaranteed part of the maturing external loan to Naftogaz (in case this loan is repaid ahead of schedule). The upward adjustment of the NIR target will be capped to US$500 million.

[4] Naftogaz is currently disputing the arrears to Gazprom. The estimates of potential liabilities arising from such disputed arrears are provided solely for the purpose of accounting for program financing and risk assessment considerations.

Table B. Eurobond Placements and Disbursements from IFIs and Official Sources: Projections for NIR/NDA Adjustment

(Cumulative flows from end-March 2014, millions of US dollars at program exchange rate)

	Eurobond placement	World Bank	EU	EBRD	EIB	Others (Canada, Japan)	**Total**
End- May 2014	1000	760.6	137.6	0	0	0	**1,898.2**
End-July 2014	1,000	761	826	0	0	0	**2,587**
End-September 2014	3,000	1,261	1,183	0	0	100	**5,544**
End-December 2014	3,000	1,511	2,215	0	0	100	**6,826**

Table C. Naftogaz Purchases of Foreign Exchange from NBU: Projections for NIR/NDA Adjustment

(Cumulative flows from end-March 2014)

	Naftogaz purchases of foreign exchange from the NBU for the purposes and in the event of paying gas supply bills and repaying currently disputed arrears to Gazprom as well as the Eurobond issue maturing in September 2014 (millions of U.S. dollars) [5]	NBU purchases of T-bonds issued by Government for Naftogaz recapitalization (millions of hryvnia)
End-May 2014	**786.4**	**10,000**
End-July 2014	**786.4**	**12,900**
End-September 2014	**5,556**	**75,100**
End-December 2014	**6,935**	**104,400**

[5] As the arrears and their size are currently disputed the estimates are tentative and provided for program financing and risks assessment purposes only.

B. Ceiling on Cumulative Change in Net Domestic Assets of the NBU (Performance Criterion)

Definition

8. Net domestic assets (NDA) of the NBU are defined as the difference between the monetary base (as defined below) and the NIR of Ukraine (as defined above). For the purpose of computing the NDA target, the NIR is valued at the program exchange rate defined in paragraph 3 and expressed in hryvnia.

Adjustment mechanism

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

- Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted downward by the full amount of the cumulative shortfall in NBU purchases of T-bonds issued by Government for Naftogaz recapitalization for the purposes and in the event of paying gas supply bills and repaying currently disputed arrears to Gazprom [6] (including by depositing funds in a restricted account) as well as the Eurobond issue maturing in September 2014 relative to the baseline projection (Table C).

- Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted downward by the hryvnia equivalent of the full amount of the cumulative shortfall in government purchases of foreign exchange from the NBU for the purpose of repaying government-guaranteed part of the maturing external loan to Naftogaz (in case this loan is repaid ahead of schedule). The downward adjustment of the NIR target will be capped to hryvnia equivalent of US$500 million, calculated using the program exchange rate defined in paragraph 3.

- NDA targets will be adjusted upward by the full amount of the cumulative excess in the total amount of NBU loans to the Deposit Guarantee Fund (DGF) as well as total amount of NBU purchases of government bonds issued for the purposes of DGF financing, and NBU purchases of government bonds issued (up to a limit of UAH 15 billion) for bank recapitalization, relative to the baseline projection (Table D).

[6] See footnote 4.

Table D. NBU Loans to DGF and Operations with Government Bonds Issued for DGF Financing or Banks Recapitalization: Projections for NDA/Monetary Base Adjustment

(Cumulative flows from end-March 2014, millions of hryvnia)

	NBU operations with Government bonds issued for DGF financing and banks recapitalization	NBU loans to DGF	**Total**
End-May 2014	0.0	0.0	**0.0**
End-July 2014	0.0	5,200	**5,200**
End-September 2014	0.0	5,200	**5,200**
End-December 2014	23,500	5,200	**28,700**

C. Ceiling on Cumulative Change in Monetary Base of the NBU (Base Money) (Indicative Target)

Definition

9. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,[7] and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A, and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts of groups 323[8], 3250, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency.

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

[8] Includes accounts of following sectors: 2 – other financial intermediaries and other financial organizations; 6 – regional and local authorities; 7 – government non-financial corporations; 8 – private and foreign-controlled non-financial corporations; 9 – non-commercial organizations serving households.

Adjustment mechanism

- Consistent with the NDA target adjustment mechanism (as defined above), monetary base targets will be adjusted upward by the full amount of the cumulative excess in the total amount of NBU loans to the Deposit Guarantee Fund (DGF) as well as total amount of NBU purchases of government bonds issued for the purposes of DGF financing or banks recapitalization (up to a limit of UAH 15 billion for purposes of recapitalization), relative to the baseline projection (Table D), and evaluated at the program exchange rate if provided in foreign exchange.

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

Definition

10. The general government comprises the central (state) government, including the Road Fund (UkrAvtoDor), all local governments, and all extra budgetary funds, including the Pension, Unemployment Insurance, Temporary Disability Insurance, Occupational Injury and Disease Insurance Funds. The budget of the general government comprises: (i) the state budget; (ii) all local government budgets; and (iii), if not already included in (i), the budgets of the extra budgetary funds listed above, as well as any other extra budgetary funds included in the monetary statistics compiled by the NBU. The government will inform the IMF staff of the creation or any pending reclassification of any new funds, programs, or entities, immediately. The cash deficit of the general government is measured by means of net financing flows as:

- total net treasury bill sales[9] (in hryvnias and foreign currency) as measured by the information kept in the NBU registry of treasury bill sales (net treasury bill sales are defined as the cumulative total funds realized from the sales of treasury bills at the primary auction and Government securities issued for recapitalization of banks and SOEs, less the cumulative total redemption of principal on treasury bills), excluding bonds issued to recapitalize Naftogaz[10] and other SOEs, banks and DGF; plus

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

[9] From here on, treasury bills are defined as all treasury securities (including long term instruments or treasury bonds).

[10] These are included in the calculation of Naftogaz' cash deficit when they are used (as collateral for a loan, or as an outright sale) by the latter to obtain financing.

government deposits in the banking system) as well as any other financing extended by entities not reflected by the monetary statistics provided by the NBU; plus

- total receipts from privatization received by the State Property Fund and local governments (including the change in the stock of refundable participation deposits); plus
- the difference between disbursements and amortization on any bond issued by the general government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus
- the difference between disbursements of foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of foreign credits by the general government (including on lent project loans); plus
- the net sales of SDR allocation in the SDR department; plus
- the net change in general government deposits in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the general government.

11. For the purposes of measuring the deficit of the general government, all flows to/from the budget in foreign currency (including from the issuance of foreign currency denominated domestic financial instruments) will be accounted in hryvnias at the official exchange rate established as of the date of the transaction.

Adjustment mechanism

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

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

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

Table E. External Financing of General Government Projects—Adjustment

Cumulative flows from January 1, 2014	In millions of hryvnia
External project financing (technical assumption for the adjuster purpose)	
End-May 2014	414
End-July 2014	1,300
End-September 2014	2,300
End-December 2014	4,700

- The ceilings on the cash deficit of the general government at end-May, end-July, end-September, and end-December 2014 are subject to an automatic adjuster corresponding to the full amount of NBU purchases of government bonds issued for the purposes of DGF financing (excluding subsequent interest payments on the securities or other instruments issued). These ceilings are also subject to an automatic adjuster corresponding to the amount of NBU purchases of government bonds issued for the purposes of banks recapitalization and DGF financing, up to a cumulative maximum of UAH 23.5 billion in 2014. The test date ceilings on the cash deficit of the general government for 2015 will be adjusted upward by any amount of the UAH 23.5 billion bank recapitalization and DGF financing ceiling under the program that is not used in 2014.

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

- The ceilings on the cash deficit of the general government at end-May, end-July, end-September, and end-December 2014 are subject to an automatic upward adjustment for the full amount of bonds used to pay VAT refund arrears (VAT bonds) accumulated before January 1, 2014, and will be limited to no more than UAH 16.7 billion cumulatively during 2014. No such bonds will be issued in 2015 or later, and therefore there is no such adjustment for the

other test dates. The ceiling on the cash deficit of the general government at all other 2014 test dates will be automatically adjusted downward by VAT refund arrears accumulated in excess of ceilings defined in Section E from January 1, 2014.

- The ceilings on the cash deficit of the general government at end-July, end-September, and end-December 2014 are subject to an upward adjustment for the full amount of Government repaying government-guaranteed part of an external loan to Naftogaz, in case this loan is repaid ahead of schedule and the repayment is recorded as above-the-line transaction. The adjustment will be equal to the actually repaid amount in US$ terms capped at US$500 million, and recalculated in hryvnia at the actual exchange rate at the time of repayment.

E. Ceiling on VAT Refund Arrears (Indicative Target)

12. The ceiling on net accumulation of VAT refund arrears is set to UAH 5.3 billion at end-July 2014, UAH 2.8 billion at end-September 2014, and UAH 0 billion at end-December 2014. The stock of VAT refund arrears is defined as those claims that have not been settled (through a cash refund, netting out against obligations of taxpayers, payment with a government bond (VAT bond) or an official decision to reject the claim) within a specified time period after the VAT refund claim has been submitted to the State Fiscal Service (SFS). In 2014, this time period is 74 days, allowing for verification of the validity and payment processing of claims. According to this definition, the stock of VAT refund arrears as of December 31, 2013 was UAH 16.7 billion and UAH 18.3 billion as of March 31, 2014.

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

Definition

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

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

- net domestic banking system credit to the company (this consists of all financing in either domestic or foreign currency extended to the company by banks less the change in company deposits in the banking system); plus

- the difference between disbursements of private foreign loans to Naftogaz (including private placements) and the amortization of private foreign loans (including private placements) ; plus
- the difference between disbursements of official foreign credits to Naftogaz (including project loans) and the amortization of official foreign credits (including project loans); plus
- the disbursements of trade credits from Gazprom to import gas; plus
- the difference between disbursements and amortization on any bonds issued by Naftogaz; plus
- the net change in deposits of Naftogaz in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by Naftogaz; plus
- net receipts from sale of financial assets (including recapitalization or other form of treasury securities issued to Naftogaz, irrespective of their issuance date); plus
- any other forms of financing of the company not identified above.

15. For the purposes of measuring the deficit of Naftogaz, all flows in foreign currency will be accounted in hryvnias at the official exchange rate as of the date of the transaction. When there are arrears outstanding as of the test date, the official exchange rate on the test date will apply to their valuation.

Adjustment mechanism

- The ceiling on the cash deficit of the general government and Naftogaz will be adjusted upward by the amount of financing by multilateral institutions and official bilateral creditors disbursed to Naftogaz for investment projects.
- The ceiling on the cash deficit of the general government and Naftogaz will be adjusted downward by the net transfers made by Gazprom (advance transit fee). These transfers are measured on a cumulative basis from the beginning of each calendar year.
- The ceiling on the cash deficit of the general government and Naftogaz will be adjusted downward by the cumulative amount of net arrears to Gazprom in 2014.[11] Gas imports bills are

[11] See footnote 4.

considered arrears the day after their payment is due (7th day of the subsequent month of imports). The arrears for imported gas will be valued at the gas price agreed between Naftogaz and Gazprom if such an agreement is reached, or based on the Stockholm Arbitration ruling. In the absence of an agreed gas price, or the price determined based on the Stockholm Arbitration ruling, a program accounting price will apply to arrears valuation. This price is used for accounting purpose only, and does not constitute an expression of a view by Fund staff on what the gas price should be.

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

Definition

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

H. Ceiling on Publicly Guaranteed Debt (Performance Criterion)

Definition

17. The ceiling on publicly guaranteed debt will apply to the amount of guarantees issued in 2014 by the central (state) government. The official exchange rate will apply to all non-UAH denominated debt. New state guarantees in 2014 will amount to no more than UAH 25 billion.

I. Other Continuous Performance Criteria

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

II. Official Exchange Rate

Determination of the official exchange rate

19. The NBU will, on a daily basis, set the official rate calculated as a weighted average of rates on the same day's interbank market transactions. NBU will make public its official exchange rate by no later than 16:00 of the day for which it is set.

III. Reporting Requirements

A. National Bank of Ukraine

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

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

22. The NBU will provide the IMF on a daily basis with information on official foreign exchange interventions. In this context, it will also provide the results of any foreign exchange auctions.

23. The NBU will provide the IMF on a daily basis with information on balances held in the analytical accounts 2900 "Accounts payable per transactions for the foreign exchange, banking and precious metals purchase and sale on behalf of banks' clients".

24. The NBU will continue to provide on its web site the daily holdings of treasury bills at primary market prices, at current exchange rates. The NBU will provide information on daily holdings of treasury bills broken down by type of holders (including state-owned banks and private banks) at primary market prices at the rate fixed on the day of auction information on t-bills sales, including in the foreign exchange, from the beginning of the year at the official rate as of the date of placement, as well as the t-bills in circulation, by principal debt outstanding at the official exchange rate as of the date of placement (OP-2); reports on each treasury bill auction; and provide to the IMF the monthly report on treasury bills, in the format agreed with the IMF staff.

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

26. The NBU will provide to the IMF, on a daily basis, the information on the banks' claims on the loans provided and liabilities in the format agreed with the IMF staff.

27. The NBU will keep providing to the IMF, on a monthly basis, general information on the NBU financing (as well as the refinancing) of the banks of Ukraine, and on the operations of mopping up (absorption) of the liquidity from the banking system (including through the CDs issuance) in the format agreed with the IMF staff. It will also provide, on a weekly basis, bank-by-bank information on the Ukrainian banking system's debt on credits received from the NBU.

28. The NBU will provide to the IMF, on a quarterly basis but not later than 30 days after the expiration of the reporting quarter, the report on the banking sector financial stability indicators in the format agreed with the IMF staff.

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

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

31. The NBU will continue to provide to the IMF the daily operational balance sheets of the NBU and commercial banks on a daily basis according to standard reporting forms, including detailed information on loans of the banking sector provided to the general government, with detailed breakdown of this information by indebtedness of the central (state) government and local budgets, including in national and foreign currency, by loan and by security, as well as the information on the balances of the funds of the Government held at the NBU, in particular, the balances of the Single Treasury Account denominated in the national currency (account 3240 A) and the funds of the State Treasury denominated in foreign currency (account 3513 A).

32. The NBU will provide to the IMF, on a monthly basis, projections for external payments falling due in the next twelve months. The data on actual settlement of external obligations, reflecting separately principal and interest payments as well as actual outturns for both the public and private sectors, shall be provided on a quarterly basis, within 80 days following the end of the quarter.

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

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

35. The NBU will provide to the IMF reports N 381.25; 381.26 with information on reserve requirements.

36. The NBU will provide the IMF, on a two weekly basis, with daily data on the total financing (including refinancing) issued by the NBU to commercial banks, broken down by types of instrument, maturity (average weighted), interest rate as well as transactions to absorb liquidity from the banking system.

37. The NBU will provide the IMF on a two weekly basis, in an agreed format, data for the entire banking sector as well as on a bank-by-bank basis for Group I and Group II banks on total assets and liabilities; risk weighted assets (for ratio H2 calculation); capital adequacy ratios for normative and regulatory capital (Tier I and Tier II); deposits (maturity, currency, and type of depositor); loans (local currency, foreign exchange, provided to corporates and households, broken down by I, II, III, IV and V category); provisions for all loans (classified by types of loans); foreign exchange net open position; banks portfolio of government (domestic government bonds) and other debt securities; mandatory reserve requirement and assets held at the NBU.

38. The NBU will once a month inform the IMF any regulatory and supervisory measures against banks violating the NBU regulations on capital adequacy, liquidity ration, large exposures, and connected lending, as well as about decisions on declaring a bank as problem or insolvent.

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

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

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

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

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

44. The NBU will communicate (electronically) to the IMF staff any changes in the accounting and valuation principles applicable to the balance-sheet data and will notify the staff before introducing any changes to the Charts of Accounts and reporting forms of both the NBU and the commercial banks.

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

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

B. Ministry of Finance

47. The Ministry of Finance will provide the IMF with the monthly consolidated balances (end-month) of other non-general government entities, including SOEs, holding accounts at the Treasury no later than 25 days after the end of the month.

48. The Treasury will continue to provide to the IMF reports on: daily operational budget execution indicators, daily inflow of borrowed funds (by currency of issuance) to the state budget and expenditures related to debt service (interest payments and principals), weekly balances of Treasury cash flow (outturn and forecast) , including data on government foreign exchange deposits, in a format agreed with IMF staff ,10-day basis data on revenue of the state, local government, and consolidated budgets, monthly data on funds, deposited with the Single Treasury Account, on the registration accounts of the entities which are not included to the state sector, information on the stock of public entities in account #3712 within the Single Treasury Account, on inflow to the State

budget from placing Treasury or any other liabilities to households in foreign and domestic currency and their redemption.

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

50. The Ministry of Finance will report monthly data on the public wage bill in line with the template agreed with the IMF staff. It will also provide monthly reports on the borrowing (disbursements, interests and amortization) of UrkAvtoDor in line with the format agreed with IMF staff. The Ministry of Finance will report to the IMF on a monthly basis, no later than 15 days after the end of the month, the cash deficit of the general government, with details on budget execution data for privatization receipts of the state and local governments; disbursements of external credits (including budget support and project loans for on-lending) to the consolidated budget and amortization of external debt by the consolidated budget; net domestic borrowing of the general government, including net t-bill issuance, issuance of other government debt instruments, and change in government deposits. The Ministry of Finance will report to the IMF on a monthly basis information on municipal borrowing and amortization of debt in format agreed with IMF staff.

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

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

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

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

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

56. The Ministry of Finance will provide data on external and domestic credit to key budgetary spending units as well as nongovernment units (including Naftogaz, State Mortgage Institution, Deposit Guarantee Fund and Agrarian Fund) that is guaranteed by the government (amount of sovereign guarantees extended by executive resolutions and actually effectuated; total amount of outstanding guarantees and list of their recipients) on a monthly basis no later than 25 days after the end of the month.

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

58. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central (state) and local budgets, starting from

January 2010. After any public sector wage increase, the Ministry of Finance will provide an estimate of its costs for the current and two subsequent fiscal years, for the state and local government budgets.

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

60. The Ministry of Finance will provide monthly data on their expenditure plans (ROSPIS) for state budget.

61. The State Fiscal Service (SFS) and, where applicable, State Customs Service (SCS) will provide monthly data, no later than 25 days after the end of the month, on tax arrears, inclusive of deferred payments, interest and penalties outstanding, in the following format:

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

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

63. The SFS will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund requests; (ii) refund requests paid in cash; (iii) refunds netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock of requests; and (vii) stock of VAT refund arrears according to the definition in paragraph 11 (unsettled VAT refund claims submitted to the SFS more than 74 days before the end-of-period.

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

65. After each amendment of the state budget, the Ministry of Finance will provide data on revenue plans (ROSPIS) for state and local budgets.

C. Ministry of Economy, Ministry of Energy and Coal Industry, Ministry of Housing and Municipal Economy of Ukraine, NURC and NERC

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

67. For each month, no later than the 25th of the following month, the government (based on information by the Ministry of Energy and Coal Industry, the Ministry of Economy, SFS/SCS, MoF, NERC, and Naftogaz) will provide IMF staff with information in electronic form (in an agreed format defined as "Ukraine: The Financial Position of Gas Sector") on financial indicators in the gas and heating sectors, including prices and volumes of domestically produced (by production entity) and imported (by sources of imports) gas, sales, tariffs, arrears, payments to the budget, subsidies, and debt. On a monthly basis, Naftogaz will provide to IMF staff updated information on the Company's financial liabilities, with a schedule of loan-by-loan interest and principal payments.

68. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information "in electronic form (in an agreed format) on the cash flows and deficit of the company, as defined above. This report will break down the total cash outlays for gas imports from Gazprom by month in a separate table mutually agreed with IMF staff. This report is subjected to auditing by a reputable external auditor, first on a monthly and then on a quarterly basis, as set out in the MEFP.

69. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information in electronic form in an agreed format on the domestic gas used by Naftogaz for sales to households, heating utilities, budget institutions, and industries, including gas produced by SC "Ukrgasvydobuvannya," SJSC "Chornomornaftogas," and OJSC "Ukrnafta".

70. For each quarter, no later than the 25th of the following month, the Ministry of Housing and Municipal Economy will provide IMF staff with information of the quantity of heating energy meters installed at a building-level measured also as a ratio to the applicable buildings.

71. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information in electronic form on the amount of Naftogaz arrears to domestic suppliers including Naftogaz subsidiaries, Ukrtransgas, Ukrgas vydobuvannya, Ukrnafta, Chornomornaftogas 90 days after they are due.

72. The Ministry of Energy and Coal Industry (based on information by Naftogaz) will report on a weekly basis data on Naftogaz daily market purchases of foreign exchange.

D. State Statistics Service

73. The State Statistics Service and Naftogaz will provide to the IMF, on a monthly basis, no later than 45 days after the end of the month, data on prices, volumes, and payments (payments data provided by Naftogaz) for imported and exported oil and natural gas by country of origin and destination.

74. In case of any revisions of gross domestic products the State Statistics Service will provide to the IMF revised quarterly data on gross domestic product (nominal, real, deflator) and their components (economic activities, expenditure, income), no later than 10 days after any revisions have been made.

Statement by the Staff Representative on Ukraine
August 29, 2014

1. **This statement provides information that has become available since the staff report for the first review of the SBA-supported program was circulated to the Executive Board**. This information does not alter the thrust of the staff appraisal.

2. **Recent data point to a deepening recession in line with the revised program**. Industrial production fell by 5.8 percent y-o-y in January–July 2014 (from 4.7 percent in 2014:H1) with significantly more pronounced contractions in the conflict-ridden regions of Donetsk and Luhansk. Retail trade turnover continued its downward trend as well, registering a decline of 1 percent in real terms for January–July. The Consensus Forecast in August downgraded growth in 2014 but remains broadly similar to staff projections (-5.6 percent and 0.8 percent in 2014–15, respectively). A larger decline of imports of goods and services (-16.6 percent) compared to exports (-9.9 percent) has more than halved the current account deficit in 2014:H1 (-64.2 percent y-o-y), in line with staff projections.

3. **The National Bank of Ukraine (NBU) has taken several measures to contain depreciation pressures on the hryvnia**. The NBU has hiked its overnight refinancing and deposit certificates rate by 250 basis points. Furthermore, the existing surrender requirement for export and some other foreign currency proceeds was raised to 100 percent for the next three months (from 50 percent up to August 20). The NBU has also tightened verification requirements for advance trade payments and some other client transactions. However, the complicated security situation and the announcement of elections in October have sustained the depreciation pressures, with the hryvnia reaching UAH 13.6–14/US$1 in recent days.

4. **All outstanding prior actions have been completed and verified. The NBU has achieved the required level of NIR by purchasing over US$200 million**. Naftogaz has deposited US$3.1 billion in a restricted account with the NBU to be used to settle gas bills and arrears with Gazprom, if and when such payments need to be made. Finally, the government has established a coordinating body subordinated to the Cabinet of Ministers to lead the regulatory simplification effort.

5. **As expected, parliamentary elections will be held in October. President Poroshenko dissolved parliament (the Rada) on August 25 and announced elections on October 26**. Despite its dissolution, the Rada will remain operational until the elections.

6. **Leading political parties have confirmed their support for the authorities' economic program**. In an open letter to the Managing Director, Mr. Sobolev, chairman of the MPs' faction of the All-Ukrainian Alliance "Bat'kivschyna", stated the alliance's support for the key objectives and policies of the authorities' Fund-supported program. Another parliamentary-represented party, UDAR, has issued a statement on its website supporting the program as well.

7. **Since the Article VIII assessment mission in June, the authorities have removed one of the two new exchange restrictions identified by the mission**. The mission found an exchange restriction arising from the imposition of absolute limits on the availability of foreign exchange for certain current international transactions (EBS/14/104, ¶12). These limits were initially imposed in early 2014 and most recently modified in May. Since the measures were imposed prior to the approval of the SBA, and the modification in May was not considered an intensification of the measure, the continuous performance criterion regarding the imposition or intensification of exchanges measures was not implicated. Effective July 29, the relevant provisions limiting access to non-cash foreign exchange for current international transactions were repealed. Staff has since reviewed the revised legal framework and determined that the exchange restriction has now been removed. The authorities are committed to removing the remaining exchange restriction and the MCPs. In this regard, staff had very productive discussions on the matter during the recent Article VIII mission, but a number of issues need to be discussed further. Pending resolution of these issues, staff does not propose approval of these measures for now. Staff will keep the Board informed of developments.

Press Release No.14/399
FOR IMMEDIATE RELEASE
August 29, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review Under Stand-By Arrangement for Ukraine and Approves US$1.39 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Ukraine's performance under an economic program supported by a Stand-By Arrangement (SBA). The completion of this review enables the disbursement of SDR 914.67 million (about US$1.39 billion), which would bring total disbursements under the arrangement to SDR 2.97 billion (about US$4.51 billion).

Overall, economic policies have generally been implemented as agreed in the program, as the Ukrainian authorities have persisted in taking difficult measures despite the volatile political situation. However, the conflict in the eastern part of the country is taking its toll on the economy and society, and compensatory measures will be critical to achieve key program targets agreed for 2014 and beyond. The program remains highly challenging and continues to hinge crucially on the assumption that the conflict will subside in the coming months.

In completing the review, the Executive Board approved waivers of nonobservance of performance criteria related to international reserve accumulation and the cash deficit of the general government on the basis of corrective actions taken. The Board also approved waivers of applicability of performance criteria related to the cash deficit of the general government, the cumulative change in net domestic assets of the central bank and publicly guaranteed debt. In addition, in light of the slight delay in completing the first review of the program, the Board approved the authorities' request for merging the remaining two reviews scheduled for 2014, while keeping the total financing under the arrangement unchanged.

Ukraine's two-year SDR 10.97 billion (about US$16.67 billion) SBA was approved on April 30, 2014 (see Press Release No. 14/189) to support the government's economic program, which aims to restore macroeconomic stability, strengthen economic governance and transparency, and launch sound and sustainable economic growth while protecting the vulnerable groups.

Following the Executive Board discussion, Ms. Christine Lagarde, IMF Managing Director and Chair, stated:

"The Ukrainian authorities have firmly implemented policies to stabilize the economy and revive growth. This strong policy record despite the much worse-than-expected environment is encouraging in light of the implementation problems that derailed previous programs and thus augurs well for the authorities' ability to keep the program on track. However, the escalating conflict in the East and ongoing geopolitical tensions have weighed heavily on the economy and society, causing a deeper recession and deviations from program targets in the short term, in particular on the central bank's net international reserves and the budget and Naftogaz deficits.

"To compensate for these deviations, the authorities have committed to a strong policy package. Specifically, they will (i) take steps to accumulate international reserves, (ii) tighten the fiscal stance in 2015–16 relative to the initial program targets, and (iii) step up efforts to put Naftogaz on a sound financial footing by improving bill collections and adjusting energy prices as needed.

"The authorities recognize the importance of maintaining exchange rate flexibility and refocusing monetary policy on price stability. They will remove administrative exchange restrictions and controls gradually at a pace consistent with macroeconomic and financial stability.

"The financial sector reform program has proceeded as scheduled. The regulatory and supervisory framework is being enhanced, bank diagnostics are on track, and the capacity of the Deposit Guarantee Fund to fulfill its mandate is being strengthened. Efforts also continue to strengthen banks' capacity to resolve bad loans, including incentive schemes for voluntary debt restructuring.

"The authorities remain committed to fiscal consolidation. They have adopted a supplementary budget to meet the revised deficit target. Efforts in this regard will focus on spending restraint and fiscal reforms to reverse the debt dynamics, while improving social safety nets. In addition, after a temporary increase in the Naftogaz deficit, the authorities are taking steps to return to the programmed deficit reduction path already in 2015.

"The authorities intend to press ahead with critical structural reforms to address governance issues and improve the business climate. Work continues on the establishment of a strong anti-corruption agency, enhancing the anti-money laundering framework, and simplifying the regulatory environment.

"Downside risks to the program remain very high. The program success hinges on a timely resolution of the conflict in the East, as well as on the authorities' strong policy performance and adherence to the planned reforms. The authorities' program continues to be an appropriate response to the existing challenges and constraints. Financial and

technical assistance from the international community in support of Ukraine reform efforts are indispensable for achieving macroeconomic stabilization and reviving growth."

Statement by Oleksandr Petryk, Alternate Executive Director for Ukraine
August 29, 2014

The Ukrainian authorities highly appreciate the cooperation with the Fund and its financial and technical assistance. The authorities have implemented policies broadly as agreed. However, adverse developments beyond the authorities' control make it advisable to allow a temporary deviation from the initial program targets, while also taking strong compensatory measures to meet key program objectives. The authorities therefore request the completion of the first review, waivers for non-observance of two end-July performance criteria and waivers of applicability for three other end-July performance criteria for which final data are not available yet. Allowing for continued financial support and continued implementation of the program will help restore macroeconomic stability, strengthen economic governance and transparency, and lay the foundation for robust and balanced economic growth.

The Ukrainian government, the National Bank of Ukraine (NBU) and the main political powers are fully committed to a comprehensive economic reform program to correct excessive fiscal and external imbalances and accelerate structural reforms. They remain confident that the policies under the program are adequate to achieve the macroeconomic objectives. In case of deviation from the program's objectives, the authorities will implement additional measures and policies in close consultation with the Fund staff.

The envisaged sequence of near and medium-term reforms aims at making the external position and public finances sustainable, inter alia, by rationalizing the energy sector; strengthening monetary policy and the financial sector as a whole; and improving the business environment.

To underscore their commitment, the authorities have implemented all prior actions for the first review of the program in a very short period, despite the complex circumstances.

The support from the Fund as well as the World Bank and other partners will be essential for achieving the program's objectives and implementation of the ambitious reforms.

Recent macroeconomic developments

Output

The Ukrainian economy contracted by 3 percent (y-o-y) in the first half of this year. After a 1.1 percent (y-o-y) decline in the first quarter, the decline accelerated to an estimated 4.7 percent (y-o-y) in the second quarter of this year, despite the strong macroeconomic adjustment measures. Difficulties with access to Russian and other CIS countries markets as well as military actions of the separatists in the Eastern part of Ukraine, caused a continued

decline in the industrial output as a whole (by 5.8 percent in the first 7 months of 2014). Industries like machinery and chemicals, which are concentrated in the east of the country, suffered heavily with output declining by 18.9 percent and 15.2 percent respectively. The steep depreciation of the currency did not help avoid a 9.2 percent fall in the output of the export-oriented metallurgy sector. On the positive side, high yields in crops harvesting contributed to the growth of agricultural output by 3.4 percent in the first seven months of the year. On the demand side, a fall in real wages led to a reduction in domestic consumer demand. Declining government capital expenditures, poor financial results of business and overall uncertainty on the back of the military conflict led to a sharp decline of investment demand.

Inflation

Annual inflation accelerated from 0.5 percent in 2013 to 12.6 percent in July 2014, mainly due to the sharp depreciation of the Hryvnia and hikes in administratively regulated tariffs. Since the beginning of the year, the Hryvnia has depreciated by more than 60 percent. Nonetheless, inflationary pressures are contained because of low aggregate demand and a persistent negative output gap. The exchange rate pass-through affected both core and non-core inflation. Non-core components were the biggest contributors to the headline CPI acceleration. Prices of non-processed food were up by 11.2 percent (y-o-y) mainly due to limited supply of some products and an increase in the price of imported food products. Fuel prices increased by 42.6 percent (y-o-y), mainly due to the depreciation of the currency. Second-round effects of fuel price inflation will push consumer prices more broadly, including because of rising transportation costs. Administratively regulated prices accelerated by 17.3 percent following the increase in tariffs under the Fund supported program.

Balance of payments

The current account deficit has been significantly reduced in the course of 2014. In the wake of the Hryvnia depreciation and the contraction of domestic demand during the first 6 months of 2014, the current account deficit was US$1.9 billion. For 2014 as a whole, the current account deficit is expected to decline to 2.5 percent of GDP (US$3.4 billion), down from a deficit of 4.4 percent projected at the time of the launch of the program, and a deficit of 9.2 percent in 2013.

In contrast with recent years, Ukraine has experienced a strong net outflow of capital, reaching US$2.3 billion during the first 6 months of this year. An unstable geopolitical situation and depreciation expectations are the main drivers of the outflows. However during the most recent months, the situation of the capital account stabilized thanks to the disbursement of official financing and lower demand for FX cash. Yet, inflows of private capital remain subdued. International reserves stood at US$16.1 billion on August 1, 2014, covering 2.4 months of imports of goods and services.

Public Finances

In the first half of 2014 the consolidated budget deficit reached 21 billion Hryvnia or about 1.4 percent of GDP down from 4.3 percent of GDP in the same period of the previous year. This fiscal consolidation was achieved mainly through frontloading the NBU profit transfer and expenditure restraint, in particular capital expenditures. Indeed, consolidated budget revenues performed poorly, because of the decline in economic activity and worsening tax collection in the east.

Monetary policy and financial system

Despite NBUs' concern about further exchange rate depreciation and corresponding pass-through for inflation and the negative impact on the banking sector, the monetary authorities believe that a flexible exchange rate is critical to protect international reserves, and as a buffer to restore the competitiveness of the economy. Since last March, the NBU has moved to a flexible exchange rate regime and abandoned foreign currency interventions as its main monetary policy instrument. In order to reach the targeted level of NIR, the NBU purchased over US$200 million in July and August (prior action). Policy and legislative measures have been taken in order to achieve price and financial stability in the near future. Among them are: finalizing diagnostic studies of the banking sector; legislation on the conversion of foreign currency deposits; amending the NBU law to strengthen the central bank's independence; enhancing the coordination between the NBU and the Deposit Guarantee Fund (DGF), and improving the governance of restructuring banks.

The performance criteria for NIR/NDA were recalibrated in light of pressures on the balance of payments beyond the authorities' control. The NBU's policy rates remain positive in real terms taking into account expected inflation a year from now.

The NBU is working hard to improve its monetary policy framework and prepare for the introduction of inflation targeting. The strategy includes three stages of preparing the basic legislation, developing all technical prerequisites, and launching inflation targeting. 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. The NBU is establishing its Monetary Policy Committee (MPC) which will set the policy interest rate, consistent with inflation objectives. The NBU will set policy objectives and use its own projections for inflation and other macroeconomic variables in the process of monetary policy decision making.

The authorities will enhance the independence of the NBU as a truly modern central bank, which will be underpinned by non-fiscal dominance, instrumental independence, forward-looking monetary policy based on the NBU's own macroeconomic forecasting and protecting the NBU from political interference. In particularly, the NBU will prepare

legislative amendments to the NBU law (structural benchmark for the end of December 2014), to strengthen the process of decision-making and increase the autonomy of the NBU's Council and Board. It also authorizes the Council to establish special reserves before any profit distribution. The NBU profits will be passed to the budget every next year after an independent audit.

Financial stability will be the second key pillar of the monetary authorities' long-term strategy. The main actions for preserving financial stability are enhancing the financial position of the Deposit Guarantee Fund (DGF); ensuring availability of contingent public funds; improving legal bank restructuring tools; enhancing coordination between the NBU and the DGF; ensuring proper governance of banks under restructuring; monitoring state ownership in recapitalized banks; managing the assets left in banks under liquidation. A financial stability unit has been established in the NBU. A Financial Stability Report will be published regularly. A modeling toolkit has been developed for stress-testing the banks.

The NBU provides liquidity to help offset the outflow of deposits from the banking system. Compared with the February-April period, the withdrawal of deposits has slowed down but continues because of the continuing high uncertainties in the geopolitical situation and corresponding expectations.

The authorities continue to push forward the financial sector reforms which will focus on improvement of the banking system's effectiveness and soundness, while strengthening confidence in the system. The authorities are on track with diagnosing and addressing weaknesses in the banking sector. Diagnostic studies and the review of business plans for the 15 largest banks have been completed (structural benchmark) and the results are being processed. The authorities presented plans to strengthen governance in the restructured banks. The core of the reforms will concentrate on restructuring and recapitalizing banks and the restructuring of NPLs in the banking system, improving the supervisory and regulatory framework, and adopting legislation based on international standards. Particularly, a law to facilitate the resolution of non-performing loans and prevent new NPL's is under consideration in Parliament (new structural benchmark)

Fiscal policy

Because the economy is facing exogenous shocks, the authorities, in consultation with the Fund, have recalibrated the path for the general government deficit while maintaining a realistic structural adjustment. The new targets compensate for the additional spending of Naftogaz for so-called reverse gas imports from Europe, the slowdown of both the economic activity and the corresponding tax collection, and some additional military spending. This results in a 5.8 percent of GDP general budget deficit for 2014, compared with 5.2 percent of GDP in the initial program. Spending restraints will continue and additional policy measures will be taken. There will be no discretionary increase of wages, pensions and social

assistance; the civil service staff will be significantly reduced, as will be spending on goods and services, subsidies and transfers. The government is stepping up revenue collection efforts as a whole, including measures to combat tax evasion schemes and to widen the tax base by reducing the number of exemptions.

Over the medium-term, the Ukrainian authorities are aiming at a gradual expenditure-based fiscal consolidation to reduce fiscal imbalances and restore credibility.

Structural reforms

A gas price dispute with Gazprom has led to accumulation of payment arrears in the second quarter of 2014, and the suspension of gas deliveries by Gazprom since June. An arbitration process to resolve the conflict is ongoing in Sweden. For purposes of immediate payment of overdue bills after the arbitrage, Naftogaz has deposited US3.1 billion in a special account with the NBU (prior action). To prepare for the heating season, Naftogaz has imported and put in storage more gas than assumed at the time of program start. Together with a larger depreciation of the currency, this has led to larger deficits for Naftogaz. The authorities have made several important steps toward energy sector reform. The gas price and heating tariffs for households were raised in May 1 and July 1 correspondingly. The new targeted social safety net which compensates the poorest for energy price hikes has become operational on July 1. The audit company was selected to conduct the quarterly cash flow audits of the Naftogaz accounts. The process of making obligatory distribution accounts is carried out.

The main objectives for the government and Naftogaz are to keep Naftogaz' deficit to no more than 4.3 percent of GDP in 2014. Energy sector reforms will focus on a step-by-step reduction of fiscal subsidies and increasing efficiency. An important mechanism for achieving these targets will be gradual, but persistent increases in retail gas prices and heating tariffs will be accompanied by further social assistance measures to mitigate the impact on low-income households. The authorities will strengthen efforts to increase payment discipline for Naftogaz clients, which is crucial for improving Naftogaz' finances.

Final remarks

Looking forward, Ukraine is faced with an extremely difficult economic and financial situation due to internal factors as well as external shocks. However, after a period of uncertainty, the adjustment program provides the basis for the authorities and the people of Ukraine to rebuild the economy and consolidate the society. There is broad consensus in Ukraine that the Stand-By Arrangement helps to maintain the reform momentum, and provides additional security against unforeseen shocks. The considerable progress made so far and the further progress to be reached in the near future will set the stage for strong and sustainable economic developments while maintaining external and internal stability.