June 2003
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Ukraine: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ukraine.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 27, 2003,** with the officials of Ukraine on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 12, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 14, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Ukraine.

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

Selected Issues Paper
Statistical Appendix

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

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

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UKRAINE

Staff Report for the 2003 Article IV Consultation with Ukraine

Prepared by the Staff Representatives for the 2003 Consultation

Approved by Oleh Havrylyshyn and Michael T. Hadjimichael

April 11, 2003

Discussions for the 2003 Article IV consultation were held in Kyiv during February 13–27, 2003. The mission met with President Kuchma, Prime Minister Yanukovych, First Deputy Prime Minister and Minister of Finance Azarov, Deputy Prime Minister Haiduk, Minister of Economy and European Integration Khoroshkovsky, Minister of Fuel and Energy Yermilov, Governor of the National Bank of Ukraine (NBU) Tyhypko, Speaker of Parliament Lytvyn, other senior officials and members of parliament, as well as representatives of the business and diplomatic communities.

The staff participating in the discussions were E. van der Mensbrugghe (head), S. Bassett, P. Lohmus, C. Mumssen, R. Tchaidze (all EU2), V. Moissinac (FAD), and L. Nielsen (PDR). L. Figliuoli and B. Lissovolik of the Resident Representative's Office in Ukraine took part in the discussions. J. Odling-Smee (Director, EU2) joined the discussions during February 17–18, 2003. Y. Yakusha, the Alternate Executive Director for Ukraine, attended the policy discussions. The team cooperated closely with the World Bank and was joined for a few days by D. Hardy, S. Geadah (MAE) and N. Rendak (LEG) on an FSAP follow-up visit.

The arrangement under the Extended Fund Facility (EFF) expired on September 3, 2002. The final reviews could not be completed, due to the non-implementation of a number of prior actions, including steps to reduce VAT refund arrears and eliminate tax exemptions. At end-March 2003, Ukraine's total outstanding debt to the Fund was SDR 1,364 million (99.4 percent of quota). The Ukrainian authorities have requested a standby arrangement, which they intend to treat as precautionary. Discussions on an economic program that could be supported under such an arrangement are continuing.

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

In concluding the last Article IV consultation on April 24, 2002, Executive Directors welcomed the strong economic performance in 2001, including high growth, low inflation, and an improved external position. They urged the authorities to press ahead with structural reforms, including a reduction in tax privileges, steps to strengthen the financial sector, and energy sector reforms.

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EXECUTIVE SUMMARY

Macroeconomic developments remained positive in 2002, reflecting prudent demand management policies and a still favorable albeit deteriorating external environment. Real GDP growth was 4½ percent, inflation fell to low levels, and unemployment declined somewhat. The current account surplus increased significantly, driven by strong exports and high transfers, and international reserves continued to accumulate at a fast pace.

Unsterilized foreign exchange interventions by the NBU kept the hryvnia constant against the U.S. dollar and supported rapid monetary growth. Monetary policy accommodated the large increase in money demand resulting from the ongoing process of remonetization. It also fuelled rapid loan growth, raising concerns about credit risk in the banking sector. Domestic interest rates remained high, partly reflecting credit risk.

Financing constraints contributed to a sharp fiscal adjustment in 2002. A sizeable shortfall in privatization receipts led to the sequestration of non-wage expenditures of the central government. Combined with strong revenue performance by extrabudgetary funds and local governments, this contributed to a small surplus of the consolidated budget in 2002. VAT refund arrears continued to accumulate.

The near-term macroeconomic outlook remains favorable. Current fiscal and monetary policies are broadly appropriate to support macroeconomic stability and real GDP growth of about 4½ percent this year. The decline in public debt and increase in international reserves are expected to continue.

The slow pace of structural reform is undermining long-term growth prospects. Progress was made on land reform and in some fiscal areas. To support long-term growth, efforts are required to reform the tax system, strengthen the banking sector, reduce quasi-fiscal operations in the energy sector, and strengthen the accountability of public institutions.

Significant policy challenges and vulnerabilities remain. Recent wage policies imply a sharp increase in public expenditures this year and next, which could constrain the scope for fiscal reforms. Given the likely reversal of several temporary factors, a tightening of monetary policy will be required to maintain low inflation. Greater exchange rate flexibility would help absorb shifts in the balance of payments and money demand, and would counter imprudent lending practices. Notwithstanding recent improvements in debt sustainability, liquidity problems could emerge in case of a deterioration of the external environment, especially if coupled with a loss of domestic confidence, which could jeopardize economic growth and the stability of the financial sector.

Discussions on a precautionary standby arrangement are continuing. Outstanding issues include steps to remain current and eliminate VAT refund arrears, significantly reduce tax exemptions, and address quasi-fiscal operations in the energy sector. Broad ownership of structural reforms would be essential.

I. Background to the Discussions

1. A new government, headed by Prime Minister Yanukovich, and a new central bank governor were appointed in late 2002. The government is currently supported by a relatively small majority in parliament. Presidential elections are scheduled for October 2004.

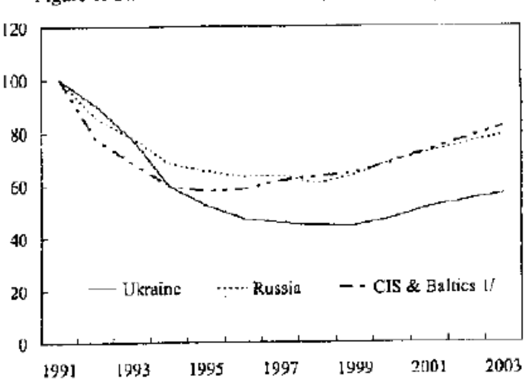
2. **GDP grew strongly for the third year running.** Ukraine's output decline during the 1990s was more severe and lasted longer than in most other countries in the region, and was followed by a strong recovery starting in 2000 (Figure 1). Real GDP growth was about 4½ percent in 2002, driven by continued strength in industry and domestic trade. Preliminary data for the first quarter of 2003 point to continued strong GDP growth. As in 2001, growth was supported by robust consumer spending, reflecting large wage increases, but also by an increase in net external demand. Investment demand fell substantially, reflecting a very large decline in inventories (mostly grains), while real fixed investment increased in line with GDP growth. Unemployment declined, reaching an average rate of about 10 percent in 2002, based on ILO methodology (Table 1).

Ukraine: Key Economic Indicators, 2000–2003

	2000	2001	2002 Prelim.	2003 Proj.
	(Percent change)			
Real GDP	5.9	9.2	4.6	4.5
Consumer prices, eop	25.8	6.1	-0.6	6.0
Broad money	45.4	42.0	41.7	21.5
	(In percent of GDP)			
Consolidated government budget balance, cash basis	-1.3	-1.6	0.5	-0.9
Current account balance	4.7	3.7	7.7	4.7
	(In months of imports of goods&services)			
Gross Reserves	0.9	1.7	2.3	2.5

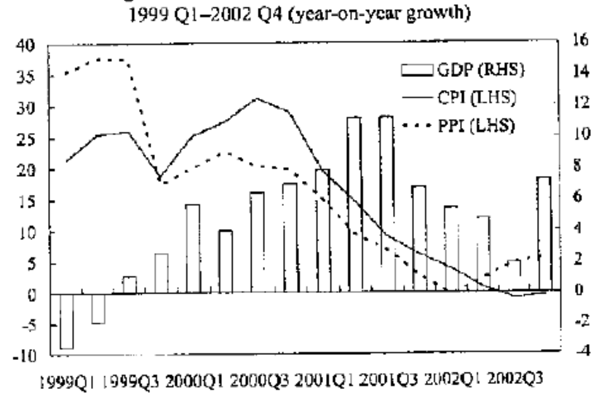
Sources: Ukrainian authorities; and Fund staff estimates.

Figure 1. Ukraine: Real GDP Level, 1991–2003 (1991=100)



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

Figure 2. Ukraine: GDP Growth and Inflation, 1999 Q1–2002 Q4 (year-on-year growth)



Sources: Ukrainian authorities; and Fund staff estimates.

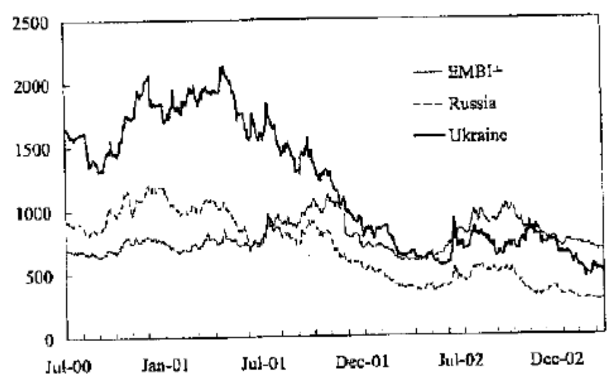
3. **Inflation declined to very low levels in 2002, partly reflecting temporary factors.** Consumer price inflation fell to near zero in 2002 (Figure 2), reflecting primarily the good harvests in 2001/02 and the resulting sharp drop in food prices, which account for almost two-thirds of the CPI. Low inflation was also supported by a significant tightening of fiscal policy and delays in increasing administered prices, as well as by continued exchange rate

stability and rapid remonetization. However, consumer price inflation picked up in late 2002 and early 2003, following an earlier increase in producer price inflation.

4. **The current account surplus increased significantly.** The trade balance was boosted by a sharp increase in exports of grain, following good harvests in 2001/02, and oil products, reflecting the upgrading of oil refineries. Recently imposed anti-dumping measures by some trading partners led to a reorientation of metals exports (Ukraine's largest export sector) to markets in Asia. The service balance surplus increased substantially, partly reflecting increased receipts from travel and a decrease in construction-related expenditures. Current transfers were boosted by workers remittances and World War II compensation payments.

5. **Private sector portfolio outflows increased in 2002** (Table 3). In early 2003, the NBU introduced new licensing requirements to reduce loopholes for capital flight (such as share sales and repurchases at differential prices), while liberalizing procedures for obtaining foreign loans. In late 2002, the government tapped the international capital markets, augmenting its 2007 Eurobond series by about US$350 million on a net basis, at a spread of about 750 basis points over U.S. treasury bonds. More recently, spreads have declined and narrowed the margin over Russia (Figure 3). Following principal payments of almost US$900 million, external debt of the government and the NBU fell to about 25 percent of GDP at the end of 2002, low by regional comparison (Figure 4). Ukraine completed all bilateral debt rescheduling agreements with its Paris Club creditors, and an agreement on comparable terms is being discussed with Turkmenistan. Gross international reserves increased to 2¼ months of imports of goods and services by end-2002, moving rapidly towards the regional average.

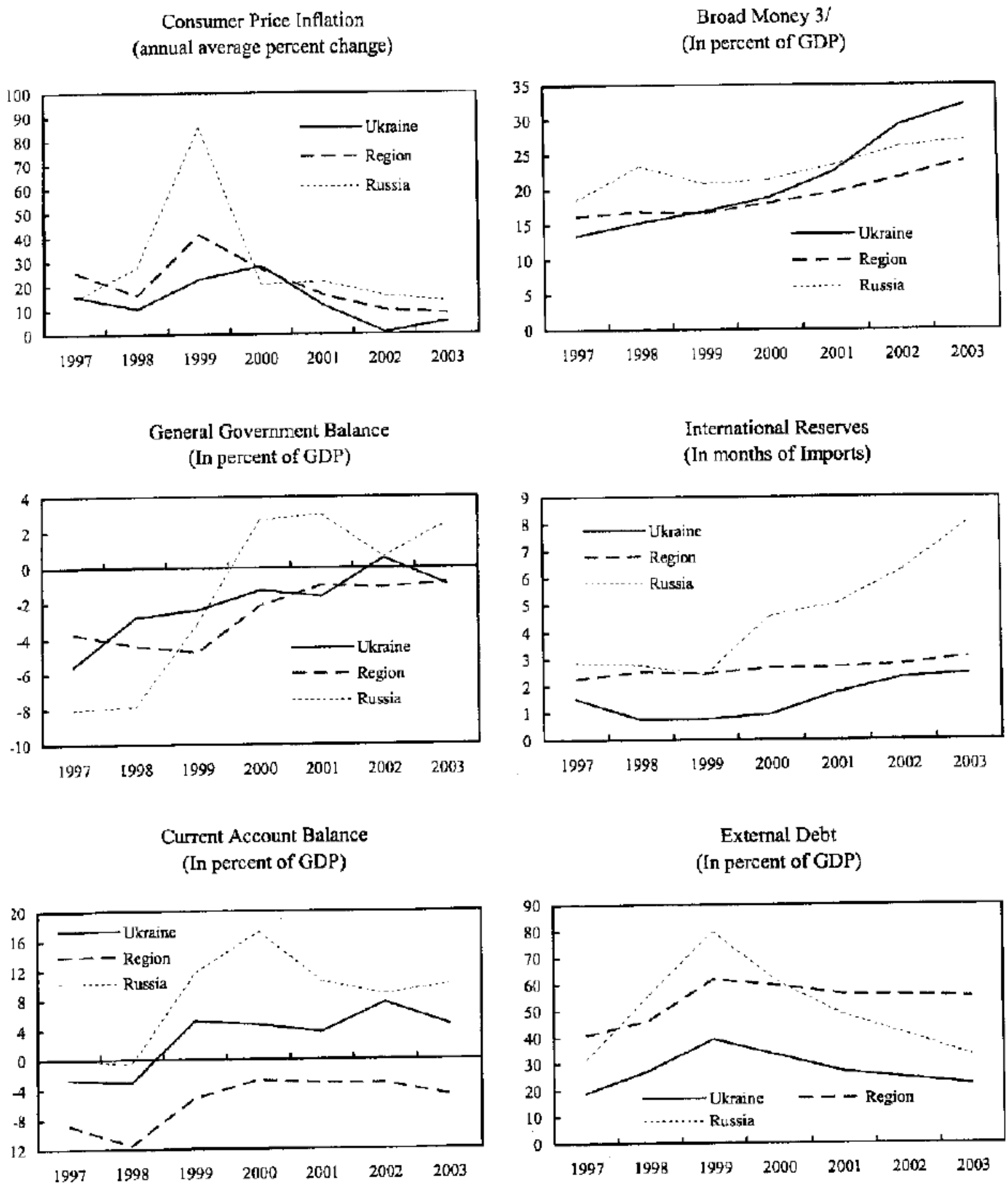
Figure 3. Ukraine: Eurobond Spreads for Ukraine, Russia and Emerging Markets, July 2000–March 2003 (Basis points)



Source: Datastream.

6. **NBU interventions kept the hryvnia constant against the U.S. dollar** (Figure 5). Following the sharp adjustment of the exchange rate in the wake of the 1998/99 financial crisis, the real effective exchange rate has remained broadly stable (Figure 6). In 2002, it depreciated by about 3 percent in terms of consumer prices and appreciated by about 1½ percent in terms of producer prices. When based on unit labor costs, the real effective exchange rate is estimated to have depreciated modestly, reflecting very high unit labor cost growth in Russia. The strong improvement in Ukraine's trade and services balance suggests that competitiveness remains adequate. In 2002, the average monthly wage in Ukraine was about US$70, compared to US$140 in Russia, and an average of about US$400 in EU accession countries.

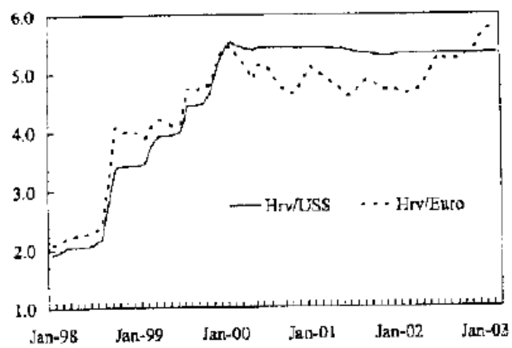
Figure 4. Ukraine and the Region: Economic Indicators, 1997–2003 1/ 2/



Source: Ukrainian authorities; and Fund staff estimates.

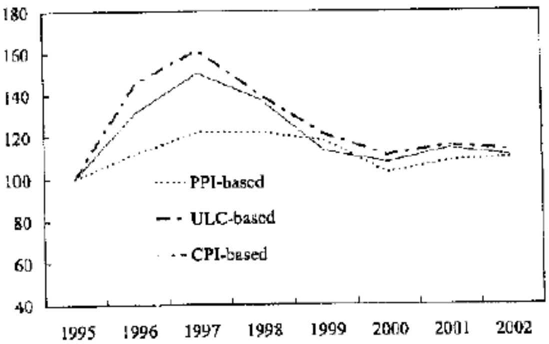
1/ Regional data are the simple average of the CIS (excluding Turkmenistan) and Baltic countries.
2/ 2003 numbers are projections.
3/ Includes foreign currency deposits.

Figure 5. Ukraine: Nominal Exchange Rate, January 1998–March 2003 (period average)



Source: National Bank of Ukraine.

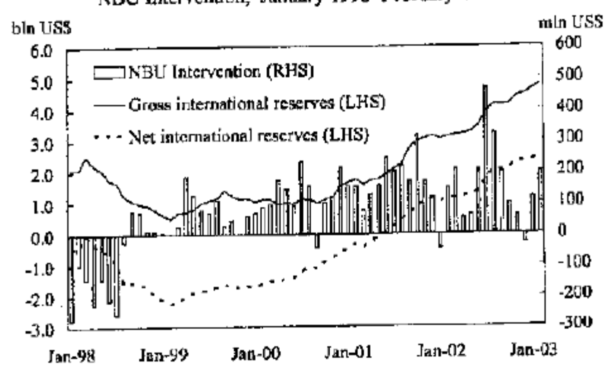
Figure 6. Ukraine: Real Effective Exchange Rates, 1995–2002 (1995=100)



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

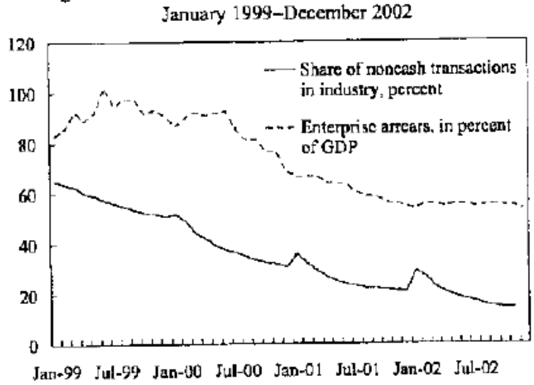
7. **Monetary aggregates continued to grow rapidly, accommodating a large increase in money demand.** Base and broad money grew by 34 and 42 percent respectively in 2002, well above the regional average, fuelled by over US$1.7 billion in unsterilized net foreign exchange purchases by the NBU (Figure 7). In response to falling consumer price inflation in 2002, the NBU reduced the refinancing rate, from 12½ percent to 7 percent, and lowered reserve requirements. The strong growth in money demand, evidenced by the large balance of payments surplus, reflected growing public confidence and the continued remonetization of the economy, with nonmonetary transactions falling to below 20 percent of industrial sales in 2002 and enterprise arrears stabilizing at lower levels (Figure 8).

Figure 7. Ukraine: International Reserves and NBU Intervention, January 1998–February 2003



Sources: Ukrainian authorities; and Fund staff estimates.

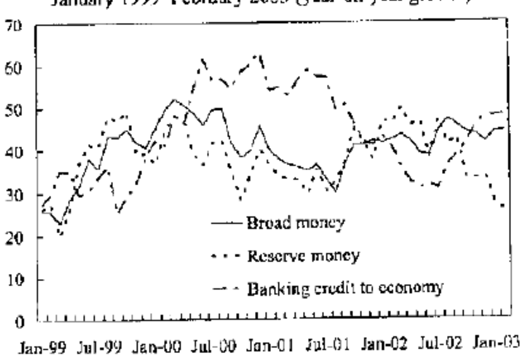
Figure 8. Ukraine: Nonmonetary Transactions and Arrears, January 1999–December 2002



Source: Ukrainian authorities.

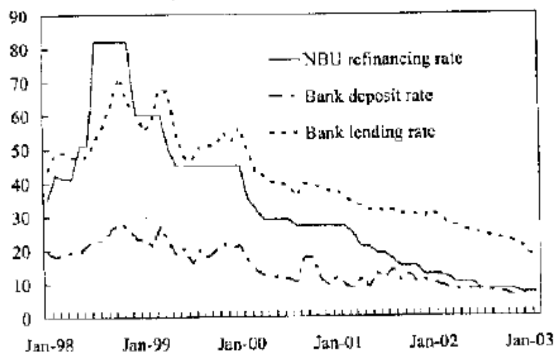
8. **The monetary expansion contributed to rapid loan growth in the banking sector.** Banking credit to the economy grew by almost 50 percent in 2002 (Figure 9), following similar growth rates in the two preceding years. The FSAP mission found that this has weakened banking sector capitalization and contributed to increased credit risk (see FSSA and Box 3). A large share of the new loans was extended for trade financing and working capital, and most loans had maturities of one year or less. Despite the very rapid credit growth, preliminary official data indicate that the share of nonperforming loans decreased only modestly in 2002, to about 22 percent. The shares of foreign currency-denominated loans and deposits remained broadly unchanged in 2002, at about 40 percent and 33 percent respectively. Interest rates decreased (Figure 10), but lending rates and spreads still remained high, partly reflecting high credit risk.

Figure 9: Ukraine: Money and Credit Developments, January 1999–February 2003 (year-on-year growth)



Sources: Ukrainian authorities; and Fund staff estimates.

Figure 10. Ukraine: Interest Rates, January 1998–February 2003 (in percent)



Source: National Bank of Ukraine.

9. **Strong revenue performance contributed to a significant fiscal adjustment.** The consolidated budget turned from a cash deficit of 1½ percent of GDP in 2001 to a surplus of ½ percent of GDP in 2002. Revenues increased by about 3 percentage points of GDP. High wage growth contributed to sharp increases in local government (income tax) and pension fund (payroll tax) revenues. VAT and excise revenues also rose markedly, partly reflecting improved tax policy and administration for imports. However, the stock of VAT refund arrears increased by 40 percent in 2002, reaching 1¼ percent of GDP, and by another 9½ percent in the first two months of 2003.

10. **Financing constraints limited the increase in expenditures implied in the 2002 budget.** Privatization receipts fell about 2 percent of GDP short of the budget target. Moreover, despite the strong overall revenue performance, nonearmarked cash revenues of the central budget were lower than budgeted, partly due to low nominal GDP growth. With wage and pension increases of 15–20 percent, significant cuts in non-protected central government spending were implemented through generalized cash rationing. There was also a small accumulation of social expenditure arrears. Moreover, due to slow progress on structural reforms, the government did not receive planned multilateral project and adjustment loans and, facing domestic financing constraints, tapped the much more costly international debt market instead.

11. **Some reforms were implemented in the fiscal area.** The single treasury account was fully implemented in mid-2002. Some tax privileges were eliminated at the beginning of 2003 (Box 2). Tax arrears increased from 3 percent of GDP at end-2001 to 6¾ percent of GDP at end-2002, mainly reflecting noncompliance in the energy sector and the inability to collect installments for tax arrears restructured under the 2001 tax amnesty. Unfunded social mandates were reinstated at the beginning of 2002, adversely affecting the financial position of communal enterprises. However, eligibility criteria were recently tightened, targeting improved, and administration strengthened, based on country-wide registration of beneficiaries.

12. **There has been little progress on energy sector reform in the last two years.** The restructuring of energy debts and the privatization of the remaining state-owned electricity distributors have been delayed. Cash collections reportedly increased to about 85–90 percent for gas and electricity (Figure 11), but the energy sector accumulated significant tax arrears in 2002.[1] The staff estimates that the quasi-fiscal deficit in the energy sector was about 2½ percent of GDP in 2002, as reflected in the increase in arrears to suppliers and the tax authorities (Table 8). In addition, the coal sector receives budgetary subsidies of about 1 percent of GDP annually. The stock of debts and arrears of state-owned energy companies amounted to an estimated 12 percent of GDP in 2002.

Figure 11a. Ukraine: Average Electricity Tariff, 1999–2002

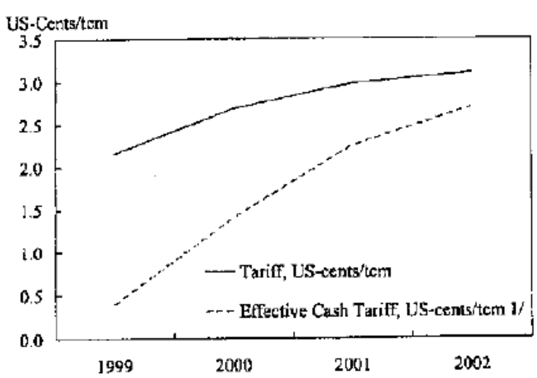
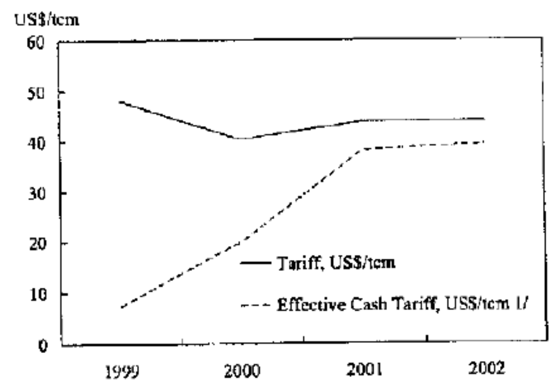


Figure 11b. Ukraine: Average Gas Tariff, 1999–2002



Source: Ukrainian authorities.
1/ Total cash collection divided by total consumption by final consumers.

13. **Progress on other structural reforms has been mixed.** According to the EBRD's transition indicators, Ukraine has gradually made progress on structural reform, but remains behind many other transition countries—not only EU accession candidates, but also Russia and Kazakhstan. An important achievement has been progress on land reform, supporting growth in the agricultural sector. However, the privatization process slowed down and privatization receipts fell in 2002, partly reflecting the lack of any large sales to strategic

[1] In the gas sector, tax payments have remained broadly constant in nominal terms over the last few years, despite the reported increase in cash collections.

investors. Modern civil and economic codes were recently adopted, strengthening contract enforcement and property rights.

II. Policy Discussions

14. **The 2003 Article IV discussions focused on economic policies for 2003/04 and the medium-term outlook.** While there was broad agreement in many policy areas, there were some differences on the assessment of risks associated with high monetary growth and bad loan portfolios in the banking sector, the NBU's new long-term lending facility, tax policy and VAT refund administration, public sector wage policy, and energy reforms.

15. **Understandings have not yet been reached on an economic program that could be supported under a precautionary standby arrangement.** While the broad macroeconomic trends have been positive and the overall macroeconomic policy stance broadly appropriate, there were uncertainties about the authorities' structural reform agenda in several macro-critical areas. Key issues include the need to address the growing problem of VAT refund arrears, to specify tax reforms aimed at eliminating exemptions and reducing tax rates, and to enhance transparency and reduce quasi-fiscal operations in the energy sector. The authorities recently submitted a comprehensive economic reform program to parliament, which highlights the need to accelerate structural reforms in many areas, including on wage policy, pension reform and social protection, privatization, competition policy, financial sector reform, tax reform, expenditure management, international cooperation, agricultural reform, and energy sector reform. The program is broadly consistent with the staff's assessment in its recent Country Strategy Paper (Box 1), although it lacks some specificity on the policies to achieve the stated reform objectives. The staff is awaiting more concrete evidence of broad-based ownership of the authorities' reform program, including passage by parliament of key economic legislation.

A. Economic Outlook and Vulnerabilities

16. **Notwithstanding the weak global environment, Ukraine's near-term economic outlook is favorable** (Table 1). Staff projects real GDP growth of about 4½ percent in 2003, supported by continued strength in consumer spending and a relaxation of the tight fiscal stance of last year. The authorities felt that higher GDP growth, up to 6 percent, might be attainable, considering the strong outturn in the first quarter of 2003. Staff noted that its projections partly reflect the weaker outlook for agriculture, but agreed that GDP growth could be higher if external conditions or the investment climate improved. Inflation is expected to rebound to about 6 percent in 2003, reflecting the reversal of several temporary factors in 2002. Higher investment and import demand are projected to lead to a reduction in the current account surplus, while portfolio outflows are projected to subside. Gross international reserves are expected to increase to about 2½ months of imports by end-2003.

Box 1: Lessons from the EFF-supported program

Following the expiration of Ukraine's economic program support under the EFF arrangement in September 2002, the staff prepared a Country Strategy Paper to draw lessons and highlight future priorities. The paper was discussed with the authorities during the mission in October/November 2002 and has been the basis for discussions of a precautionary stand-by arrangement.

Key lessons from the EFF-supported program include:

- Fiscal discipline is central to alleviating macroeconomic risks. Exchange rate-based stabilization, as practiced until the 1998/99 financial crisis, bears significant risks, especially if fiscal discipline is limited. The reversal of the short-term capital flows that helped finance a large fiscal deficit in 1997 led to the near exhaustion of Ukraine's international reserves in 1998 and subsequently to a very large depreciation of the currency. Since 2000, fiscal tightening and prudent debt policies have substantially reduced macroeconomic vulnerabilities.

- Lack of program ownership inhibits progress on structural reform. While implementation of structural benchmarks under the program was satisfactory, overall reform progress was limited, especially in cases where the ultimate objectives of reform were opposed by vested interest and positive reform steps were partly offset by subsequent counterproductive measures.

- Streamlining of structural conditionality helps focus on macro-critical issues. From 2000 onwards, Fund conditionality focused more narrowly on fiscal and central bank reforms, leaving the coverage of many other areas to the World Bank. The failure to implement several prior actions for the final reviews under the EFF in 2002 showed that streamlining alone is not sufficient to achieve ownership.

- Long-term growth requires substantial progress on strengthening governance and transparency in order to improve the investment climate. Key challenges include tax reform (to create a level playing field), financial sector reform (to alleviate credit risk), and energy sector reform (to reduce quasi-fiscal operations).

The authorities broadly agreed with the staff's analysis, including with the emphasis on program ownership and structural reform. They discussed future challenges with staff. The authorities subsequently drafted their own economic reform program, for parliamentary approval.

17. **Intensified structural reforms are necessary to sustain high economic growth over the long term.** The economic recovery that followed the deep output slump in the 1990s was made possible by the sharp real depreciation in the wake of the 1998/99 financial crisis and by the establishment of macroeconomic stability, which encouraged rapid remonetization and export growth. A combination of low wages and large excess capacities supported the recovery of the industrial sector. There were also some structural shifts driven by land reform and the emergence of small- and medium-sized enterprises, boosting agricultural production and trade. However, these factors are not sufficient to ensure sustained economic growth over the long run, as labor costs continue to rise and the existing capital stock ages. Investment and productivity growth will require an improvement in the

investment climate, which is currently constrained by a distorted tax system, banking system weaknesses, quasi-fiscal activities in the energy sector, as well as problems with governance, transparency and the rule of law. The authorities stressed that their economic program envisages an acceleration of structural reforms in these areas.

18. **Ukraine's financial position is projected to improve further.** On the basis of the authorities' envisaged structural reform program, the staff's medium-term baseline scenario projects annual average real GDP growth of 4 percent (Table 2).[2] The scenario assumes a small primary surplus throughout the forecast period and reflects the authorities' intention to keep new external borrowing in line with external amortization, supporting the continued decline in public and external debt ratios. With accelerated structural reforms, private sector investment and import demand would increase, unwinding the current account surplus. The capital account is projected to improve as outflows of private capital subside and foreign direct investment increases (Table 3), assuming a gradual improvement in the investment climate. The relatively strong balance of payments position would allow the NBU to achieve its gross reserves target of 3 months of imports by mid-decade.

19. **The mission discussed economic risks and vulnerabilities.** Under baseline assumptions, public and external debt ratios are relatively low and declining, and could absorb some temporary economic shocks (Appendix IV). To assess risks to debt sustainability under more adverse conditions, the staff prepared a low-case scenario (Table 4), which assumes slower progress on structural reforms and a looser fiscal stance (reflecting the risk of continued high wage growth and tax rate reductions with only limited elimination of exemptions). Sensitivity analysis shows that temporary economic shocks—such as a sharp real depreciation, increase in interest rates, or decline in growth—would jeopardize fiscal sustainability in this scenario. Staff also warned that liquidity problems could emerge in the event of fiscal slippages, spillovers of energy debts, financial sector problems, and/or a loss of domestic confidence. In addition, the possibility of sustained higher oil prices, a delayed global recovery, loss of access to the international debt markets, and sustained anti-dumping restrictions could adversely affect the balance of payments. Vulnerability indicators are summarized in Table 5.

20. **The authorities stressed that progress on structural reform could produce higher GDP growth than projected in the baseline scenario, thus alleviating vulnerabilities.** Staff agreed that Ukraine's economy could continue to expand rapidly in the near term, but felt that the poor investment climate would constrain industrial restructuring and productivity growth, implying limited upside potential for GDP growth over the long run (high-case scenario in Table 4).

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[2] This relatively modest growth rate takes into account the projected decline in the population and the relatively poor institutional quality in Ukraine (see Chapter 1, Selected Issues Paper).

B. Fiscal Policy and Reform

21. **The 2003 budget is consistent with debt sustainability, while relaxing the ex-post tight fiscal stance of 2002.** The authorities stressed that the budget is realistic and prudent, with a central budget deficit of only ¾ percent of GDP. The staff noted that the deficit may turn out somewhat lower, as external project financing and related expenditures are likely to fall short of the budget assumption. On this bases, the consolidated deficit is projected at about 1 percent of GDP (Table 6), taking into account borrowing plans of the city of Kyiv and the government's intention to ensure the financial balance of all social insurance funds. The authorities and staff agreed that the privatization process was currently too slow to achieve the budget receipt target of 1 percent of GDP and that additional domestic borrowing may be needed to finance the shortfall. Even in this case, total government and NBU debt would still decline by about 3 percentage points of GDP in 2003, to 32 percent of GDP.[3]

Ukraine: Consolidated Government Finances, 2001–2003
(In percent of GDP) 1/

	2001	2002		2003	
		Budget	Prelim.	Budget	Proj.
Revenue and grants	33.5	37.5	36.5	37.3	37.1
o/w: nonearmarked cash revenue	18.9	22.1	21.8	22.2	22.0
Expenditure	35.1	39.4	35.9	38.6	38.0
o/w: Interest payments	2.0	1.8	1.3	1.4	1.3
Overall cash balance	-1.6	-1.9	0.5	-1.3	-0.9
Financing	1.6	1.9	-0.5	1.3	0.9
Net external	0.4	-0.3	-0.7	0.5	0.0
Net domestic	-0.1	-0.4	-0.3	-0.1	0.4
Privatization	1.3	2.6	0.5	0.9	0.6

1/ Based on staff estimates of nominal GDP for all columns.

22. **There was agreement that the budget revenue target is attainable, on account of prudent macroeconomic assumptions and revenue-raising measures.** The revenue base is projected to increase as a result of the suspension of several tax preferences; the closing of profit tax loopholes; hikes in excise rates and improvements in excise administration; and the likely strength of income and payroll taxes. Staff pointed to risks of shortfalls on profit transfers and dividends, and expressed concern about recent changes to the VAT on imported natural gas, which may create revenue leakages.

23. **Staff warned that the large expenditure increase implied by the 2003 budget may constrain the scope for fiscal reforms.** Public spending is projected to expand by

[3] This excludes contingent liabilities. Energy debts alone are estimated at 12 percent of GDP.

2 percentage points of GDP, primarily on account of large wage increases and higher local government spending. In the staff's view, such expenditure levels are likely to constrain the scope for rate-reducing tax reforms and may also create rigidities that could impede future expenditure reforms aimed at strengthening health, education, and the social safety net. The staff stressed the risks of setting expenditures mainly on the basis of immediate resource availability and welcomed the authorities' intention to develop a medium-term expenditure strategy, as noted in their economic reform program.

24. **The recently approved new minimum wage law is not fully funded in the 2003 budget.** Following a 40 percent minimum wage increase in 2002, the new law stipulates two additional increases, 12 percent in January 2003 and another 28 percent in July 2003. The authorities shared the staff's concerns about the law's impact on the public sector wage bill, given the direct link of the minimum wage to public sector wage scales. The staff estimated that the full implementation of the new minimum wage law would create a fiscal gap of at least 1 percent of GDP in 2003 and raise the annual wage bill by 3 percentage points of GDP between 2002 and 2004. The authorities indicated that they would submit legislation to cut low-priority budget spending to finance the first increase and postpone the second increase until January 2004. The mission recommended to rescind the second minimum wage increase and link future wage increases to employment rationalization.

25. **The authorities noted their intention to eliminate the stock of VAT refund arrears gradually.** They plan to halt the accumulation of VAT refund arrears and settle a third of the end-2002 stock this year (equivalent to ½ percent of GDP), as provided for in the budget, and the remainder in 2004. Given the adverse impact of the continued rapid accumulation of VAT refund arrears on tax compliance, export incentives, and the rule of law, the staff felt that a more expedient repayment schedule would be warranted, especially as no interest is being paid on the arrears. To address the underlying weaknesses in governance, staff recommended enhancing the accountability of the state tax administration, which reports solely to the President of Ukraine.

26. **The staff broadly supported the authorities' plans for tax reforms linking rate reductions to base broadening and the elimination of tax preferences.** The recent discontinuation of tax breaks for metallurgical firms and tax credits for military housing have been steps in this direction. The enterprise profit tax rate will be reduced from 30 percent to 25 percent from January 1, 2004. Parliament has approved in the second reading a draft personal income tax law that would replace the current progressive rate structure with a flat tax rate of 13 percent and a higher non-taxable threshold. The government is also considering reducing the VAT rate (currently 20 percent). The staff stressed the need to reduce tax exemptions significantly (Box 2), but noted that even then, the envisaged reforms would produce a large revenue loss.[4] The authorities expect that the tax reforms would shift

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[4] The staff estimates that the tax rate changes currently under discussion would amount to a gross revenue loss of almost 3 percentage points of GDP, about half of which could be offset if substantial measures are taken to broaden the tax base and eliminate tax privileges.

activities from the informal to the official economy. Staff noted that this effect may be limited, as long as the payroll tax remains high. To enhance transparency, the mission recommended including all remaining tax privileges in the annual budget as tax expenditures for parliamentary approval.

Box 2. Tax Preferences

The revenue forgone through tax preferences (non-standard tax exemptions and privileges) is projected to decline by about ¾ percentage point of GDP between 2001 and 2003, but still remain relatively high. For the central government budget, the costs of tax preferences in 2003 represent 17 percent of tax revenue. Tax breaks for the metallurgical sector, deductions for investment in metallurgy, mining, and chemical industries, as well as some tax deductions for electricity tariff surcharges have been removed. Tax credits for construction companies providing military housing and tax exemptions for the publishing industry have been suspended for a year.

Tax Preferences, 2001–2003 (in percent of GDP)

	2001 est.	2002 proj.	2003 proj.
Total revenue forgone	4.3	4.4	3.5
Enterprise profit tax	1.3	0.8	0.2
Personal income tax	0.3	0.3	0.3
VAT	2.1	2.4	2.2
Import duties	0.2	0.3	0.2
Land tax	0.5	0.6	0.5
Other	0.1	0.0	0.0

Sources: Finance Ministry; STA; and Fund staff estimates.

The staff's recommendations include: eliminating tax preferences for specific economic sectors, such as automobile manufacturing, transportation, and housing construction, and special economic zones; eliminating the large implicit subsidies granted to agriculture via special VAT regimes, by ensuring that VAT refunds cannot be not claimed on VAT that has never been paid to the budget; and improving the targeting of tax exemptions related to health, education, and research, including by limiting VAT exemptions for pharmaceutical products to core medical supplies. For more details on Ukraine's tax system, see Chapter 3, Selected Issues Paper.

27. **The authorities noted their intention to move ahead with social protection and pension reforms.** The authorities have not yet agreed on revisions to the mandatory state pension law, but they reaffirmed their commitment to adopt a benefit formula and mechanisms discouraging early retirement, compatible with the actuarial balance of the pension system. Following recent measures to streamline unfunded social privileges, the staff urged the authorities to replace all social privileges with income-linked cash transfers. In the long term, the existing complex system of social entitlements should be unified into a single income-targeted cash transfer.

28. **The authorities are undertaking further reforms in tax administration and treasury management.** Plans to expand the coverage of existing large taxpayer offices in 2003 should help improve tax compliance. In view of the fast accumulation of tax arrears last year, it would be important to enhance the tax administration's debt collection abilities, including by ensuring its flexibility to commence formal enforcement action at any time. The mission welcomed efforts to expand the treasury system to most regional governments and the pension fund within the next two years. Staff stressed the need to make the necessary legislative changes to pave the way for the establishment of a modern system of commitment controls.

C. Monetary and Exchange Rate Policy

29. **The NBU indicated that the primary objective of monetary policy is low inflation.** The authorities noted that monetary policy had been successful in reducing inflation to very low levels. They stressed that a tighter monetary policy would have unduly constrained credit to the private sector and possibly led to deflation. The NBU agreed with staff that a transparent monetary policy framework and central bank independence are central to achieving the inflation objective. For the near term, the NBU will continue its policy of rebuilding its net international reserves and targeting an appropriate rate of money growth. However, given the difficulty in predicting shifts in money demand, the NBU will also monitor inflation developments carefully and respond quickly to such shifts. Over the longer term, the NBU intends to move towards an explicit inflation targeting framework. Staff supported this objective, but noted that it will require a strengthening of the banking system, deepening of financial markets, further development of monetary instruments, a floating exchange rate regime, and a more predictable transmission of monetary policy to inflation (see Chapter 4 of the Selected Issues Paper).

30. **The authorities acknowledged the need for greater exchange rate flexibility to absorb shifts in the balance of payments and money demand.** However, they expressed concern about the practicalities, as well as the impact on certain economic sectors. The mission stressed the risks from the current *de facto* fixed exchange rate regime. It suggested that foreign exchange interventions should be guided primarily by the authorities' international reserves objective and that it would be easiest to introduce exchange rate flexibility at a time when market conditions are relatively favorable, as is currently the case.

31. **There was agreement in principle that a tightening of monetary policy will be required to keep inflation low in 2003**. The NBU assumes that money demand growth and the decline in velocity will decelerate this year. Its monetary program projects broad money growth to fall from 42 percent in 2002 to a range of 22–27 percent in 2003, which should be consistent with an end-year inflation objective of 6 percent. The NBU expects that, as in previous years and in the first quarter of 2003, monetary growth will be primarily driven by the accumulation of net international reserves, with only limited increase in net domestic assets of the central bank (Table 7). The staff stressed its concern about incipient inflationary risks, reflecting the projected fiscal relaxation, the reversal of temporary factors affecting the CPI last year, and a slowdown in the pace of remonetization (as nonmonetary transactions have now reached relatively low levels). The recent pick up in consumer and producer price

inflation may reflect these pressures. The NBU stressed that it will remain vigilant with respect to inflationary developments, indicating that it stands ready to adjust monetary policy as needed.

32. **The mission expressed concern about the NBU's new long-term credit facility.** The authorities argued that this facility, which provides loans with up to 3-year maturity to commercial banks at the refinance rate (currently 7 percent), would help the development of a long-term credit market and reduce interest rates, without jeopardizing financing stability. The mission agreed that, to the extent that the amounts would be limited and consistent with the monetary program, it would not endanger the inflation objective. However, the facility could be seen as a nontransparent way of providing public credit to enterprises at below market rates. It may also restrict the NBU's ability to intervene in the domestic money market to smooth exogenous shocks. The mission argued that liquidity support to banks should be based on short-term refinancing at market rates and that the objective of developing the long-term credit market and reducing interest rates should be pursued through structural reforms to strengthen the banking sector and creditor rights.

D. Financial Sector Reform

33. **The authorities agreed that further reforms are necessary to address credit risk in the financial sector, highlighted in the FSSA** (Box 3). The authorities have made some progress, by establishing a regulator for non-bank financial institutions and by strengthening regulations on insider lending and large loans. The mission stressed the need to enforce prudential regulations and strengthen the banking sector's safety net, given rapid credit growth in recent years in the context of a weak legal and institutional environment. High real interest rates and the large share of nonperforming loans are indications that credit risk remains pervasive and calls into question the sustainability of the recent credit expansion. The authorities felt that banking credit to the economy still remains relatively low—just under 20 percent of GDP at end-2002—and pointed to the gradual decline in nonperforming loans. The NBU indicated that it would increase the minimum risk-weighted capital adequacy ratio from the current 8 percent to 10 percent. New laws on secured interest and mortgages should help to strengthen creditor rights. The NBU also aims to enhance its supervisory capacity with respect to assessing credit risks and controlling related-party lending. The mission stressed the importance of developing the domestic securities market, to enhance monetary policy instruments and help banks diversify their assets.

34. **The authorities are working with the World Bank to make further progress in strengthening the financial position of a major bank.** The share of loans in total assets decreased in 2002 and the bank's liquidity position strengthened due to an increase in the deposit base and the transfer of the pension fund accounts from another commercial bank. However, the bank remains heavily undercapitalized and subject to significant credit risks. The mission cautioned against the planned establishment of a state-owned development bank, given poor experience in other countries.

Box 3: Main Findings and Recommendations of the FSAP Missions

Despite rapid growth in recent years, the Ukrainian financial sector remains relatively small and is concentrated in commercial banking. Total assets of the 157 banks amounted to about 30 percent of GDP at end-2002.

Credit risk remains pervasive in the financial system, with about 22 percent of bank loans classified as nonperforming and another 40 percent as "watch" at the end of 2002. The very high rates of credit growth in recent years have put in doubt the quality of newly extended loans, given weak internal controls and credit assessment capabilities in most banks. Credit risk is enhanced by insider lending, as well as poor corporate disclosure and weak creditor rights. Foreign-currency denominated loans to borrowers without significant foreign exchange earnings give rise to additional credit risk.

Lending rates have remained high in real terms, reflecting credit risk premia and large operating costs. If macroeconomic conditions were to deteriorate, upward pressure on interest rates could further undermine credit quality. Liquidity in the banking sector has fallen continuously over the past three years, although it is still relatively high. Rapid loan growth has reduced capital adequacy in the sector, reducing the safety net in case of an economic downturn. The weak financial condition of a major bank is a key challenge to the system.

Key recommendations:

- The minimum required capital adequacy ratio should be increased to at least 10 percent.
- Minimum provisioning rates should be raised to reflect expected recovery rates.
- The legal framework for banking supervision should be improved, by strengthening the regulatory control over all significant bank investments and over connected lending.
- The basic legal and institutional framework of corporate governance in Ukraine should be strengthened, moving towards international standards of accounting and audit.
- The NBU should improve supervision and enforce discipline in not granting forbearance.
- The NBU should help stabilize systemic liquidity, by improving its short-term liquidity forecasting and more actively intervening in the domestic money market.
- The authorities should help develop the securities market to support the diversification of banking assets.

35. **The authorities indicated that they intend to make further progress in combating money laundering and terrorism financing.** A comprehensive anti-money laundering law was passed in November 2002, and amended in December 2002 and in February 2003. Associated laws have also been amended and a financial monitoring department was created at the ministry of finance, which is expected to become operational when the new anti-money laundering law becomes effective in June 2003. While the authorities noted that the sanctions that were temporarily imposed in late 2002 and early 2003 did not entail significant financial costs to the banking sector, they intend to make it a priority to implement FATF recommendations, with a view to be taken off the list of noncooperative jurisdictions this year.

E. Public Sector Reform

36. **The staff discussed with the authorities the large quasi-fiscal operations and debts in the energy sector.** The authorities pointed to high cash collection ratios as an indication of progress on energy reform, and noted their objective to increase these further, to 92 and 90 percent for electricity and gas respectively. They noted their intention to finalize a debt restructuring plan for the energy sector, in consultation with the World Bank and other donors, which will be instrumental in setting the conditions for the privatization of the remaining state-owned regional energy distributors. The staff did not receive a clear explanation why the high cash collection rates have not translated into better tax compliance. The continued accumulation of tax and supplier arrears by energy companies points to the possibility of below-cost tariff levels and/or poor governance. The mission urged the authorities to develop a monitoring system to assess the financial position in the electricity and gas sectors (see Chapter 6, Selected Issues Paper, for an analysis of quasi-fiscal operations in the energy sector).

37. **The staff stressed the need to enhance transparency in the gas sector.** The mission expressed considerable concern that the government is not exercising its responsibility at holding *Naftogaz*, the fully state-owned monopoly, accountable. The authorities expect to make progress in completing the second-stage and implementing the third-stage audit of *Naftogaz* this year. A financial rehabilitation plan of the company is to be developed with assistance from the World Bank. The staff recommended the regular publication of financial reports by *Naftogaz* and other large public enterprises. Regarding the coal sector, the authorities noted progress in closing unprofitable mines and acknowledged that further restructuring will be important.

38. **The authorities presented their draft privatization program for 2003–2008.** It calls for the privatization of large enterprises and a further reduction of companies excluded from privatization. The authorities also intend to unify the land and real estate registration process and allow for the free trade in land, as well as mortgage lending, starting in 2005. The staff welcomed these plans, while urging the authorities to ensure that state assets are sold under open and competitive conditions.

39. **The staff emphasized the need to strengthen governance and enhance transparency in the public sector.** The authorities should aim to make their policies more predictable and rules-based. The staff pointed to the perception of widespread corruption, the lack of transparency in the gas sector, the steady accumulation of VAT refund arrears, recent wage policies outside the budget process, the new long-term credit facility of the NBU, and the lack of predictability of the privatization process as examples of policies that have undermined the business environment.

40. **The authorities highlighted their objective to join the WTO next year.** The implied progressive trade liberalization, coupled with ongoing efforts at implementing EU standardization and certification regulations, would help strengthen of Ukraine's trading regime. The imposition of anti-dumping duties by several trading partners in 2002 posed significant challenges to Ukraine's metal producers, which reoriented exports to Asian

markets. Grain exports to the EU were also hindered. There were no major changes to the import tariff system, which has *ad valorem* tariffs ranging from 0 to 70 percent and an average weighted rate of 7 percent. Import duty exemptions include those granted to enterprises located in designated Free Economic Zones. Non-tariff barriers include differential excise rates for some products that are both imported and domestically produced, as well as other tax exemptions in support of domestic automobile, aircraft, and ship-building industries. Ukraine imposes export tariffs on hides, live animals, sunflower, and scrap metal. The latter tariff was introduced in January 2003 at a rate of €30 per metric ton. For more details on Ukraine's trade policies, see Chapter 5, Selected Issues Paper.

F. Statistics

41. **The authorities are continuing to improve the quality of Ukraine's economic statistics.** On January 10, 2003, Ukraine became the 52nd subscriber (the first in the CIS) to the Fund's Special Data Dissemination Standard (SDDS). Overall, Ukraine's statistics are disseminated in a timely manner. The mission followed up on the progress made in implementing the ROSC data module recommendations (Appendix III). The release of monthly data on international reserves and foreign currency liquidity started in mid-2002. The first international investment position was compiled by the NBU last year.

42. **There remain important shortcomings, mostly in national accounts and balance of payments data.** The staff urged authorities to take the necessary steps to disseminate data on external debt, following the expiration of the transition period under the SDDS at end-March 2003. The authorities hope to introduce base-year indexed volume measures of GDP and its components by 2004. The staff noted its concern that nominal GDP may be significantly underestimated due to difficulties in estimating the informal economy (Chapter 2, Selected Issues Paper). Moreover, movements in and out of the official economy may lead to mis-estimation of GDP growth rates.

III. Staff Appraisal

43. **Ukraine's strong macroeconomic performance over the past three years reflects prudent demand management policies and favorable external factors.** Robust GDP growth, low inflation, the rapid rebuilding of international reserves, and the reduction in public debt were made possible by a tight fiscal policy, the rapid pace of remonetization, and the exchange rate adjustment following the 1998/99 financial crisis. Despite the weakening global economy, Ukraine has benefited from strong net export demand.

44. **While the near-term outlook is favorable, vulnerabilities remain.** Notwithstanding global weaknesses and uncertainties, GDP growth is expected to remain solid in 2003, and the balance of payments position strong. However, there are incipient inflationary risks, due to the likely reversal of some temporary factors. Moreover, while prudent debt policies have strengthened Ukraine's financial position, liquidity risks remain. A drop in domestic confidence could pose a significant challenge to the current stance of monetary and exchange rate policy. External conditions could worsen if the expected global recovery is delayed. The

health of the banking sector could deteriorate in an economic downturn. Macroeconomic policy slippages could reverse recent improvements in fiscal sustainability.

45. **The pace of structural reforms has been insufficient to sustain high economic growth over the long run.** While there has been progress in a several areas such as land reform, steps to reduce nonmonetary transactions, and some fiscal reforms, many fundamental economic problems remain. During this recent period of good macroeconomic performance, the staff regrets that the authorities have not seized this opportunity to accelerate structural reform. The investment climate remains poor, reflecting a heavily distorted tax system, significant banking system weaknesses, lack of progress on energy reforms, an unstable legal environment, as well as lack of transparency and poor governance in the public sector. Moreover, the pace of privatization has slowed down. While the ongoing economic recovery may continue over the near term, it is unlikely to be sustained, unless structural reforms are accelerated to support investment and productivity growth.

46. **The government deserves credit for handling a difficult fiscal situation in 2002, although the quality of adjustment was poor in some respects.** Despite the very strong revenue performance, the central budget faced significant constraints, primarily due to a sizeable shortfall in privatization receipts and large wage increases. This resulted in broad-based spending cuts, and VAT refund arrears continued to accumulate. In addition, the slow pace of structural reform forced the government to substitute multilateral financing with more expensive Eurobond financing. Little progress was made on some key fiscal reforms, such as tax policy and social safety net reform.

47. **The fiscal stance implied by the 2003 budget is broadly appropriate, but large wage increases constrain the scope for fiscal reforms and create uncertainties for 2004.** The 2003 budget is more realistic than last year's, but it allows for a very large increase in government spending, which could rise even further in 2004 on the basis of the recent minimum wage law. This makes tax reforms less affordable and constrains the scope for reforming the social sector and enhancing public investment. While the staff supports the objective to raise wages in the public sector, this should be carefully phased and linked to employment rationalization, with the aim to maintain a low deficit in 2004.

48. **Tax reform remains a high priority.** Recent changes to the profit tax have been a step in the right direction. The authorities should work with parliament on further tax reforms, linking rate reductions to a broadening of the tax base and an elimination of tax exemptions in order to create a level playing field. To provide a more stable tax environment, the staff recommends enhancing the accountability of the tax authorities, refraining from further tax amnesties, and eliminating the stock of VAT refund arrears as soon as possible, which would be an important signal to reinforce the rule of law.

49. **Monetary policy has so far been successful in supporting low inflation.** The NBU has accommodated the rapid growth in money demand by absorbing the surplus on the balance of payments and rebuilding its international reserves. Looking ahead, it will be critical to monitor inflationary developments carefully. A tightening of monetary policy is

likely to be needed to keep inflation low, given the expected reversal of several temporary factors that kept inflation low last year and the possibility of a slowdown in money demand.

50. **The authorities should emphasize publicly that the primary objective of monetary policy is low inflation.** While the exchange rate remains competitive, the staff strongly supports a move towards greater exchange rate flexibility, given the risks of keeping the exchange rate *de facto* fixed, such as imprudent lending practices and limited control over monetary growth, which could lead to volatile inflation. The staff recommends to continue to target net international reserves and monetary aggregates, while adjusting money supply in response to changes in the inflation outlook. Moving towards full-fledged inflation targeting does not appear feasible at this point, given the lack of developed financial markets and uncertainties about the monetary transmission mechanism.

51. **The staff urges the authorities to implement key recommendations of the recent FSAP missions.** The planned increase in the minimum capital adequacy ratio would be an important step, given the rapid credit growth. The NBU should also aim to enforce prudential regulations vigorously and make significant progress in restructuring a major bank. The staff welcomes the authorities' efforts to bring Ukraine's anti-money laundering legislation in line with FATF recommendations and would stress the need to focus on implementation. The staff is concerned about the NBU's new long-term lending facility. The objective of lowering interest rates and lengthening loan maturities should instead be pursued through structural reforms aimed at strengthening creditor rights and the financial sector.

52. **Sustained macroeconomic stability and growth would require efforts to strengthen governance.** Increasing the transparency and accountability of public institutions and making government policy more rules-based would help improve the investment climate. In the energy sector, the large stocks and flows of debts and the lack of transparency, especially in the gas sector, constitute significant risks to Ukraine's fiscal position. Accelerating the privatization process and making it more transparent would enhance growth prospects. Another important step would be for Ukraine to achieve the intended goal of joining the WTO next year.

53. **Statistical data are broadly adequate for surveillance purposes.** The staff welcomes Ukraine's recent subscription to the SDDS, but urges the authorities to address a number of data weaknesses, including on national accounts, balance of payments and short-term external debt.

54. **As outlined in the staff's Country Strategy Paper, a credible structural reform program with broad ownership, in addition to preserving macroeconomic stability, would be a key element of an economic program that could be supported under a precautionary standby arrangement.** The authorities are in the process of specifying such a program, in consultation with parliament. The staff stands ready to continue discussions on an economic program that merits the support of the Fund.

55. The staff recommends that the next Article IV consultation with Ukraine be held on the standard 12-month cycle.

Table 1. Ukraine: Selected Economic Indicators, 1998–2004

	1998	1999	2000	2001	2002	2003	2004
					Prelim.	Proj. 1/	Proj. 1/
Output and employment							
Nominal GDP (in billions of hryvnia)	102.6	130.4	170.1	204.2	220.6	243.5	265.9
Nominal GDP (in billions of U.S. dollars)	41.8	31.6	31.3	38.0	41.4	...	...
Real GDP (annual change in percent)	-1.9	-0.2	5.9	9.2	4.6	4.5	4.0
Unemployment rate (ILO definition)	11.3	11.9	11.7	11.1	10.0 1/	...	...
Prices and wages (percent change)							
Consumer prices, period average	10.6	22.7	28.2	12.0	0.8	5.2	5.0
Consumer prices, end of period	20.0	19.2	25.8	6.1	-0.6	6.0	4.0
Producer prices, end of period	35.1	15.7	20.6	0.9	5.7	...	...
Average monthly wages, annual average	6.8	16.1	30.2	34.9	20.7	...	...
Consolidated budget (in percent of GDP)							
Revenue	35.6	31.9	33.4	33.5	36.5	37.1	35.4
Expenditure (cash basis)	38.4	34.2	34.7	35.1	35.9	38.0	36.5
Cash balance	-2.8	-2.4	-1.3	-1.6	0.5	-0.9	-1.0
Primary balance (cash basis)	-0.4	0.0	1.8	0.4	1.9	0.4	0.5
Commitments balance 2/	-3.1	-1.4	0.2	-1.7	0.2	-0.4	-0.4
Privatization proceeds	0.5	0.6	1.3	1.3	0.5	0.6	0.6
Net domestic financing	1.0	1.5	0.3	-0.1	-0.3	0.4	0.5
Net external financing	1.4	0.2	-0.3	0.4	-0.7	0.0	-0.1
Money and credit (end of period, percent change)							
Credit to nongovernment	16.7	38.6	63.0	41.0	47.5	21.9	...
Net credit to government	76.9	37.5	-1.9	-5.1	-0.6	5.0	
Base money	21.9	39.2	40.1	37.4	33.6	15.3	...
Broad money	25.3	40.4	45.4	42.0	41.7	21.5	...
Velocity 3/	7.3	6.9	6.3	5.2	4.0	3.4	...
Average hryvnia lending rate (in percent, period average)	54.5	55.0	41.5	32.3	25.5	...	...
Average hryvnia deposit rate (in percent, period average)	22.3	20.7	13.7	11.0	7.9	...	...
Balance of payments							
Current account balance (in millions of U.S. dollars)	-1,296	1,658	1,481	1,402	3,173	2,113	1,396
Current account balance (in percent of GDP)	-3.1	5.2	4.7	3.7	7.7	4.7	2.9
Gross reserves (end of period)							
In months of imports of goods and services	0.6	0.7	0.9	1.7	2.3	2.5	2.7
Public external debt (in percent of GDP) 4/	26.5	39.5	33.1	26.6	24.6	22.2	20.1
Debt service (in percent of exports of goods&services) 4/ 5/	11.1	15.8	10.4	6.7	5.4	8.0	8.4
Exports (annual change in percent)	-11.1	-3.7	19.2	8.7	9.2	4.6	4.7
Imports (annual change in percent)	-17.0	-20.5	15.4	13.0	6.3	7.7	6.8
Terms of trade (annual change in percent)	4.7	9.2	-8.2	1.0	1.7	-0.8	0.9
Memorandum items:							
Exchange rate							
Hryvnia per U.S. dollar, end of period	3.43	5.22	5.43	5.30	5.33	...	...
Hryvnia per U.S. dollar, period average	2.45	4.13	5.44	5.37	5.33	...	...
Real effective exchange rate, (percent change) 6/	-8.5	-17.9	-4.6	5.9	-3.0	...	...

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

1/ Staff projections.
2/ Cash balance adjusted for the net accumulation of expenditure arrears on wages, pensions, social benefits, utility payments, and VAT refunds.
3/ Annual GDP divided by period-average broad money (M3).
4/ Government and government-guaranteed debt, and NBU debt. Excludes debt by state-owned enterprises. Historic debt data are preliminary.
5/ After rescheduling.
6/ Period average. Staff estimates using INS database. Based on CPI and average trade weights for 1995-2001.

Table 2. Ukraine: Medium-term Macroeconomic Framework, 2000–2008 1/

	2000	2001	2002 Prelim.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
				(percent change)					
Output and prices									
Nominal GDP (in billions of hryvnia)	170.1	204.2	220.6	243.5	265.9	287.6	311.1	336.4	363.9
Real GDP growth	5.9	9.2	4.6	4.5	4.0	4.0	4.0	4.0	4.0
Consumer prices (period average)	28.2	12.0	0.8	5.2	5.0	4.0	4.0	4.0	4.0
				(percent of GDP)					
Consolidated budget									
Revenue and grants	33.4	33.5	36.5	37.1	35.4	35.2	35.0	34.8	34.6
Expenditure and net lending (cash basis)	34.7	35.1	35.9	38.0	36.5	36.3	36.3	36.0	35.9
of which: interest	3.1	2.0	1.3	1.3	1.6	1.8	1.8	1.7	1.7
Cash balance	-1.3	-1.6	0.5	-0.9	-1.0	-1.1	-1.3	-1.2	-1.3
Commitments balance	0.2	-1.7	0.2	-0.4	-0.4	-1.1	-1.3	-1.2	-1.3
Privatization receipts	1.3	1.3	0.5	0.6	0.6	0.8	0.7	0.6	0.5
Net domestic financing	0.3	-0.1	-0.3	0.4	0.5	0.4	0.7	0.7	0.8
Net external financing	-0.3	0.4	-0.7	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Public debt (end of period) 2/	45.9	37.3	34.7	31.7	29.4	27.1	25.2	23.5	22.2
Domestic	12.8	10.7	10.1	9.5	9.3	8.9	8.9	8.9	9.1
External	33.1	26.6	24.6	22.2	20.1	18.2	16.3	14.5	13.1
General government	26.4	21.6	20.1	18.5	17.2	16.0	14.9	13.9	13.0
NBU	6.7	5.0	4.5	3.7	2.9	2.2	1.3	0.6	0.1
				(percent of GDP, unless otherwise indicated)					
External sector									
Current account balance, % of GDP	4.7	3.7	7.7	4.7	2.9	1.8	1.0	0.6	0.2
Merchandise exports, value (percentage change)	19.2	8.7	9.2	4.6	4.7	5.9	6.1	6.5	6.5
Merchandise imports, value (percentage change)	15.4	13.0	6.3	7.7	6.8	6.8	6.8	6.8	6.8
Gross official reserves (end of period)									
in billions of U.S. dollars	1.5	3.1	4.4	5.1	5.8	6.8	7.5	8.1	8.6
in months of imports of goods and services	0.9	1.7	2.3	2.5	2.7	2.9	3.0	3.0	3.0
External debt service (percent of XGS) 2/	10.4	6.7	5.4	8.0	8.4	9.1	10.0	9.5	8.0
Real effective exchange rate (percent change) 3/	-4.6	5.9	-3.0	1.7	0.6	0.7	0.7	0.7	0.7
				(percent of GDP)					
Savings-Investment Balance									
Foreign savings	-4.7	-3.7	-7.7	-4.7	-2.9	-1.8	-1.0	-0.6	-0.2
Domestic savings	24.2	25.5	26.6	25.8	25.0	23.8	23.6	23.4	23.1
Private	23.3	24.7	24.2	24.5	23.7	22.7	22.3	21.9	21.8
Public	0.9	0.8	2.4	1.3	1.2	1.2	1.4	1.4	1.3
Investment	19.4	21.8	18.9	21.1	22.1	22.0	22.6	22.8	22.9
Private	17.3	19.4	17.1	18.9	19.8	19.8	20.0	20.1	20.3
Public	2.1	2.4	1.9	2.2	2.3	2.3	2.6	2.7	2.6

Sources: Ukrainian authorities and Fund staff estimates.

1/ Baseline scenario, based on current macroeconomic policies and the authorities' plans to accelerate structural reforms.

2/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

3/ Period average. Staff estimates using INS database. Based on CPI and average trade weights for 1995-2001.

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008
			Prelim.			Projections			
	(In millions of U.S. dollars; unless otherwise indicated)								
Current account balance	1,481	1,402	3,173	2,113	1,396	942	563	345	108
Merchandise trade balance	779	198	710	182	-216	-414	-594	-703	-824
Exports	15,722	17,091	18,669	19,520	20,437	21,643	22,963	24,456	26,046
Imports	-14,943	-16,893	-17,959	-19,338	-20,653	-22,057	-23,557	-25,159	-26,870
Of which: Energy	-5,947	-6,182	-6,539	-7,156	-7,340	-7,530	-7,726	-7,929	-8,140
Services (net)	796	415	1,147	726	584	450	325	323	320
Receipts 1/	3,800	3,995	4,682	4,478	4,599	4,746	4,922	5,242	5,582
Payments	-3,004	-3,580	-3,535	-3,752	-4,015	-4,296	-4,596	-4,918	-5,262
Income (net)	-942	-667	-606	-695	-673	-694	-769	-875	-988
Of which: Interest on public debt 2/	-655	-529	-475	-559	-589	-578	-569	-560	-553
Current transfers (net)	848	1,456	1,922	1,900	1,700	1,600	1,600	1,600	1,600
Financial and capital account	-690	100	-1,137	-395	558	1,161	1,439	1,462	1,581
Direct investment and capital transfers (net)	586	772	713	750	800	850	930	965	994
Portfolio equity	-195	-735	-1,957	-1,366	-528	2	189	150	210
Bonds and medium and long-term loans (net)	-87	-120	375	252	250	240	220	230	240
Of which: Bonds and loans (official)	-358	-361	-235	-8	-0	-0	0	-0	-0
Disbursements	179	475	444	1,148	1,251	1,537	1,837	1,886	1,684
Repayments 1/ 2/	-537	-836	-679	-1,156	-1,251	-1,537	-1,837	-1,886	-1,684
Other capital (net)	-994	183	-268	-30	36	69	99	117	138
Of which: Natural gas arrears (net) 3/	161	137	166	...	...	...	...	...	...
Errors and omissions	-150	-231	-885	-885	-885	-885	-885	-885	-885
Overall balance	641	1,271	1,151	833	1,068	1,219	1,116	922	804
Gross official reserves (- is increase)	-398	-1,606	-1,045	-637	-794	-943	-737	-543	-511
Net use of IMF resources	-604	-79	-191	-196	-274	-276	-379	-379	-293
Purchases	245	375	--	--	--	--	--	--	--
Repurchases	-849	-454	-191	-196	-274	-276	-379	-379	-293
Official arrears to bilateral creditors (+ is increase)	361	-361	...	...	...	...	...	...	...
Rescheduling 4/	...	775	85	...	...	...	...	...	...
Memorandum items:									
Total public external debt 2/	10,349	10,118	10,194	9,989	9,715	9,439	9,060	8,680	8,387
Public external debt (in percent of GDP) 2/	33.1	26.6	24.6	22.2	20.1	18.2	16.3	14.5	13.1
Stock of external gas arrears 3/	1,577	1,714	1,880	...	...	...	...	...	...
Current account (in percent of GDP)	4.7	3.7	7.7	4.7	2.9	1.8	1.0	0.6	0.2
Excluding transfers	2.0	-0.1	3.0	0.5	-0.6	-1.3	-1.9	-2.1	-2.3
Debt service ratio (in percent of exports of goods and services) 2/ 4/									
Before rescheduling	10.4	8.7	5.7	...	...	...	...	...	...
After rescheduling	10.4	6.7	5.4	8.0	8.4	9.1	10.0	9.5	8.0
Of which: Interest payments	3.4	2.5	2.0	2.3	2.4	2.2	2.0	1.9	1.7
Gross international reserves (end of period)	1,505	3,089	4,417	5,054	5,848	6,791	7,528	8,071	8,582
In months of next year's imports of goods and services	0.9	1.7	2.3	2.5	2.7	2.9	3.0	3.0	3.0
Over next year's official debt service	0.8	2.3	2.3	2.4	2.4	2.4	2.7	3.2	3.6
Merchandise export values (percent change) 5/	19.2	8.7	9.2	4.6	4.7	5.9	6.1	6.5	6.5
Merchandise import values (percent change)	15.4	13.0	6.3	7.7	6.8	6.8	6.8	6.8	6.8
Merchandise export volume (percent change) 5/	16.5	6.1	7.2	2.7	3.2	4.1	4.2	4.6	4.6
Merchandise import volume (percent change)	3.5	11.4	6.1	4.9	6.2	5.5	5.3	5.3	5.3
Terms of trade (percent change)	-8.2	1.0	1.7	-0.8	0.9	0.4	0.4	0.4	0.3

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

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

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

3/ Change in outstanding stock of arrears stemming from natural gas imports as reported by Naftogaz.

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

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

Table 4. Ukraine: Medium-term Scenarios, 2000-2008

	2000	2001	2002 Prelim.	High-case scenario 1/ 2003	2004	2005	2006	2007	2008	Low-case scenario 2/ 2003	2004	2005	2006	2007	2008
							(percent change)								
Output															
Real GDP growth	5.9	9.2	4.6	6.0	6.0	5.5	5.0	5.0	5.0	4.0	2.0	2.0	2.0	2.0	2.0
							(percent of GDP)								
Consolidated budget															
Revenue and grants	33.4	33.5	36.5	37.1	35.4	35.2	35.0	34.8	34.6	37.1	34.7	34.5	34.3	34.1	33.9
Expenditure and net lending (cash basis)	34.7	35.1	35.9	38.0	36.5	36.3	36.3	36.0	35.9	38.5	38.7	38.7	39.1	39.2	39.2
of which: interest	3.1	2.0	1.3	1.3	1.5	1.7	1.7	1.6	1.5	1.3	2.8	3.2	3.6	3.9	4.3
Cash balance	-1.3	-1.6	0.5	-0.9	-1.0	-1.1	-1.3	-1.2	-1.3	-1.4	-4.0	-4.2	-4.8	-5.1	-5.3
Privatization receipts	1.3	1.3	0.5	0.6	0.6	0.8	0.7	0.6	0.5	0.2	0.2	0.4	0.3	0.2	0.1
Net domestic financing	0.3	-0.1	-0.3	0.4	0.5	0.4	0.7	0.7	0.8	1.3	3.9	3.8	4.6	5.0	5.3
Net external financing	-0.3	0.4	-0.7	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Public debt (end of period) 3/	45.9	37.3	34.7	31.4	28.5	26.0	23.9	22.1	20.7	32.9	34.4	35.8	37.7	40.0	42.6
Domestic	12.8	10.7	10.1	9.4	9.0	8.6	8.5	8.5	8.6	10.5	13.7	16.8	20.4	24.2	28.1
External	33.1	26.6	24.6	21.9	19.5	17.4	15.4	13.6	12.1	22.3	20.7	19.1	17.4	15.8	14.5
							(percent of GDP, unless otherwise indicated)								
External sector															
Current account balance, % of GDP	4.7	3.7	7.7	4.6	2.8	1.7	0.8	0.2	-0.5	4.7	3.2	2.3	1.5	0.9	0.2
Merchandise exports, value (percentage change)	19.2	8.7	9.2	4.6	4.7	6.4	7.1	7.5	7.5	4.6	2.7	3.9	4.1	4.5	4.5
Merchandise imports, value (percentage change)	15.4	13.0	6.3	7.7	7.8	7.8	7.8	7.8	7.8	7.7	4.8	4.8	4.8	4.8	4.8
Gross official reserves (end of period) in months of imports of goods and services	0.9	1.7	2.3	2.4	2.7	3.0	3.1	3.2	3.2	2.5	2.3	2.2	2.0	1.7	1.4
External debt service (percent of XGS) 3/	10.4	6.7	5.4	8.0	8.4	8.9	9.7	9.2	7.6	8.0	8.6	9.3	10.4	10.1	8.7
							(percent of GDP)								
Savings-Investment Balance															
Foreign savings	-4.7	-3.7	-7.7	-4.6	-2.8	-1.7	-0.8	-0.2	0.5	-4.7	-3.2	-2.3	-1.5	-0.9	-0.2
Domestic savings	24.2	25.5	26.6	26.3	25.9	24.7	24.5	23.9	23.4	24.9	22.3	21.4	21.2	20.7	20.2
Private	23.3	24.7	24.2	24.9	24.6	23.5	23.1	22.5	22.1	24.0	24.0	23.3	23.3	23.1	22.9
Public	0.9	0.8	2.4	1.3	1.2	1.2	1.4	1.4	1.3	0.8	-1.7	-1.9	-2.1	-2.5	-2.7
Investment	19.4	21.8	18.9	21.6	23.1	23.0	23.6	23.8	23.9	20.1	19.1	19.0	19.6	19.8	19.9
Private	17.3	19.4	17.1	19.4	20.8	20.8	21.0	21.1	21.3	17.9	16.8	16.8	17.0	17.1	17.3
Public	2.1	2.4	1.9	2.2	2.3	2.3	2.6	2.7	2.6	2.2	2.3	2.3	2.6	2.7	2.6

Sources: Ukrainian authorities and Fund staff estimates.

1/ Compared to the baseline, the high-case scenario assumes more rapid progress on structural reforms, an improved investment climate, and a more favorable external environment.

2/ Compared to the baseline, the low-case scenario assumes slower pace of structural reform, a looser fiscal policy, lower privatization receipts, higher interest rates, and more capital flight.

3/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.

Table 5. Ukraine: Indicators of Vulnerability, 1998–2003

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003		
					Prel.	Latest Estimate	Date	Proj.
Financial indicators								
Public debt 1/	41.8	55.5	45.9	37.3	34.7	31.0	2/28	31.7
Broad money (percent change, 12-month basis)	25.3	40.4	45.4	42.0	41.7	44.2	2/28	21.5
Private sector credit (percent change, 12-month basis)	16.7	38.6	63.0	41.0	47.5	48.1	2/28	21.9
Share of non-performing loans in total loans (percent)	35.6	35.8	29.6	25.1	21.9	...		...
Share of foreign currency loans in total lending (percent)	40.5	46.5	42.1	41.7	39.9	39.8	2/28	...
Share of foreign currency deposits in total deposits (percent)	39.0	44.3	38.7	33.0	32.7	34.0	2/28	30.5
Ratio of the stock of treasury bills to reserves	3.0	1.9	1.3	0.7	0.5	0.5	2/28	0.4
Ratio of broad money to reserves	5.9	3.9	3.9	2.8	2.7	2.6	2/28	2.8
3 month T-bill yield (percent)	50.5	33.0	21.8	15.3	13.5	...		...
External Indicators								
Exports of merchandise (percent change in US$)	-11.1	-3.7	19.2	8.7	9.2	...		4.6
Imports of merchandise (percent change in US$)	-17.0	-20.5	15.4	13.0	6.3	...		7.7
Current account balance	-3.1	5.2	4.7	3.7	7.7	...		4.7
Capital and financial account balance	1.2	-1.6	-2.2	0.3	-2.7	...		-0.9
Public medium and long-term external debt	26.5	39.5	33.1	26.6	24.6	...		22.2
Public medium and long-term external debt service	4.7	8.5	6.5	4.8	3.2	...		4.2
Short term external debt 2/	4.4	4.6	5.9	5.1	4.0	4.8	2/28	4.8
Ratio of short-term external debt to reserves	2.3	1.3	1.2	0.6	0.4	0.5	2/28	0.4
Gross reserves in months of imports	0.6	0.7	0.9	1.7	2.3	2.4	2/28	2.5
Exchange rate (Hrv/US$, period average)	2.4	4.1	5.4	5.4	5.3	5.3	2/28	...
Real effective exchange rate (percent change) 3/	-8.5	-17.9	-4.6	5.9	-3.0	...		...
Financial Market Indicators								
Stock market index (PFTS) 4/	21.6	39.1	55.5	42.7	57.3	57.8	2/28	...
Foreign currency debt rating 5/	B3	B3	Caa1	Caa1	B2	B2	Feb.	...
Spread on benchmark Eurobonds (basis points, end of period) 6/	...	...	1430	780	750	481	2/28	...

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

1/ Domestic and external debt contracted by the general government and the NBU.

2/ Data include amortization of public debt falling due within the year, central bank short-term liabilities, short term financial liabilities of the commercial banks, and treasury bill holdings of non-residents. There are no reliable data on private capital flows and some capital inflows may be misclassified as current account transactions.

3/ An appreciation is indicated by a positive growth rate; period average; CPI-based.

4/ Based on the average weighted price (in US dollars) of common shares of issuers meeting Ukraine's First Stock Trading System (PFTS) listing requirements with the highest liquidity. The index base is 100 as of October 1, 1997.

5/ Moody's Investors Service rating.

6/ Relative to yield on U.S. treasury bonds.

Table 6. Ukraine: Consolidated Government Finances, 1998–2003

	1998	1999	2000	2001	2002	2003	
					Prelim.	Budget	Proj.
				(in millions of Hrv)			
Revenue and grants	36,497	41,555	56,774	68,435	80,438	89,520	90,362
Tax revenue	34,798	39,287	47,633	56,929	68,879	77,340	77,904
Taxes on income, profit	9,793	11,584	14,812	18,168	21,385	24,867	25,709
o/w: Personal Income Tax	3,571	4,434	6,378	8,775	10,824	11,883	12,599
o/w: Enterprise Profit Tax	5,694	6,352	7,698	8,280	9,398	11,826	11,826
Taxes on payroll 1/	9,934	10,335	12,282	16,085	20,105	23,582	23,053
Property taxes	1,115	1,090	1,376	1,619	1,806	1,700	1,794
Domestic taxes on goods and services	11,932	14,340	16,847	18,258	22,279	23,692	23,701
o/w: VAT	7,460	8,409	9,441	10,348	13,471	13,652	13,234
Taxes on international trade	973	1,238	1,561	1,945	2,371	2,610	2,618
Other taxes	1,051	699	754	853	932	888	1,029
Nontax, capital revenue, and grants	1,699	2,268	9,141	11,506	11,559	12,181	12,458
o/w: NBU profit transfer	375	248	500	500	235	700	131
Expenditure 2/	39,349	44,655	58,949	71,711	79,277	92,752	92,636
General public services	1,782	1,876	4,229	4,420	4,369	5,054	...
Defense	1,573	1,709	2,504	3,337	3,395	4,378	...
Public order and safety affairs	1,416	1,527	2,637	3,717	4,431	4,653	...
Education affairs and services	3,634	3,725	5,843	7,798	10,544	12,225	...
Health affairs and services	3,041	3,250	4,251	5,403	7,117	8,248	...
Social security and welfare affairs	16,347	20,200	24,581	30,293	36,716	40,717	...
o/w: Pension Fund	8,619	10,841	12,678	15,547	20,061	22,361	22,378
Housing and community services	1,549	1,376	1,381	1,746	1,359	983	...
Recreational, cultural, religious affairs	610	721	1,038	1,319	1,348	1,655	...
Energy, agriculture, industry, and transports	3,973	3,924	4,100	4,839	6,627	9,969	...
Interest payments	2,418	3,087	5,292	4,060	2,954	3,359	3,285
Domestic interest payments	1,685	1,251	2,385	1,651	714	514	514
Foreign interest payments	733	1,837	2,907	2,409	2,240	2,845	2,771
Other and statistical discrepancy	3,006	3,260	3,093	4,779	419	1,511	...
Overall cash balance	-2,852	-3,100	-2,175	-3,276	1,161	-3,232	-2,274
Net accumulation of VAT refund arrears	...	...	...	1,172	848	-1,000	-1,000
Net accumulation of energy and utility arrears	...	...	-2,766	-158	-379	0	0
Net social arrears accumulation	285	-1,250	-1,745	-724	257	-430	-300
Other arrears (interest)	...	...	-724	0	0	0	0
Commitment balance 3/	-3,137	-1,851	294	-3,566	434	-1,802	-974
Financing	2,852	3,100	2,175	3,276	-1,161	3,232	2,274
Net external	1,387	268	-584	866	-1,550	1,162	-35
Disbursements	3,780	2,263	381	2,252	2,020	7,276	6,202
o/w: project loans	...	...	...	610	189	1,430	713
Amortization	-2,393	-1,996	-965	-1,386	-3,570	-6,114	-6,237
Net domestic	994	2,011	469	-152	-693	-157	909
Privatization	471	822	2,290	2,562	1,082	2,228	1,400
Memorandum items:							
End-period stock of VAT refund arrears	...	...	...	2,095	2,943	1,943	1,943
End-period stock of social arrears	4,339	3,089	1,344	621	878	448	578
Earmarked revenue	12,963	14,893	20,517	29,893	32,405	36,331	36,675
Nonearmarked cash revenue	...	20,567	35,988	38,545	48,032	53,189	53,688
Nominal GDP	102,593	130,442	170,070	204,190	220,556	240,000	243,500
				(in percent of GDP)			
Revenue and grants	35.6	31.9	33.4	33.5	36.5	37.3	37.1
o/w: Tax revenue	33.9	30.1	28.0	27.9	31.2	32.2	32.0
Expenditure 2/	38.4	34.2	34.7	35.1	35.9	38.6	38.0
o/w: Pension Fund	8.4	8.3	7.5	7.6	9.1	9.3	9.2
o/w: Interest payments	2.4	2.4	3.1	2.0	1.3	1.4	1.3
Overall cash balance	-2.8	-2.4	-1.3	-1.6	0.5	-1.3	-0.9
Commitment balance 3/	-3.1	-1.4	0.2	-1.7	0.2	-0.8	-0.4
Financing	2.8	2.4	1.3	1.6	-0.5	1.3	0.9
Net external	1.4	0.2	-0.3	0.4	-0.7	0.5	0.0
Disbursements	3.7	1.7	0.2	1.1	0.9	3.0	2.5
Amortization	-2.3	-1.5	-0.6	-0.7	-1.6	-2.5	-2.6
Net domestic	1.0	1.5	0.3	-0.1	-0.3	-0.1	0.4
Privatization	0.5	0.6	1.3	1.3	0.5	0.9	0.6
Memorandum items:							
Primary balance	-0.4	0.0	1.8	0.4	1.9	0.1	0.4
Nonearmarked cash revenue	...	15.8	21.2	18.9	21.8	22.2	22.0
Government wage bill	6.7	5.5	6.1	6.6	7.2	8.0	8.5

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

1/ Starting from 2001, includes the newly-created Accident Fund.

2/ Reported on a cash basis. Due to a new budget classification, expenditure data beginning in 2002 are not comparable to earlier years.

3/ Cash balance adjusted for the net accumulation of overdue VAT refunds, energy and utility payment arrears, and social payment arrears.

Table 7. Ukraine: Monetary Accounts, 2000–2003

	2000	2001	2002				2003			
	Dec	Dec	Mar	Jun	Sep	Dec.	Mar.	Jun	Sep	Dec.
	Act.	Act.	Act.	Act.	Act.	Prel.	Proj.	Proj.	Proj.	Proj.
	(in millions of hryvnia)									
Monetary Survey										
Net foreign assets 1/	-33	7,210	7,575	8,666	12,612	14,336	13,368	16,475	17,564	18,780
(In millions of US dollars)	-6	1,361	1,423	1,626	2,366	2,688	2,507	3,090	3,294	3,522
Net domestic assets	32,121	38,345	39,770	42,529	45,118	50,196	53,100	53,648	56,592	59,640
Domestic credit	39,966	47,449	49,167	52,312	55,985	61,156	64,278	65,044	68,205	71,471
Net credit to government	19,348	18,367	18,247	18,327	18,077	18,253	20,591	18,575	19,343	19,160
Credit to nongovernment	20,619	29,082	30,920	33,985	37,908	42,903	43,687	46,469	48,862	52,311
Other items, net	-7,846	-9,104	-9,397	-9,783	-10,867	-10,960	-11,178	-11,396	-11,613	-11,831
Broad money	32,088	45,555	47,345	51,195	57,729	64,532	66,468	70,124	74,156	78,420
Hryvnia broad money	24,631	36,958	38,345	41,564	46,980	52,089	53,839	56,940	60,363	63,990
Foreign currency deposits	7,457	8,597	9,000	9,632	10,749	12,443	12,629	13,183	13,793	14,429
Accounts of the National Bank of Ukraine										
Net international reserves 1/	-3,089	6,249	6,613	7,941	11,544	13,548	12,580	15,688	16,777	17,992
(In millions of U.S. dollars)	-568	1,179	1,243	1,490	2,166	2,541	2,359	2,942	3,146	3,374
Net domestic assets 2/	19,870	16,806	18,463	18,287	17,614	17,260	18,322	17,105	17,658	17,518
Net domestic credit	20,972	18,232	19,979	20,116	19,146	19,143	20,204	18,988	19,541	19,401
Net credit to government	19,937	18,509	18,483	19,082	17,732	17,448	18,308	16,941	17,394	17,004
Net credit to nongovernment	92	31	49	73	64	-53	-53	-53	-53	-53
Claims on banks	943	-309	1,446	960	1,350	1,748	1,950	2,100	2,200	2,450
Other items, net	-1,102	-1,426	-1,516	-1,830	-1,531	-1,883	-1,883	-1,883	-1,883	-1,883
Base money	16,781	23,055	25,076	26,227	29,158	30,808	30,902	32,793	34,435	35,511
Currency in circulation	12,799	19,465	19,646	21,441	23,655	26,434	26,587	28,260	29,662	31,093
Banks' reserves	3,982	3,590	5,430	4,786	5,503	4,374	4,315	4,533	4,772	4,417
Deposit Money Banks										
Net foreign assets	2,503	664	521	365	491	242	242	242	242	242
Net domestic assets	17,729	25,117	28,624	30,349	34,933	39,604	41,589	43,722	46,451	49,534
Domestic credit	19,880	28,798	30,592	33,134	38,157	43,606	45,867	48,000	50,708	54,364
Net credit to government	-590	-142	-236	-755	345	805	2,283	1,633	1,949	2,156
Credit to the economy	20,469	28,940	30,828	33,889	37,812	42,800	43,584	46,366	48,759	52,208
Banks' reserves	3,982	3,590	5,430	4,786	5,503	4,374	4,315	4,533	4,772	4,417
Other Items Net	-6,133	-7,271	-7,397	-7,571	-8,727	-8,376	-8,593	-8,811	-9,029	-9,247
Banks' Liabilities	20,231	25,782	29,145	30,715	35,424	39,847	41,831	43,964	46,693	49,776
Credit to banks from NBU	943	-309	1,446	960	1,350	1,748	1,950	2,100	2,200	2,450
Deposits	19,289	26,091	27,699	29,755	34,074	38,098	39,881	41,864	44,493	47,326
	(Percentage change from end of previous year)									
Memorandum items:										
Broad money	45.4	42.0	3.9	12.4	26.7	41.7	3.0	8.7	14.9	21.5
Credit to nongovernment	63.0	41.0	6.3	16.9	30.3	47.5	1.8	8.3	13.9	21.9
Real broad money 3/	15.6	33.8	5.1	14.5	31.0	42.5	-0.3	4.2	10.2	14.6
Real credit to nongovernment 3/	29.5	32.9	7.5	19.0	34.8	48.4	-1.4	3.8	9.2	15.0
Base money	40.1	37.4	8.8	13.8	26.5	33.6	0.3	6.4	11.8	15.3
	(Ratio)									
Velocity of broad money 4/	6.3	5.2	3.8	3.6	4.1	4.0	3.0	3.1	3.4	3.4
Money multiplier	1.9	2.0	1.9	2.0	2.0	2.1	2.2	2.1	2.2	2.2

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

1/ Historical data for NIR are at actual exchange rates; program projections are based on end-2002 cross exchange rates.

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

3/ Deflated by the CPI.

4/ Period average.

Table 8: Quasi-fiscal Operations in the Energy Sector, 2000–2002

	2000	2001	2002 Prelim.
	(In percent of GDP)		
Quasi-Fiscal Deficit in the Energy Sector	5.2	3.9	3.4
Gas	1.8	1.3	1.5
Electricity	2.4	1.5	0.8
Heat	-0.2	0.1	0.1
Coal	1.2	0.9	0.9
Consolidated Deficit of the Public Sector 1/	5.0	4.1	0.9
= Consolidated Budget Deficit (Cash basis)	1.3	1.6	-0.5
+ Quasi-Fiscal Deficit in the Energy Sector	5.2	3.9	3.4
- Change in Tax Arrears	0.3	0.5	1.1
- Subsidies	1.2	0.9	0.9
Consolidated Debt of the Public Sector 1/	...	...	43.9
Government and NBU	45.9	37.3	34.7
o.w. external	33.1	26.6	24.6
Energy Sector Debt (excluding tax arrears)	...	...	9.2
Gas	...	...	4.5
o.w. external	...	...	4.5
Electricity	...	...	4.7
Memorandum Items:			
Average Gas Tariff, US$ per thousand cubic meters	40.4	43.9	44.1
Average Electricity Tariff, US cents per kWh	2.7	3.0	3.1
Cash Collection Ratio, gas sector, percent 2/ 3/	49.2	87.1	88.3
Cash Collection Ratio, electricity sector, percent 2/	52.1	75.5	87.2
Budgetary Subsidies to Coal Industry, percent of GDP	1.2	0.9	0.9
Stock of Tax Arrears in the Energy Sector	...	...	3.0

Sources: Ukrainian authorities; and Fund staff estimates.

1/ Excludes non-energy state-owned enterprises.
2/ Cash payments by final consumers as a share of total billing.
3/ Data provided by Naftogaz.

Table 9. Ukraine: Social and Demographic Indicators

	Ukraine	Europe & Central Asia	Lower-Middle-Income
2000			
Population, mid-year (millions)	50	474	2,048
GNP per capita (Atlas method, US$)	700	2,010	2,324
Average annual growth, 1980-2000			
Population (%)	-0.1	0.5	1.3
Labor Force (%)	-0.3	0.5	1.7
Most recent estimate (latest year available, 1993-2000)			
Poverty (% of population below national poverty line)	26	...	...
Urban population (% of total population)	68	65	42
Life expectancy at birth (years)	67	69	68
Infant mortality (per 1,000 live births)	13	20	33
Child malnutrition (% of children under 5)	...	...	11
Illiteracy (% of population age 15+)	1	2	12
Gross primary enrollment (% of school-age population)	100	100	106
Male	100	101	105
Female	100	99	99

Source: World Bank.

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

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

II. **General Resources Account:**	**SDR Million**	**Quota**
Quota	1,372.00	100.0
Fund holdings of currency	2736.16	199.43
Reserve position in Fund	0.00	0.0

III. **SDR Department:**	**SDR Million**	**% Allocation**
Holdings	11.90	N/A

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**%Quota**
Extended arrangements	1,177.17	85.80
Systemic transformation	186.99	13.63

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
EFF	09/04/98	09/03/02	1,919.95	1,193.0
Stand-by	08/25/97	08/24/98	398.92	181.33
Stand-by	05/10/96	02/23/97	598.20	598.20

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

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	144.52	201.80	202.83	278.97	278.98
Charges/interest	23.18	27.16	22.46	17.33	10.86
Total	151.86	228.96	225.28	296.31	289.83

VII. **Safeguards Assessments:**

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

The External Audit assessment was completed on February 3, 2001. The assessment concluded that the NBU's external audit mechanism meets internationally accepted standards, as reported in EBS/01/152 (09/04/01). Under a successor arrangement, the NBU would be subject to a full safeguards assessment. The necessary documentation was requested from the authorities on December 30, 2002.

VIII. Exchange Arrangements:

In September 1996, the authorities introduced the hryvnia (Hrv) at a conversion rate of karbovancts (Krb) 100,000 to Hrv 1. The rate was initially informally pegged to the dollar. In September 1997, the peg was replaced by a formal band of Hrv 1.7–Hrv 1.9 per U.S. dollar. The limits of the band were moved on several occasions, most recently on February 9, 1999, to Hrv 3.4–4.6 per U.S. dollar. Since March 19, 1999, the exchange rate for the hryvnia has been allowed to be determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention of allowing the free float of the hryvnia. On December 31, 2002 the hryvnia stood at Hrv 5.33 per U.S. dollar. The authorities intervene regularly to limit fluctuations in the exchange rate.

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

IX. Article IV Consultation:

Ukraine is on the standard 12-month consultation cycle. The staff report (SM/02/109, 04/01/02), Staff Supplement (SM/02/109, 04/23/02), and the Selected Issues and Statistical Appendix (SM/02/100, 04/10/02) were considered by the Executive Board on April 24, 2002.

X. FSAP Participation and ROSCs

A joint World Bank-International Monetary Fund mission conducted an assessment of Ukraine financial sector as part of the Financial Sector Assessment Program (FSAP) between May 10–24, 2002. The Financial Sector Stability Assessment (FSSA) report is under preparation for Board discussion. The observance of the following standards and codes were also assessed: Basel Core Principles for Effective Banking Supervision; Code of Good Practices on Transparency in Monetary and Financial Policies; CPSS Core Principles for Systemically Important Payment Systems; OECD Principles for Corporate Governance; Accounting and Auditing Practises; World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights System; and AML/CFT Methodology. Data ROSC Module was conducted in April 3–17, 2002. Fiscal Transparency (experimental module) was issued in September 3, 1999 (document number EBS/99/158).

XI. Fund Technical Assistance Missions, October 1998–2002
(As of December 31, 2002)

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

XII. Fund Resident Representatives and Advisors, 1998–2002

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

UKRAINE: RELATIONS WITH THE WORLD BANK
(As of March 2003)

Country Assistance Strategy

The main objective of the World Bank Country Assistance Strategy (CAS) for Ukraine, approved on September 12, 2000, and covering fiscal years 2001–03, is to assist the government and civil society in obtaining sustained growth and poverty reduction in Ukraine. The CAS focuses on filling the gap between formal institutions and informal behaviors. To do so, the strategy addresses the institution-building challenges both from the demand side (civil society) and supply side (government). It proposes a $1.816 billion Base Case lending program to support structural reforms and a $456 million Low Case lending program. The envisaged investment program includes support in environment, private sector development, health, education, agriculture title distribution and rural finance, tax administration, statistics and social investment. The Ukraine program is currently in the Base Case lending scenario.

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

The CAS presents a two-legged strategy:

- the first (under the *Low Case*) aims to support civil society in its demand for better governance, and addresses globally sensitive areas; and
- the second (which would be added under the *Base Case*) aims to support opportunities to strengthen institutions that foster sustainable development, when these opportunities present themselves. Preparation of a new, results-oriented CAS for FY04–07 has already commenced.

World Bank program

As of March 14, 2003, the World Bank commitments to Ukraine totaled $3.283 billion and net disbursements amounted to $2.309 billion.

The current project portfolio consists of 10 operations. A series of Programmatic Adjustment Loans (PALs) make up the Bank's fast disbursing policy-support program. PAL is conceived as a sequence of three separate operations, totaling up to $750 million, with disbursements depending entirely on performance. The PAL covers five cross-sectoral issues: (i) financial accountability; (ii) regulatory framework; (iii) property rights; (iv) public sector accountability; and (v) social sustainability. PAL I ($250 million) was approved by the World Bank Board of Executive Directors on September 20, 2001 and fully disbursed in two tranches of $150 million and $100 million, respectively. PAL II ($250 million) is currently in advance stages of preparation. The Treasury System Project ($16.4 million) currently under implementation assists the government in creating an efficient budget management system. The State Tax Administration Modernization Project ($100 million), for which the Bank approved a $2 million PPF, is currently under preparation and expected to be presented to the Board this fiscal year.

The **agriculture sector** program includes three projects under preparation: a Rural Land Titling and Cadastre Development Project ($193.2 million), which will support the distribution of land titles to new land owners, a Rural Finance Project ($200 million), and a Title Registration Project (TBD).

Good progress has been made in **energy efficiency and district heating**. Two District Heating Projects (a $200 million Kyiv District Heating Improvement Project and an $18.29 million Kyiv Public Building Energy Efficiency Project) are under implementation. A Sevastopol Heat Improvement Project ($28.19 million) was signed in September 2002, but is not yet effective. In the **coal sector**, the Bank is finalizing a Coal Sector Study to determine the fiscal impact of the sector on the economy.

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

Privatization and financial sector reform have been receiving strong attention in the Bank's program. To promote a stronger private sector, an APL for Private Sector Development ($30 million) was signed in October 2002, but is not yet effective. In addition, the World Bank has been helping the Ukrainian government with a restructuring plan for the Savings Bank. An Export Development Project ($70 million) is being implemented to promote Ukrainian economy's export capacity and to strengthen institutional capacity of state-owned Ukreximbank. In order to attract private investment, the Commercial Sea Launch guarantee operation ($100 million) was approved by the Bank in 1997. Also, the government requested a technical assistance operation ($5 million) for E-development, which was negotiated in March 2003.

In the **social sector**, the Bank is implementing a Social Investment Fund ($50.21 million) which provides support to poor communities. In addition, a TB/AIDS Control Project ($60 million), aimed at fighting the epidemics and improving prevention systems, was approved in December 2002. A Social Protection Reform Administration Project is planned, and an Equal Access to Quality Education Project is in the stage of identification.

Environmental work is proceeding well. A GEF project that is addressing the problem of Ozone-Depleting Substances is nearing completion and a new GEF grant on preserving the Azov-Black Sea wetlands ($6.9 million) has been approved.

The Bank is also providing significant **non-lending support**. In FY02, two reports, the Country Procurement Assessment Report (CPAR) and the Country Financial Accountability Assessment (CFAA), were discussed with the government and action plans for their implementation have been agreed. Implementation of these action plans is included in the PAL program and support for them has been extended by a government-executed grant from the Dutch government. The Bank has also finished a study on Regional Development and Regional Policy, a Public Expenditure/Institutional Review, a Health Policy Note and Education Policy Note. An Environmental Public Expenditure Review is being finalized. A poverty assessment is underway which will update the poverty profile and examine the poverty dynamics since the last review was conducted in 1999. Economic studies, a new CEM, a Trade Study and an Energy Study, are also being initiated.

The World Bank is currently holding public consultations around the regions of Ukraine in preparation of a new CAS covering Bank fiscal years of 2004–07. The new CAS is scheduled for Board presentation early in FY 2004.

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

UKRAINE: RELATIONS WITH THE EBRD
(As of January 2003)

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

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

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

4. Thus since the summer of 2000 the EBRD's strategy has been to focus on strengthening the financial sector and supporting the needs of SMEs; promoting the

commercialization and structural reform of public utilities, services and improving energy efficiency; supporting the transition of the enterprise sector, especially in agribusiness, consumer products, and intermediate goods. In addition, the EBRD has sought to improve nuclear safety through the Nuclear Safety Account and the Chernobyl Shelter Fund initiatives, and ensure a clear understanding of the outstanding conditions to be fulfilled in respect of the K2R4 project financing to cover the completion of two nuclear power plants.

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

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

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

7. With respect to the K2R4 project, this project was approved by the EBRD Board on December 7, 2000 subject to fulfillment of four conditions, namely the permanent closure of the Chernobyl nuclear power plant; a number of important safety assurances; resumption by the IMF of the Extended Fund Facility to Ukraine; and commitments by the other institutions expected to provide funds for the project. A meeting of the Board on November 29, 2001 was due to confirm approval of the loan on the EBRD President's recommendation that the

conditions had been met. The loan could then have been signed by December 6, 2001. However, at the Board meeting, the Director for Ukraine stated that, in view of issues raised by the Prime Minister of Ukraine in a letter to the EBRD President the day before, the project was not yet ready for final approval by the Board. Since then, discussions between the EBRD and the Ukraine authorities on the project have continued.

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

9. The EBRD's portfolio in Ukraine has increased from 5 projects in 1994 to 56 by the end of December 2002. These amount to a historical net business volume of EUR 1,293.1 million. Of this amount EUR 895.3 million represented the Portfolio (operating assets plus undrawn commitments), of which 68 percent were assigned to the private sector (EUR 610.0 million) and 32 percent to the state sector (EUR 285.3 million). Operating assets amounted to EUR 494.0 million at the end of December 2002.

10. The outstanding commitments to Ukraine represent almost 6 percent of the total of the EBRD's commitments to all its countries of operation. There are in addition Technical Cooperation activities in Ukraine and these currently include 377 projects with a total value of commitments of almost EUR 53.8 million. These are mainly related to project preparation and implementation.

11. Projects in the financial sector account for slightly over 25 percent of the EBRD's commitment to Ukraine, with much of this represented by the loans provided under sovereign guarantee to support the development of small and medium size companies in Ukraine through lending via participating banks. The first of these loans (for EUR 143 million) was signed at the end of 1994, and is now fully disbursed. A second credit line (for EUR 52 million) was signed at the time of the EBRD's Annual Meeting in Kyiv in May 1998, but was only approved by the Rada in early 2000. The energy sector accounts for a further 21 percent of all commitments. The largest single project in this category is in the power sector; other projects include the development of oil and gas resources, gas transit and energy efficiency. Projects in manufacturing, including agribusiness, account for 32 percent, transport 12 percent, telecommunications 6 percent, municipal infrastructure 2 percent, with tourism, property and shipping accounting for most of the remaining 2 percent of all commitments.

Statistical Appendix

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

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

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

Real Sector

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

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

Government Finance Statistics

6. The Ministry of Finance (MoF) and the State Treasury (STU) have made considerable progress in the compilation of fiscal data. The MoF publishes monthly data on operations of the central and regional government in 25 days at present. The economic classification of transactions and the classification of outstanding debt are consistent with the GFSM 1986. The functional classification from 2002 is consistent with the GFSM 2001. For central

government, all transactions pass and are coded through Treasury Single Account (TSA). Local government revenues are already handled by the TSA; starting from 2004, the local government expenditures will be covered.

7. The ROSC report highlighted that the Government Finance Statistics (GFS) are available monthly but do not provide the equivalent coverage to that set out in the GFSM 1986. The data formats are more suited to the short-term needs of monitoring the execution of the budget in the current year. The report also encourages to re-disseminate annual data for general government for 1999–2001 based on the format for submission to the IMF GFS Yearbook, and to publish more extensive documentation of definitions, sources, and methods to enhance accessibility of the data for users. In addition, the non-budget social security funds in the disseminated data on central government operations have to be incorporated, and further work should be done towards improving timeliness of these data.

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

Money and banking statistics

9. Ukraine has received extensive technical assistance in money and banking statistics, and substantial improvements have already been made. The ROSC mission suggested to improve the timeliness of the analytical accounts of the central bank to meet SDDS requirements using the daily accounting records excluding internal organizations. While the authorities are using the flexibility option under the SDDS, the staff urged them to proceed at the required deadline.

10. The authorities are working on disseminating information on the compilation of monetary data, including on major aggregates and differences from internationally accepted standards; as well as on establishing a migration plan to adopt the recommendations included in the *MFSM 2000*.

11. Other recommendations highlighted in the ROSC report are: (i) expand the coverage of the monetary data, including on nonbank financial institutions issuing deposit substitutes;

(ii) enhance the consistency of monetary data; (iii) separately identify information on financial derivatives; and (iv) verify consistency of monetary statistics and government finance statistics on a regular basis.

Balance of Payments Statistics

12. Ukraine reports balance of payments statistics to STA on a quarterly basis with a lag of about ten weeks, and the statistics are compiled in broad conformity with the conceptual framework of the *BPM5*. The principal data sources are a closed ITRS, administrative data sources, and a survey of enterprises. Following the recommendations of the ROSC, the authorities have expanded the survey on inter-enterprise arrears to include information relevant for balance of payments purposes, and are going to implement lower reporting

thresholds for banks. Due to lack of financing, the authorities have not implemented travelers' surveys in order to improve the quality of shuttle trade, compensation of employees, and travel estimates. Some methodological weaknesses exist in private portfolio and FDI surveys. The authorities have made progress in disseminating international reserves data. The release of monthly data, in line with the Fund's reserve template, started in mid-2002. Though the cooperation between different government agencies has improved in recent years, the problems still exist in coordinating the work of the National Bank of Ukraine, the State Committee on Statistics, and Ministry of Finance. Particularly, reporting on short-term external debt suffers from the lack of coordination.

Ukraine: Core Statistical Indicators
(as of April 10, 2003)

	Exchange rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt	Debt Service
Date of latest observation	April 8, 2003	March 31, 2003	February 28, 2003	April 8, 2003	April 8, 2003	April 8, 2003	March 2003	January, 2003	2002	February, 2003	February, 2003	February, 2003	February, 2003
Date received	April 10, 2003	April 5, 2003	March 19 2003	April 10, 2003	April 10, 2003	April 10, 2003	April 7, 2003	March, 2003	March, 2003	March 25, 2003	March 25, 2003	March, 2003	March, 2003
Frequency of data	D	D	M	D	D	D	M	M	Q	M	M	M	M
Frequency of reporting	D	D	M	D	D	D	M	M	Q	M	M	M	M
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	V	C	C	C	C	C
Confidentiality	C	B	B	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	V	M	M	M	M	M	Q	Q	M	M	Q	Q

1/ Gross Official Reserves and Net International Reserves

Explanation of abbreviations:

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

UKRAINE: EXTERNAL AND FISCAL SUSTAINABILITY

1. This appendix presents an external and fiscal sustainability analysis for Ukraine, using the IMF template.[1] The purpose is to try to identify potential risks to debt sustainability by applying various economic shocks. The calculations are based on the baseline medium-term framework shown in Table 2 of the staff report. In addition, in order to stress-test Ukraine's debt position, a low-case scenario is developed. The sensitivity analysis reveals that under baseline assumptions (and by implication under more optimistic assumptions), debt ratios remain sustainable over the long run, even when subjected to large transitory shocks. By contrast, in the low-case scenario, the same shocks lead to high and unsustainable debt ratios. The appendix also discusses vulnerabilities to adverse domestic and/or external shocks (see also vulnerability indicators summarized in Table 5 of the staff report).

Background

2. Ukraine's debt-to-GDP ratio is moderate. Government and central bank debt is currently estimated to be about 35 percent of GDP, with external debt amounting to about 25 percent of GDP. However, this excludes contingent liabilities.[2] About three quarters of the external debt is to official creditors, with bonds held by commercial creditors making up the remainder. The data quality of private external debt and short-term debt are too weak to provide an estimate of total external debt by maturity. Domestic debt mainly comprises restructured bonds held by the NBU and other government liabilities to the central bank, incurred in earlier years. As the government is not allowed to borrow directly from the NBU, the main source of new domestic borrowing is the domestic securities market. This market remains underdeveloped, with the total stock of treasury bills held by commercial banks and non-banks amounting to only about 1 percent of GDP.

3. Improved macroeconomic management in recent years has led to a decline in public debt, reflecting declining fiscal deficits and net repayments to the Fund. In addition, treasury bills held by nonresidents, which led to liquidity problems in 1998, no longer pose a significant risk. Gross reserves increased fourfold in the three years to end-2002, reaching about 2¼ months of imports of goods and services. There has been a current account surplus since 1999. International credit ratings have improved[3] and spreads on Ukrainian Eurobonds have declined significantly, to below 500 basis points above U.S. treasury bonds in early March 2003.

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[1] See SM/02/166.

[2] The staff estimates that energy debts (including tax and supplier arrears) amounted to about 12 percent of GDP at the end of 2002. The official debt of Ukraine does also not include any potential claims related to the pre-1992 deposits at the Savings Bank of the former Soviet Union.

[3] Moody's upgraded Ukraine's sovereign credit rating to B2 in January 2002.

Macroeconomic scenarios and sensitivity analysis

4. The baseline medium-term scenario (Table 2 of the staff report) assumes an accelerated pace of reform and the continuation of small primary fiscal surpluses, with new external borrowing limited to external amortization payments. In this scenario, real GDP is projected to grow about 4 percent per year and the current account surplus is assumed to decline gradually. The public sector debt ratio (government and central bank only) is projected to decline from 35 percent of GDP to 22 percent of GDP by 2008.

5. Sensitivity analysis suggests that, even when exposed to large shocks, public and external debt ratios are sustainable in the baseline (Appendix Figure 1, Table 1, Table 2). All the sensitivity shocks performed in the baseline scenario result in public debt ratios which converge to below 40 percent of GDP by the 2008.[4] A one-time 30 percent real depreciation would raise the public debt-to-GDP ratio about 10 percentage points, to about 45 percent of GDP in 2003. A real interest rate increase of 25 percentage points would have an even larger impact, although a shock of this magnitude is not likely. Similarly, external debt ratios appear to be sustainable in the long run, partly reflecting prudent external borrowing and current account surpluses in the baseline. Given these results, it can be inferred that under more optimistic assumptions, such as higher GDP growth, debt sustainability would be even more robust.

6. In order to stress test Ukraine's debt position under more adverse assumptions, a low-case scenario is constructed for illustration (Table 4 of the staff report). This scenario assumes stalled structural reforms and a looser fiscal stance. The lack of structural reform would undermine investment and export growth, and real GDP growth would be only about 2 percent per year on average. Weak private sector confidence would imply higher interest rates, by an assumed 3 percentage points, and would lead to capital outflows of an assumed $1 billion per year relative to the baseline. As a result, the public debt-to-GDP ratio would rise and international reserves would fall.

7. In the low-case scenario, the sensitivity analysis shows that the same shocks result in high and unsustainable debt-to-GDP ratios (Appendix Figure 2, Table 3, Table 4). A temporary interest rate increase, growth decline, and depreciation would all lead to continuous growth in public debt ratios, reaching over 50 percent of GDP by 2008. In the case of external debt, the underlying assumptions for external borrowing are the same as in the baseline, resulting in declining external debt ratios—although levels are somewhat higher than in the baseline. As in the baseline, the most significant shock in the low-case scenario would be from a large exchange rate depreciation in 2003–04. In this case the external debt-to-GDP ratio would rise to around 60 percent and remain high for the rest of the projection period, well above the benchmark threshold of 40 percent for emerging markets.[5]

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[4] When key economic assumptions are set to their historical averages, the public debt ratio is even lower than in the baseline, due to negative real interest rates over the historical period.

[5] An external debt-to-GDP ratio of 40 percent is considered a useful benchmark (SM/02/166). The probability of a crisis or correction is around 2-5 percent if a country is below this threshold, but rises

(continued)

8. Even if debt ratios remain stable, liquidity-related financial problems could emerge in case of a loss in domestic confidence and/or loss of access to external financing, as was the case in 1998/99.[6] If residents lose confidence in macroeconomic stability, a combination of capital outflows and re-dollarization could put downward pressure on the exchange rate and on international reserves. In the very near term, such a scenario would probably not lead to insurmountable external liquidity problems, even if Ukraine's access to international capital markets was temporarily disrupted, given official reserves of about US$4.4 billion at end-2002 and public external debt service projected at about US$1.9 billion for 2003. Nevertheless, fiscal pressures could emerge from a combination of a depreciation of the currency, which would raise debt service in local currency terms. Moreover, it may be difficult to substitute planned external borrowing with domestic borrowing, possibly implying the need for significant expenditure cuts. Over the medium term, liquidity risks of this type could grow further, especially if the government was to loosen its fiscal stance and tap the Eurobond market more aggressively than assumed in the baseline (where new issuance roughly equals external amortization).

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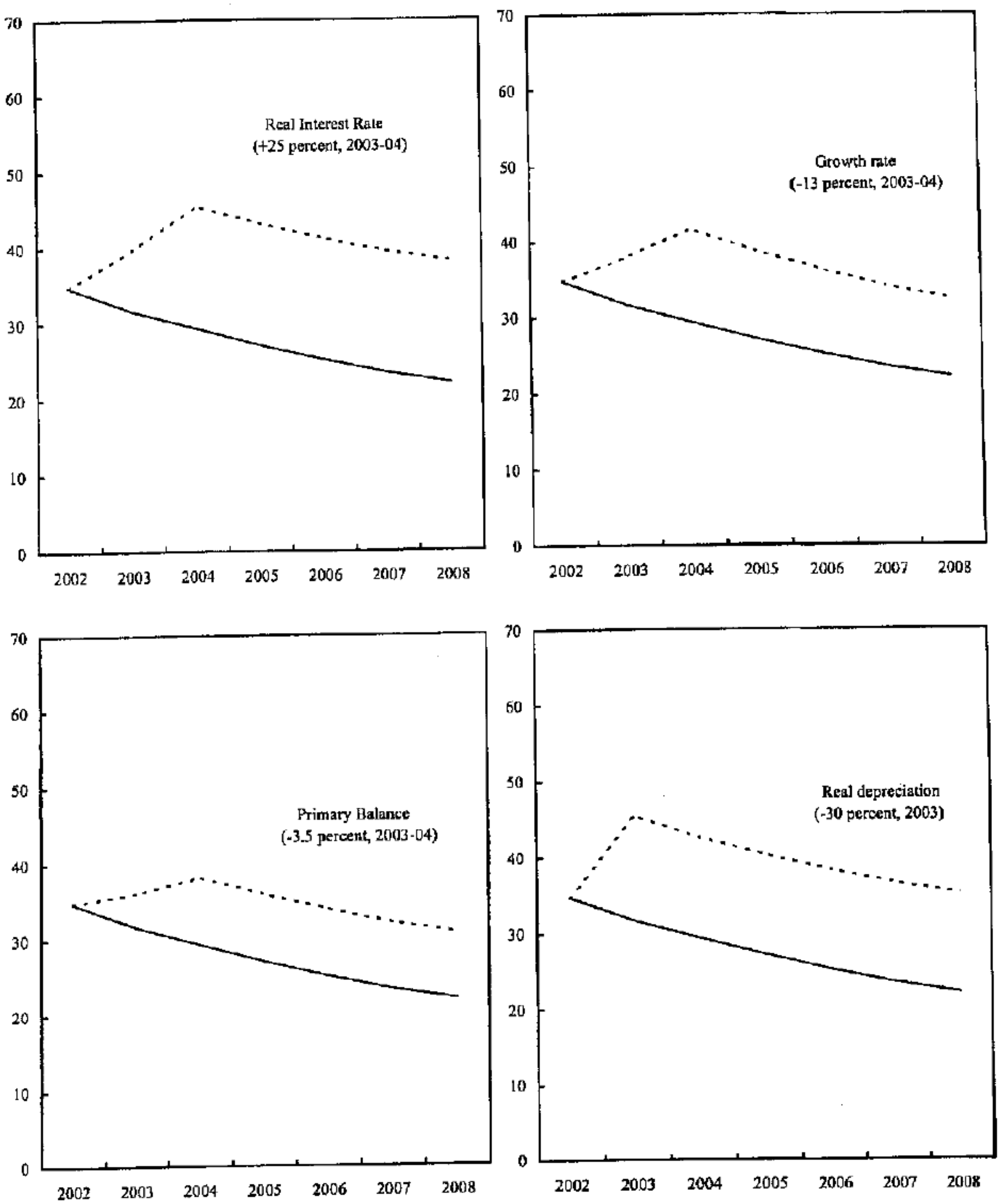
to about 15-20 percent if it is above the threshold. However, the benchmark threshold can be higher for countries with a high export-to-GDP ratio as in the case of Ukraine. For instance for countries with greater than 10 percent export-to-GDP ratio, the threshold ratio rises to 50 percent and up to 65 percent for countries with exports in excess of 40 percent of GDP.

[6] Despite a moderate debt ratio, Ukraine experienced a severe financial crisis in 1998/99, due to liquidity problems stemming from low reserves and a loss of investor confidence. In 1997, a large fiscal deficit was financed by short-term treasury bills, many of which were held by foreign banks. Liquidity problems emerged in late 1997, when foreign investors became reluctant to roll over the debt in the wake of the Asian crisis. The NBU began to sell large amounts of reserves to support the hryvnia. By the advent of the Russian crisis in August 1998, reserves had fallen to well below one month of imports and the NBU soon suspended its interventions. The exchange rate subsequently depreciated by some 60 percent.

Figure 1. Ukraine: Public Debt Sensitivity Analysis–Baseline Scenario, 2002–2008
(In percent of GDP)



Source: Fund Staff Estimates.

Table 1. Ukraine: Baseline Scenario, Public Sector Debt Sustainability Framework, 1998-2008

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections											
1 Public sector debt 1/	41.8	55.5	45.9	37.3	34.7	31.7	29.4	27.1	25.2	23.5	22.2
o/w foreign-currency denominated	24.6	35.2	32.7	30.3	28.0	25.4	23.2	21.1	19.2	17.3	15.8
2 Change in public sector debt	9.2	13.7	-9.6	-8.6	-2.6	-3.0	-2.3	-2.2	-1.9	-1.7	-1.3
3 Identified debt-creating flows (4+7+12)	15.4	5.3	-11.6	-8.1	-3.6	-2.1	-2.4	-1.6	-1.3	-1.2	-0.9
4 Primary deficit	0.4	-0.2	-1.7	-0.4	-1.9	-0.4	-0.5	-0.7	-0.5	-0.5	-0.4
5 Revenue and grants	35.6	31.9	33.4	33.5	36.5	37.1	35.4	35.2	35.0	34.8	34.6
6 Primary (noninterest) expenditure	36.0	31.7	31.7	33.1	34.6	36.7	34.9	34.5	34.5	34.3	34.2
7 Automatic debt dynamics 2/	15.5	6.1	-8.6	-6.5	-1.3	-1.1	-1.3	-0.1	-0.1	-0.1	0.0
8 Contribution from interest rate/growth differential 3/	-0.6	-6.3	-9.9	-5.7	-1.4	-1.9	-1.1	-0.4	-0.3	-0.2	-0.1
9 Of which contribution from real interest rate	-1.2	-6.4	-7.5	-2.2	0.2	-0.5	0.1	0.7	0.7	0.7	0.8
10 Of which contribution from real GDP growth	0.6	0.1	-2.5	-3.5	-1.6	-1.4	-1.2	-1.1	-1.0	-0.9	-0.9
11 Contribution from exchange rate depreciation 4/	16.0	12.4	1.4	-0.8	0.2	0.8	-0.2	0.3	0.2	0.1	0.1
12 Other identified debt-creating flows	-0.5	-0.6	-1.3	-1.3	-0.5	-0.6	-0.6	-0.8	-0.7	-0.6	-0.5
13 Privatization receipts (negative)	-0.5	-0.6	-1.3	-1.3	-0.5	-0.6	-0.6	-0.8	-0.7	-0.6	-0.5
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-6.2	8.4	2.0	-0.4	1.0	-1.0	0.1	-0.6	-0.6	-0.6	-0.4
Public sector debt-to-revenue ratio 1/	117.5	174.0	137.5	111.4	95.3	85.4	83.0	77.1	72.0	67.4	64.0
Gross financing need 5/	12.9	10.5	7.3	7.2	4.4	6.6	7.1	7.6	8.6	8.7	8.3
in billions of U.S. dollars	5.4	3.3	2.3	2.7	1.8	3.0	3.4	3.9	4.8	5.2	5.3
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	-1.9	-0.2	5.9	9.2	4.6	4.5	4.0	4.0	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 6/	8.0	7.9	7.0	5.2	3.9	4.3	5.4	6.6	7.1	7.4	7.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.1	-19.5	-16.1	-4.8	0.6	-1.4	0.4	2.6	3.1	3.4	3.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-44.6	-34.3	-4.0	2.6	-0.6	-3.1	0.9	-1.3	-0.7	-0.7	-0.7
Inflation rate (GDP deflator, in percent)	12.1	27.4	23.2	10.0	3.3	5.6	5.0	4.0	4.0	4.0	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-16.7	-12.3	5.9	14.1	9.2	10.8	-1.1	2.9	4.0	3.4	3.7
II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2008						28.5	23.4	18.5	14.4	11.0	8.4
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						39.8	45.5	43.2	41.2	39.4	38.1
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						38.0	41.6	38.7	36.3	34.8	32.4
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						36.2	38.2	35.9	34.0	32.2	30.9
5. Combination of 2-4 using one standard deviation shocks						39.6	44.7	34.3	24.3	14.6	5.3
6. One time 30 percent real depreciation in 2003 7/						45.5	42.6	40.3	38.3	36.5	35.2
7. 10 percent of GDP increase in other debt-creating flows in 2003						41.7	39.0	36.7	34.7	32.9	31.6

Historical Statistics for Key Variables (past 7 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	0.2	1.9	-0.5
Real GDP growth (in percent)	0.6	6.5	4.1
Nominal interest rate (in percent) 6/	6.4	1.5	6.4
Real interest rate (in percent)	-16.5	20.1	2.0
Inflation rate (GDP deflator, in percent)	22.9	20.8	4.4
Revenue to GDP ratio	35.2	2.4	35.4

1/ The public sector covers general government. Gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Ukraine: Baseline Scenario, External Debt Sustainability Framework, 1998–2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						I. Baseline Medium-Term Projections					
1 **External debt**	26.5	39.5	33.1	26.6	24.6	22.2	20.1	18.2	16.3	14.5	13.1
2 Change in external debt	7.3	13.0	-6.4	-6.5	-2.0	-2.5	-2.1	-1.9	-1.9	-1.7	-1.5
3 Identified external debt-creating flows (4+8+11)	4.6	1.5	-5.6	-9.3	-7.4	-5.8	-5.0	-5.5	-4.5	-3.6	-3.0
4 Current account deficit, excluding interest payments	0.7	-8.2	-6.8	-5.1	-8.8	-5.9	-4.1	-2.9	-2.0	-1.5	-1.0
5 Deficit in balance of goods and services	2.9	-5.8	-5.0	-1.6	-4.5	-2.0	-0.8	-0.1	0.5	0.6	0.8
6 Exports	42.1	54.0	62.4	55.5	56.4	53.2	51.8	50.8	50.1	49.7	49.3
7 Imports	45.0	48.2	57.4	53.9	51.9	51.2	51.0	50.8	50.5	50.3	50.0
8 Net non-debt creating capital inflows (negative)	-2.3	-1.9	-1.3	0.3	2.5	0.9	-0.7	-2.3	-2.2	-1.9	-1.8
9 Net foreign direct investment, equity	1.8	1.5	1.9	2.0	1.7	1.7	1.7	1.6	1.7	1.6	1.5
10 Net portfolio investment,equity	0.5	0.4	-0.6	-2.3	-4.1	-2.5	-1.0	0.6	0.6	0.3	0.3
11 Automatic debt dynamics 1/	6.2	11.6	2.5	-4.5	-1.0	-0.8	-0.3	-0.3	-0.2	-0.2	-0.1
12 Contribution from nominal interest rate	2.4	3.0	2.1	1.4	1.1	1.2	1.2	1.1	1.0	0.9	0.9
13 Contribution from real GDP growth	0.4	0.1	-2.3	-2.5	-1.1	-1.0	-0.8	-0.7	-0.7	-0.6	-0.5
14 Contribution from price and exchange rate changes 2/	3.3	8.6	2.7	-3.4	-1.1	-1.0	-0.7	-0.6	-0.6	-0.5	-0.5
14 Residual, incl. change in gross foreign assets (2-3)	2.7	11.6	-0.8	2.8	5.4	3.4	3.0	3.6	2.6	1.9	1.5
External debt-to-exports ratio (in percent)	63.0	73.2	53.0	48.0	43.7	41.6	38.8	35.8	32.5	29.2	26.5
Gross external financing need (in billions of US dollars) 3/	3.0	0.6	0.2	0.4	-1.7	0.0	0.9	1.7	2.5	2.7	2.7
in percent of GDP	7.1	1.8	0.7	0.9	-4.0	0.1	1.9	3.2	4.4	4.6	4.2
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	-1.9	-0.2	5.9	9.2	4.6	4.5	4.0	4.0	4.0	4.0	4.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-24.0	-40.7	-24.1	1.3	0.9	-1.4	-1.8	-0.7	-0.7	-0.7	-0.7
GDP deflator in US dollars (change in percent)	-14.8	-24.4	-6.5	11.4	4.2	4.2	3.1	3.2	3.2	3.2	3.2
Nominal external interest rate (in percent)	10.6	8.5	5.2	5.1	4.7	5.5	5.9	5.9	6.0	6.2	6.4
Growth of exports (US dollar terms, in percent)	-13.4	-3.2	14.4	8.0	10.7	2.8	4.3	5.4	5.7	6.5	6.5
Growth of imports (US dollar terms, in percent)	-14.0	-19.1	17.8	14.1	5.0	7.4	6.8	6.8	6.8	6.8	6.8
						II. Stress Tests for External Debt Ratio					
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-08						24.4	23.7	23.6	22.5	20.6	18.4
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						23.4	22.5	20.5	18.6	16.8	15.3
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						26.7	29.5	27.5	25.4	23.6	22.0
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						37.6	58.8	56.4	54.0	51.8	50.1
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						33.8	41.4	39.2	37.0	35.0	33.4
6. Combination of 2-5 using one standard deviation shocks						39.6	58.5	56.1	53.7	51.6	49.8
7. One time 30 percent nominal depreciation in 2003						31.9	29.7	27.7	25.7	23.8	22.3

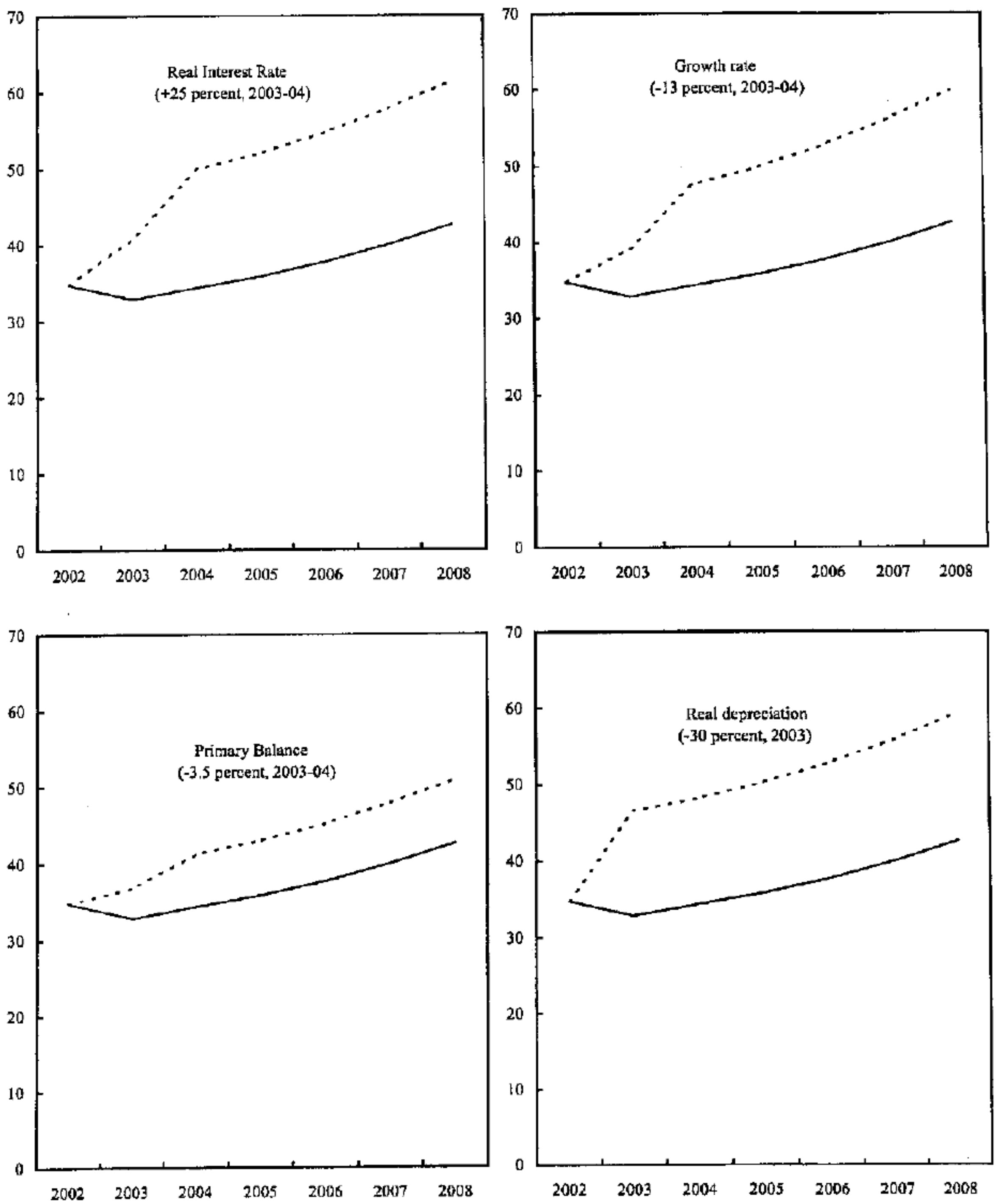
Historical Statistics for Key Variables (past 7 years)	Average 1996-2002	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	-3.6	4.7	-2.9
Net non-debt creating capital inflows	0.8	1.7	1.3
Nominal external interest rate (in percent)	6.8	2.1	6.0
Real GDP growth (in percent)	0.6	6.5	4.1
GDP deflator in US dollars (change in percent)	2.8	19.8	3.4

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

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

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

Figure 2. Ukraine: Public Debt Sensitivity Analysis, Lowcase Scenario, 2002–2008
(In percent of GDP)



Source: Fund Staff Estimates.

Table 3. Ukraine: Low-Case Scenario, Public Sector Debt Sustainability Framework, 1998–2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Lowcase Medium-Term Projections											
1 Public sector debt 1/	41.8	55.5	45.9	37.3	34.7	32.9	34.4	35.8	37.7	40.0	42.6
o/w foreign-currency denominated	24.6	35.2	32.7	30.3	28.0	26.3	26.4	24.5	22.9	21.1	19.4
2 Change in public sector debt	9.2	13.7	-9.6	-8.6	-2.6	-1.9	1.5	1.5	1.9	2.3	2.6
3 Identified debt-creating flows (4+7+12)	15.4	5.3	-11.6	-8.1	-3.6	-0.9	1.4	2.1	2.6	2.9	3.1
4 Primary deficit	0.4	-0.2	-1.7	-0.4	-1.9	0.1	1.2	1.0	1.2	1.2	1.0
5 Revenue and grants	35.6	31.9	33.4	33.5	36.5	37.1	34.7	34.5	34.3	34.1	33.9
6 Primary (noninterest) expenditure	36.0	31.7	31.7	33.1	34.6	37.2	35.9	35.5	35.5	35.3	34.9
7 Automatic debt dynamics 2/	15.5	6.1	-8.6	-6.5	-1.3	-0.8	0.4	1.5	1.7	1.9	2.2
8 Contribution from interest rate/growth differential 3/	-0.6	-6.3	-9.9	-5.7	-1.4	-1.7	0.6	1.2	1.5	1.8	2.0
9 Of which contribution from real interest rate	-1.2	-6.4	-7.5	-2.2	0.2	-0.4	1.2	1.8	2.2	2.5	2.8
10 Of which contribution from real GDP growth	0.6	0.1	-2.5	-3.5	-1.6	-1.3	-0.6	-0.6	-0.7	-0.7	-0.8
11 Contribution from exchange rate depreciation 4/	16.0	12.4	1.4	-0.8	0.2	0.9	-0.2	0.3	0.2	0.1	0.1
12 Other identified debt-creating flows	-0.5	-0.6	-1.3	-1.3	-0.5	-0.2	-0.2	-0.4	-0.3	-0.2	-0.1
13 Privatization receipts (negative)	-0.5	-0.6	-1.3	-1.3	-0.5	-0.2	-0.2	-0.4	-0.3	-0.2	-0.1
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-6.2	8.4	2.0	-0.4	1.0	-1.0	0.1	-0.6	-0.7	-0.6	-0.5
Public sector debt-to-revenue ratio 1/	117.5	174.0	137.5	111.4	95.3	88.6	99.0	103.8	110.0	117.3	125.7
Gross financing need 5/	12.9	10.5	7.3	7.2	4.4	7.2	10.4	12.2	14.8	19.3	21.7
in billions of U.S. dollars	5.4	3.3	2.3	2.7	1.8	3.2	4.9	6.1	7.7	10.6	12.5
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	-1.9	-0.2	5.9	9.2	4.6	4.0	2.0	2.0	2.0	2.0	2.0
Average nominal interest rate on public debt (in percent) 6/	8.0	7.9	7.0	5.2	3.9	4.3	9.1	9.7	10.6	11.0	11.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.1	-19.5	-16.1	-4.8	0.6	-1.0	4.1	5.7	6.6	7.0	7.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	-44.6	-34.3	-4.0	2.6	-0.6	-3.1	0.9	-1.3	-0.7	-0.7	-0.7
Inflation rate (GDP deflator, in percent)	12.1	27.4	23.2	10.0	3.3	5.2	5.0	4.0	4.0	4.0	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-16.7	-12.3	5.9	14.1	9.2	11.8	-1.6	0.9	2.0	1.4	0.8
II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2008						28.9	24.2	19.6	15.7	12.5	10.1
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						40.9	49.9	52.0	54.7	57.8	61.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						39.2	47.5	49.8	52.7	56.1	60.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						36.8	41.2	43.8	45.2	47.9	50.9
5. Combination of 2-4 using one standard deviation shocks						40.1	45.7	40.8	36.2	31.7	27.2
6. One time 30 percent real depreciation in 2003 7/						46.5	48.2	50.3	52.8	55.9	59.3
7. 10 percent of GDP increase in other debt-creating flows in 2003						42.9	44.5	46.4	48.8	51.6	54.9

Historical Statistics for Key Variables (past 7 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	0.2	1.9	0.9
Real GDP growth (in percent)	0.6	6.5	2.3
Nominal interest rate (in percent) 6/	6.4	1.5	9.4
Real interest rate (in percent)	-16.5	20.1	5.0
Inflation rate (GDP deflator, in percent)	22.9	20.8	4.4
Revenue to GDP ratio	35.2	2.4	34.8

1/ The pubic sector covers general government. Gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 4. Ukraine: Low-Case Scenario, External Debt Sustainability Framework, 1998–2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Lowcase Medium-Term Projections											
1 **External debt**	26.5	39.5	33.1	26.6	24.6	22.3	20.7	19.1	17.4	15.8	14.5
2 Change in external debt	7.3	13.0	-6.4	-6.5	-2.0	-2.3	-1.7	-1.6	-1.7	-1.6	-1.3
3 Identified external debt-creating flows (4+8+11)	4.6	1.5	-5.6	-9.3	-7.4	-5.7	-5.0	-5.8	-4.9	-3.9	-3.1
4 Current account deficit, excluding interest payments	0.7	-8.2	-6.8	-5.1	-8.8	-6.0	-4.5	-3.5	-2.6	-1.9	-1.2
5 Deficit in balance of goods and services	2.9	-5.8	-5.0	-1.6	-4.5	-2.0	0.5	0.9	1.2	1.4	1.5
6 Exports	42.1	54.0	62.4	55.5	56.4	53.7	52.4	51.7	51.2	50.8	50.4
7 Imports	45.0	48.2	57.4	53.9	51.9	51.6	52.9	52.6	52.4	52.2	51.9
8 Net non-debt creating capital inflows (negative)	-2.3	-1.9	-1.3	0.3	2.5	0.9	-0.7	-2.4	-2.4	-2.1	-2.0
9 Net foreign direct investment, equity	1.8	1.5	1.9	2.0	1.7	1.7	1.7	1.7	1.8	1.8	1.7
10 Net portfolio investment,equity	0.5	0.4	-0.6	-2.3	-4.1	-2.5	-1.0	0.7	0.6	0.3	0.3
11 Automatic debt dynamics 1/	6.2	11.6	2.5	-4.5	-1.0	-0.6	0.2	0.1	0.1	0.1	0.2
12 Contribution from nominal interest rate	2.4	3.0	2.1	1.4	1.1	1.3	1.3	1.2	1.1	1.0	1.0
13 Contribution from real GDP growth	0.4	0.1	-2.3	-2.5	-1.1	-0.9	-0.4	-0.4	-0.4	-0.3	-0.3
14 Contribution from price and exchange rate changes 2/	3.3	8.6	2.7	-3.4	-1.1	-0.9	-0.7	-0.6	-0.6	-0.5	-0.5
14 Residual, incl. change in gross foreign assets (2-3)	2.7	11.6	-0.8	2.8	5.4	3.4	3.3	4.2	3.2	2.3	1.8
External debt-to-exports ratio (in percent)	63.0	73.2	53.0	48.0	43.7	41.6	39.4	36.9	34.0	31.2	28.8
Gross external financing need (in billions of US dollars) 3/	3.0	0.6	-0.2	-0.2	-1.7	0.0	0.8	1.5	2.2	2.6	2.6
in percent of GDP	7.1	1.8	-0.6	-0.6	-4.0	0.1	1.7	2.9	4.3	4.7	4.6
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	-1.9	-0.2	5.9	9.2	4.6	4.0	2.0	2.0	2.0	2.0	2.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-24.0	-40.7	-24.1	1.3	0.9	-1.4	-1.8	-0.7	-0.7	-0.7	-0.7
GDP deflator in US dollars (change in percent)	-14.8	-24.4	-6.5	11.4	4.2	3.8	3.1	3.2	3.2	3.2	3.2
Nominal external interest rate (in percent)	10.6	8.5	5.2	5.1	4.7	5.5	5.9	5.9	6.0	6.2	6.4
Growth of exports (US dollar terms, in percent)	-13.4	-3.2	14.4	8.0	10.7	2.8	2.7	3.9	4.1	4.5	4.5
Growth of imports (US dollar terms, in percent)	-14.0	-19.1	17.8	14.1	5.0	7.4	7.7	4.8	4.8	4.8	4.8
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-08						24.4	24.1	24.6	24.1	22.8	20.8
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						23.6	23.1	21.5	19.9	18.3	17.1
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						26.8	29.6	28.0	26.4	24.9	23.7
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						37.8	60.2	58.9	57.5	56.3	55.4
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						34.0	42.6	41.2	39.6	38.2	37.2
6. Combination of 2-5 using one standard deviation shocks						39.6	58.9	57.6	56.1	54.9	54.0
7. One time 30 percent nominal depreciation in 2003						32.2	30.6	29.0	27.4	25.9	24.8

Historical Statistics for Key Variables (past 7 years)	Average 1996-2002	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	-3.6	4.7	-3.3
Net non-debt creating capital inflows	0.8	1.7	1.5
Nominal external interest rate (in percent)	6.8	2.1	6.0
Real GDP growth (in percent)	0.6	6.5	2.3
GDP deflator in US dollars (change in percent)	2.8	19.8	3.3

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

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

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

INTERNATIONAL MONETARY FUND
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IMF Concludes 2003 Article IV Consultation with Ukraine

On May 14, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.[1]

Background

Real GDP grew by over 4½ percent in 2002, marking the third year of Ukraine's economic expansion following the 1998/99 financial crisis. As in 2001, growth was supported by robust consumer spending, reflecting large wage increases, but also by an increase in net external demand. Consumer price inflation fell to near zero in 2002, reflecting primarily the good harvests in 2001/02 and the resulting sharp drop in food prices. Low inflation was also supported by a tightening of fiscal policy and delays in increasing administered prices, as well as by continued exchange rate stability and rapid remonetization. Inflation has, however, picked up in late 2002 and early 2003.

The current account surplus increased significantly in 2002. The trade balance was boosted by a sharp increase in exports of grain and oil products. Recently imposed anti-dumping measures by some trading partners led to a reorientation of metals exports to markets in Asia. Current transfers were boosted by workers remittances and World War II compensation payments, while private sector portfolio outflows increased. In late 2002, the government augmented its 2007 Eurobond series by about US$350 million on a net basis, but due to large amortization payments, public external debt continued to decline. Gross international reserves increased to 2¼ months of imports of goods and services by end-2002.

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

National Bank of Ukraine (NBU) interventions kept the hryvnia constant against the U.S. dollar. Following the sharp exchange rate adjustment in the wake of the 1998/99 financial crisis, the real effective exchange rate has remained broadly stable. The strong improvement in Ukraine's trade and services balance suggests that competitiveness remains adequate, as reflected in Ukraine's comparatively low wage level.

Monetary aggregates continued to grow rapidly in 2002, fuelled by large unsterilized net foreign exchange purchases by the NBU. In response to falling inflation in 2002, the NBU reduced the refinancing rate and lowered reserve requirements. Strong growth in money demand, evidenced by the large balance of payments surplus, reflected growing public confidence and the continued remonetization of the economy. The monetary expansion contributed to the continuation of very rapid loan growth in the banking sector. Recent Financial Sector Assessment Program (FSAP) missions found that this has weakened banking sector capitalization and contributed to increased credit risk. Interest rates decreased, but lending rates and spreads still remained high. The share of nonperforming loans remains also relatively high. There was no significant change in dollarization in 2002.

The consolidated budget turned from a cash deficit of 1½ percent of GDP in 2001 to a surplus of ½ percent of GDP in 2002. Revenues increased sharply, partly due to high wage growth and improvements in tax administration. However, the stock of Value Added Tax (VAT) refund arrears increased further, reaching 1¼ percent of GDP at end-2002. A significant shortfall in privatization receipts and large wage and pension increases led to significant cuts in non-wage central government spending. Tax arrears increased, mainly reflecting noncompliance in the energy sector and the inability to collect installments for tax arrears restructured under the 2001 tax amnesty. The single treasury account was fully implemented and some tax privileges were eliminated. Unfunded social mandates were reinstated at the beginning of 2002, although eligibility criteria were recently tightened, targeting improved, and administration strengthened.

Progress on other structural reforms was mixed in 2002. Ongoing land reforms continued to support growth in the agricultural sector. However, the broader privatization process slowed down, partly reflecting the lack of any large sales to strategic investors. The restructuring of energy debts and the privatization of the remaining state-owned electricity distributors were delayed. Cash collections reportedly increased to about 85–90 percent for gas and electricity, but the energy sector accumulated significant tax arrears in 2002. The staff estimates that the quasi-fiscal deficit in the energy sector was about 2½ percent of GDP, as reflected in the increase in arrears to suppliers and the tax authorities. In addition, the coal sector receives budgetary subsidies of about 1 percent of GDP annually. The stock of debts and arrears of state-owned energy companies amounted to an estimated 12 percent of GDP.

Executive Board Assessment

Executive Directors noted Ukraine's strong macroeconomic performance in 2002, marked by robust GDP growth, low inflation, improved external position, and a rapid decline in public debt. Directors commended the authorities for their prudent demand management policies, including tight fiscal policy, but regretted that the authorities did not seize the opportunity to accelerate structural reforms. Going forward, they urged the authorities to maintain sound macroeconomic policies and to revive and accelerate structural reforms.

Directors considered that Ukraine's near-term outlook remains favorable, with economic growth in 2003 expected to remain solid and the balance of payments position strong. Nevertheless, the economy remains vulnerable to a number of risks. Directors noted the incipient inflationary risks, reflecting the recent high monetary growth, the large increases in the minimum wage and the wage bill, and the likely reversal of several temporary factors that kept inflation low in 2002. In addition, a delayed global recovery or macroeconomic policy slippages could undermine economic performance and weaken the banking sector. Directors noted that the remonetization of the economy has contributed to recent performance, and prudent debt policies have strengthened Ukraine's financial position. However, domestic confidence must be sustained to support the current stance of monetary and exchange rate policy. Overall, Directors considered that strong policies will therefore remain essential to protect the economy from any potential shocks and guarantee medium-term sustainability.

Directors stressed that an acceleration of structural reform will be necessary to improve the investment climate, create an enabling environment for the private sector, and increase productivity to achieve sustained economic growth and reduce poverty over the long term. They noted recent progress in land reform and small and medium-scale enterprise development and privatization. Among the priority areas requiring clear definition and further action are reforms of the tax system and the social safety net, a strengthening of the financial sector, reform of the energy sector, and improvements in transparency and governance—not only in the public sector but also in the private sector where there is a particular need for sound corporate governance.

Directors considered that the proposed fiscal stance for 2003 is appropriate. They nevertheless expressed concern about several fiscal issues that should be resolved as soon as possible. These include the continued accumulation of VAT refund arrears, which is jeopardizing tax compliance, exports, and the overall perception of the rule of law if it is not reversed. They were also concerned about the large increase in government spending, which could rise further in 2004 on the basis of the new minimum wage law. They considered that tax reform remains a high priority, but were concerned by the implications for the fiscal stance of rate-reducing reforms, which could constrain the scope for reforming the social sector. Directors suggested that further increases in public sector wages should be limited as much as possible, carefully phased, and linked to employment rationalization, with the aim of maintaining a low fiscal deficit in 2004.

Directors urged that, as part of the planned tax reforms, rate reductions should be linked with a broadening of the tax base and elimination of tax exemptions. They welcomed recent changes to the profit tax as a step in the right direction. Directors urged the authorities to work with parliament on further reforms, including the elimination of tax preferences under the VAT. In addition, they stressed the importance of providing a stable tax environment, which will need to involve greater accountability of the tax authorities and the rapid elimination of the stock of VAT refund arrears.

Directors endorsed the primary focus of monetary policy on keeping inflation low, and commended the authorities for reducing inflation in 2002. Going forward, they urged the authorities to monitor price trends closely, and to be ready to tighten monetary policy if needed to keep inflation low. They supported greater central bank independence. Directors agreed with the view that the hryvnia remains competitive. They urged the authorities to move towards greater exchange rate flexibility to absorb shifts in either direction in money demand and the balance of payments. They supported the authorities' intention to move toward a more explicit inflation targeting regime over the longer term, with the further development of financial markets and a more predictable monetary transmission mechanism.

Directors urged the authorities to implement the main recommendations of the recent FSAP missions to strengthen the banking system. High real interest rates and the still large share of nonperforming loans are indications that credit risk remains pervasive and calls into question the sustainability of the recent rapid growth in bank credit. Directors endorsed the importance of proceeding with the strengthening of the financial position of a major bank without further delay. Directors expressed concern about the NBU's new long-term lending facility, which may distort the credit market, limit the flexibility of monetary policy, and raise governance issues. They urged the NBU to focus its efforts on more fundamental banking issues, including improving banking supervision, raising capital ratios, and moving to close banks that do not meet prudential requirements. Directors welcomed recent steps to bring Ukraine's anti-money laundering legislation in line with Financial Action Task Force recommendations, and urged the authorities to move swiftly to its full implementation.

Directors stressed the importance of enhancing transparency, strengthening governance, and creating a level playing field for all economic agents. They welcomed the authorities' intention to accelerate the privatization process and urged that it be transparent and competitive.

Directors cautioned that large quasi-fiscal deficits and debts in the energy sector, manifested in the continued accumulation of tax and supplier arrears, constitute significant risks to fiscal policy and call for ensuring hard budget constraints. Addressing these problems will require greater transparency and accountability, especially with respect to the state-owned gas monopoly, *Naftogaz*.

Directors supported the authorities' goal of joining the World Trade Organization next year. They considered that the resulting progressive trade liberalization should help to strengthen Ukraine's economy and underpin its further integration into the world economy.

Directors welcomed the recent improvements in economic statistics, and Ukraine's subscription to the Special Data Dissemination Standard—the first among the countries of the Commonwealth of Independent States.

Directors commended the constructive dialogue between the Fund and the authorities aimed at reaching agreement in the near future on a program under a precautionary arrangement with the Fund. A strengthening of structural reforms, with broad ownership, and policies to preserve macroeconomic stability will be an essential part of such a program.

Directors encouraged the authorities to continue to include collective action clauses in their future sovereign debt issuances.

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

Ukraine: Selected Economic Indicators

	2000 Est.	2001 Est.	2002 Prel.	2003 Proj.
	(Percent change, unless indicated otherwise)			
Production and prices				
Nominal GDP (in billions of hryvnia)	170.1	204.2	220.6	243.5
Real GDP growth	5.9	9.2	4.6[2]	4.5
Consumer price index (period average)	28.2	12.0	0.8	5.2
Consumer price index (end of period)	25.8	6.1	-0.6	6.0
	(In percent of GDP)			
Public finance				
Consolidated government budget balance, cash basis	-1.3	-1.6	0.5	-0.9
Primary balance	1.8	0.4	1.9	0.4
Revenue	33.4	33.5	36.5	37.1
Expenditure	34.7	35.1	35.9	38.0
	(Annual change in percent, unless indicated otherwise)			
Money and credit				
Base money	40.1	37.4	33.6	15.3
Broad money	45.4	42.0	41.7	21.5
Credit to nongovernment	63.0	41.0	47.5	21.9
Velocity (annual GDP divided by period-average broad money)	6.3	5.2	4.0	3.4
External sector				
Current account balance (in percent of GDP)	4.7	3.7	7.7	4.7
External public debt (in percent of GDP)	33.1	26.6	24.6	22.2
Debt service ratio, after rescheduling (in percent of exports of goods and services)	10.4	6.7	5.4	8.0
Terms of trade (annual change in percent)	-8.2	1.0	1.7	-0.8
Gross reserves (end of period; in months of next year's imports of goods and services)	0.9	1.7	2.3	2.5

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

[2] More recent official estimates indicate that growth was 4.8%

Statement by Yuriy G. Yakusha, Alternate Executive Director for Ukraine
May 14, 2003

The Ukrainian authorities value relations with the Fund and appreciate the constructive staff discussions during the Article IV consultation and in the course of the financial sector assessment program. The dialogue with staff was also helpful because it happened at the time when the government program of actions had been drafted. This program recently got decisive support from Parliament (335 votes out of 450).

The authorities share most staff assessments of the challenges ahead in creating conditions for sustainable growth and stability for the medium term. At the same time some staff projections in the past (inter alia, with respect to growth, inflation, budget deficits, current account, reserve accumulation) have occasionally proven to be rather cautious if compared with ex-post real outcomes.

The pace of implementation of some structural reforms have not satisfied the authorities. In particular the implementation of necessary tax reforms has been rather slow. Diagnostics of major structural shortcomings by staff coincides with the respective chapters of the government's own program of actions and with the program of strengthening of the banking sector developed by the NBU.

Macroeconomic developments

The Ukrainian economy has continued to grow and in the course of the last three years growth exceeded 21 percent. Recent data for 2002 shows that GDP grew by 4.8 percent last year, and so far this year, some acceleration of growth has been recorded. In the course of the first quarter, GDP grew by 7 percent. The recent industrial growth data for four months (over 11 percent) suggests that growth so far continues to be robust.

Economic growth has allowed official average per capita incomes to reach the so-called calculated minimum comfort levels, thus constituting an additional important step in fighting poverty. Alongside improvements in tax compliance, this year, growth has allowed the authorities to fully finance all social and other budget expenditures (while an overall surplus has been recorded). The budget has been executed this year in the so-called automatic mode (with no government intervention to ration expenditures). This is happening for the first time since independence.

The external position continued to strengthen and the NBU has been able to increase reserves which, despite still being modest, are finally counted in months rather than weeks or days of imports. As of May 12, gross reserves exceeded USD 5 billion. In the course of the three previous years, net repayments of foreign debt stood at about USD 2.4 billion, including USD 1 billion in 2002. Already this year over 0.5 billion of foreign debt payments has been made. Alongside the general reduction in indebtedness, the spreads on Ukrainian bonds narrowed substantially in 2002-2003.

Export performance over the medium term was rather modest, which is explained by the structure of exports (mostly so-called sensitive group exports such as metals, chemicals, textile and agricultural products). Rather uneven exports dynamics are also explained by trade restrictions imposed by important trading partners. The authorities are grateful for the attention to the issues of artificial trade barriers that Ukrainian exporters are facing. Recently, some successful efforts in diversifying trade were undertaken, and trade balance improved significantly in 2002. Nevertheless, harmful losses still occurred in many traditional markets.

The authorities share staff concerns over the still high level of the shadow economy. Unreported economic activity is reflecting both a legacy of past instability and a still inadequate level of trust. The fact that budget revenues improved recently faster than economic growth, suggests that much unreported activity is finally coming out of the shadow. Increased levels of trust are also evident in the high rate of increases in households' deposits in the banking system (which have been growing by about 70 percent per year in the course of 2001-2002), in sizeable increases in the numbers of registered small businesses and entrepreneurs, and even in recently improved demographic indicators.

Nevertheless it cannot be argued that official GDP is underestimated to a sizeable extent. Ukraine joined SDDS in early 2003, and is implementing recommendations of a data ROSC. Statistical improvements alongside further implementation of structural reforms and strengthening of market institutions will contribute to the reduction of the size of the shadow economy.

It is important to keep recent economic trends in perspective. A reader of the vulnerability assessments in the staff appraisal may inadvertently get the wrong impression about the direction of change in the magnitude of macroeconomic risks. Table 5 on p.28 of SM/03/133 on vulnerability indicators, emphasizes this perspective very well: public debt, the share of poorly performing loans, the extent of dollarization, the level of domestic interest rates, and the Eurobond spreads have all substantially decreased. The external position has substantially improved, while short-term debt is rather small and decreasing further. The projected end-2003 level of reserve accumulation is almost achieved by mid-May.

Fiscal policy

In the course of 2002-2003 the previous trend of the falling ratio of budget revenues to GDP has been reversed. Despite the far from ideal quality of the 2002 budget (it was an election year), last year ended with an overall budget surplus (a result about 2 percentage points of GDP better than the staff's previous Article IV fiscal projections). However, the quality of last year's fiscal adjustment was poor due to the significant shortfall in the envisaged privatization receipts which forced the authorities to severely cut expenditures.

The 2003 budget is of a better quality, so one can reasonably expect better budget execution this year. So far this year the authorities cleared all previously accumulated arrears on social assistance for families with children and reduced arrears for other types of assistance. There have been no arrears on budget sector wages. Still, the authorities had to prepare changes to the current budget in order to correct the parliament's own decisions on minimum wage hikes approved outside the budget legislation.

The authorities do not share some of the staff assessments on the possibility of fiscal expansion for this and coming years. The authorities remain committed to maintaining a small primary surplus. The budget has so far recorded an overall surplus in 2003.

The tax system has recently developed in the right direction, but as authorities themselves admit, progress was rather slow. Some privileges were removed and the free economic zones regime has been tightened, while tax administration has been strengthened. In order to further improve the latter, the comprehensive project with the World Bank has been recently negotiated.

Overall transparency of the budget process and the quality of expenditure programs has recently been improved, the Treasury single account was fully implemented, the government is working on better targeting social assistance programs and the authorities have expressed interest in doing a follow up to the fiscal ROSC module.

The process of removing tax exemptions has been proceeding, but no legislative breakthrough has yet occurred, in particular with respect to changing the existing controversial and inefficient VAT legislation. Despite some very modest most recent positive developments in clearing VAT refund arrears, the comprehensive solution of this problem requires legislative changes. The level of fraud under the existing legal loopholes remains extremely high, while VAT refund claims continue to increase rapidly. The authorities realize the necessity of further broadening the VAT tax base to achieve the much needed improvement in the investment climate. So far the authorities have been cautious only with staff recommendations on removing VAT exemptions for medical supplies, because most countries have preferential tax treatment for pharmaceuticals.

Discussions on VAT legislation are still not completed by parliamentarians. There have been initial delays in an overall radical overhauling of legislation in Ukraine (even the new Constitution was adopted much later than in other countries). As a result, only half of the new Tax code has been approved to date, while parliament in general managed to approve many other reform related Codes in the course of the last two years, including a new: Criminal Code, Budget Code, Economic Code, Civil Code, Custom Code, Land Code. Ukrainian legislators are also making efforts to amend many pieces of legislation in order to meet WTO requirements and continue to make changes in legislation in order to harmonize them with EU standards. Simultaneously various political reform proposals are debated, including rather radical changes to the Constitution.

Monetary policy and strengthening of the banking sector

Last year a modest CPI deflation was recorded in Ukraine, which is rightly explained by staff in non-monetary factors, predominantly of a temporary and seasonal nature, stemming from the fact that agricultural products comprise a significant part of the CPI basket. Some acceleration of inflation so far this year has also happened due to volatile food and energy prices, while the role of monetary factors in this acceleration is being debated among the authorities. Probably, it would have been helpful to assess more regularly the underlying core inflation. In any event, the monetary program approved for this year is based on much more conservative assumptions about the growth in money demand. In case of continuous evidence of the acceleration of inflation, the monetary authorities stand ready to implement additional measures to protect price stability.

The mechanism of providing the longer term liquidity by the NBU has been amended several times this year in order, inter alia, to address concerns expressed by staff and to improve risk management practices and remove possibilities of official interventions in the decision making process by banks, who in fact allocate credit independently. The NBU sees this mechanism as a temporary and symbolic tool for encouraging inter-bank cooperation (no syndicated loans were extended in Ukraine so far), facilitating the emergence of viable longer term business projects and thus contributing to developing long-term credit market, while promoting the use of more sophisticated credit risk management techniques. The overall volume of such a longer term refinancing in the course of last year has been indeed symbolic at Hrv 121.5 million, while this year the volume has been zero so far. As soon as the institutions for better protection of a creditor's rights are developed, there will be no need for such temporary mechanisms. The National Bank remains of the opinion, that by occasionally offering longer term refinancing under the appropriate safeguards (and within the parameters of the monetary program) stability will not be jeopardized. The NBU is committed to strengthening the banking sector which is the mainstream way of addressing the existing shortcomings of the credit market.

Regarding the exchange rate dynamics, the authorities would like to emphasize that they see merit in a greater nominal exchange rate flexibility as an absorber of balance of payments or money demand fluctuations in case such fluctuations occur. Inflation targeting is considered by the authorities as a medium-term objective, while effective implementation of such a regime requires better understanding of monetary policy transmission and a more predictable pace of the remonetization process.

The authorities are grateful for the comprehensive assessment of the financial sector by the FSAP team. Some of the FSAP recommendations have already been implemented. An effort is underway to strengthen creditor rights, increase the capital adequacy ratio, further improve a supervisory capacity, and enforce new AML/CFO legislation. Overall reserves and provisioning by banks has improved considerably in the course of 2002 and the first quarter of 2003, while, as of the first quarter of 2003, only 8 (all small) out of 157 banks remained unprofitable.

The authorities would appreciate a better explanation of the differences in loan classification used by the authorities and in the FSSA, as well as at least some references with respect to international comparability of loans considered to be non performing in Ukraine and other transition countries. While FSSA is classifying 22% of loans as non performing, the authorities would like to emphasize that a share of bad and prolonged loans has decreased *from 16.8 percent at the beginning of 2001 to 9.9 percent at the beginning of 2002 and to 7.2 percent at the beginning of 2003*, while the risks for the loans under other substandard categories has been estimated at only about 20 percent.

Structural reforms

Staff reports are rather skeptical with respect to the recent record of structural reform implementation, especially in improving the tax system and increasing transparency in the gas segment of the energy sector. These challenges along with the improvement of the privatization process are high on the authorities' own agenda. Staff reports are providing evidence that changes in the right direction are nevertheless occurring (the cost of tax exemptions, the size of quasi-fiscal deficits have been decreasing). In addition to the issues identified by staff the government is committed to implementing the second stage of administrative reform, pension reform, reform of labor relations, as well as reforms needed for WTO accession. Judicial reform was launched last year, while land and agricultural reforms have been progressing. It is expected that the issue of minimum wage is going to be addressed by parliament in the coming days in the context of amending the 2003 budget.

The authorities share the overall spirit of staff recommendations on the necessity to move more consistently towards rules based policies and from discretion. This overall direction of changes also requires improvements in governance, in enforcing the rule of law and accountability of the public sector.

Program negotiations

The authorities have expressed interest in a new (this time precautionary) arrangement with the Fund. So far two rounds of negotiations have occurred. The last one - in late February - started with the authorities having submitted their own memorandum of economic policies. The principal pillars and the macro framework for the possible future program have been agreed upon, but no final agreement has yet been reached. The remaining differences are related mainly to a still not entirely clear schedule of legislative approval of the rest of the Tax Code, and the schedule of VAT refund arrears clearance (which also depends on legislative actions). There is no disagreement with respect to the direction of reforms, while some differences remain with respect to how many measures are going to be treated as prior actions. As authorities believe, the extensive lists of a very detailed prior actions (most of them prior not even to the Board meeting, but prior to concluding an agreement on the program) are extending the process of program negotiations and delaying the probable timing of the beginning of this new arrangement.