INTERNATIONAL MONETARY FUND

Staff Country Reports

December 2008
IMF Country Report No. 08/384

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

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

- The staff report for the Request for Stand-by Arrangement, prepared by a staff team of the IMF, following discussions that ended on October 28, 2008, 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 November 3, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of November 3, 2008, on the assessment of the risks to the Fund and the Fund's liquidity position.

- A Press Release summarizing the views of the Executive Board as expressed during its November 5, 2008 discussion of the staff report that completed the request.

- A statement by the Executive Director for Ukraine.

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

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INTERNATIONAL MONETARY FUND

UKRAINE

Request for Stand-By Arrangement

Prepared by the European Department in Consultation with Other Departments

Approved by Juha Kähkönen and Adnan Mazarei

November 3, 2008

- **Stand-By Arrangement**. In the attached letter, the Ukrainian authorities are requesting a two-year $16.5 billion (SDR 11 billion) Stand-By Arrangement involving exceptional access (802 percent of quota). An initial purchase of SDR 3 billion becomes available upon Board approval of the arrangement, and the remainder phased thereafter, subject to quarterly reviews. The request is being considered under the Emergency Financing Mechanism (EFM). In the letter the authorities outline the economic program for which they seek Fund financial support and describe its economic policy objectives. The two key objectives are (i) to stabilize the domestic financial system against a backdrop of global deleveraging and a domestic crisis of confidence; and (ii) to facilitate adjustment of the economy to a large terms of trade shock. The authorities' plan incorporates monetary and exchange rate policy shifts, banking recapitalization, and fiscal and incomes policy adjustments. Policies have been set recognizing that there are difficult trade-offs between the two objectives.

- **Discussions**. During October 16–28, 2008 the staff team met with the President, Mr. Yuschenko; the Prime Minister, Ms. Tymoshenko; the Speaker of the Parliament, Mr. Yatseniuk; the Minister of Finance, Mr. Pynzenyk; the Governor of the National Bank of Ukraine, Mr. Stelmakh; the First Deputy Chief of Staff of the Presidential Administration, Mr. Schlapak; and other senior officials; ambassadors; as well as representatives of the private banking and business communities. The mission also met the leaders of the Party of Regions, Mr. Yanukovich and other senior representatives.

- **Staff**. The staff team comprised Ms. Pazarbasioglu (head); Messrs. Flanagan and Moulin (EUR); Mr. Arslanalp (FAD); Messrs. Garcia-Pascual and Olafsson (MCM); and Mr. Hofman (SPR). Mr. Horvath, resident representative, assisted the mission, and the mission cooperated closely with World Bank staff on structural issues. Mr. Yakusha, Alternate Executive Director for Ukraine, attended most meetings.

- **Publication**. The Ukrainian authorities have consented to the publication of the staff report.

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I. Introduction

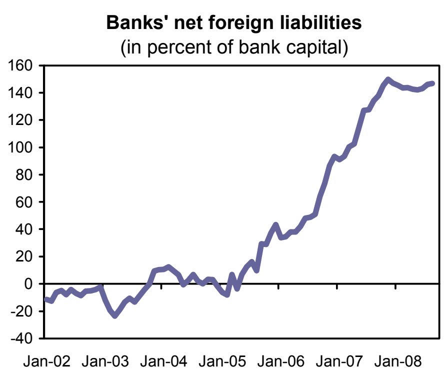
1. **Ukraine's economy has grown very rapidly since 2000;** average growth has been in excess of 7 percent. Initially, this reflected supply-side factors: utilization of large excess capacity and productivity gains built on a host of structural reforms. Since 2005, real demand growth averaged about 15 percent, propelled by a capital-inflow driven credit boom and a redistribution of the large terms-of- trade gains to the population through incomes policies.

2. **By mid 2008, however, the economy was overheating** (Table 1, Figure 1). Credit growth exceeded 70 percent, CPI inflation exceeded 30 percent, wage growth settled in the 30–40 percent range, a buoyant property market pushed valuations to high levels relative to Ukraine's PPP-adjusted income, and imports surged at an annual rate of 50–60 percent. The current account deficit reached 7 percent of GDP by Q2 2008, leaving the rigidly managed currency substantially overvalued.

3. **The Ukrainian economy was exposed along multiple dimensions** (Table 2):

- **Terms-of-trade** gains had stemmed from (i) a rise in steel prices to a level far exceeding their real long-term trend; and (ii) lingering Russian energy subsidies (Table 3). With steel representing some 40 percent of exports and 15 percent of GDP, and gas imports some 6 percent of GDP, any correction represented a major impact.

- **Large capital inflows** left banks and corporates reliant on short-term external funding (Tables 4–5). Although reserve coverage of imports exceeded 4 months, short-term external debt and external debt service began to build up, leaving short-term debt coverage at just 75 percent in September 2008.



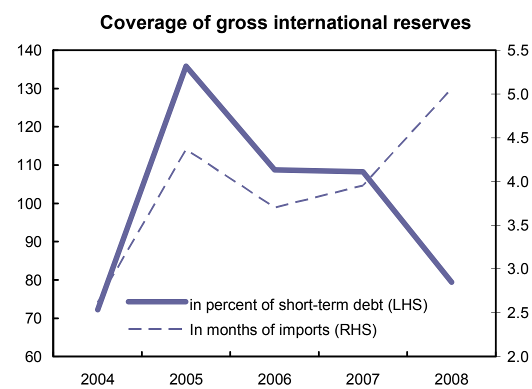
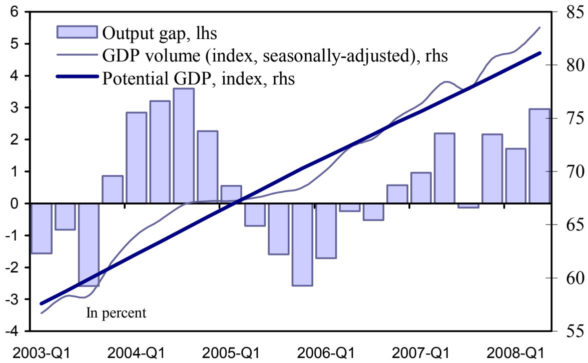
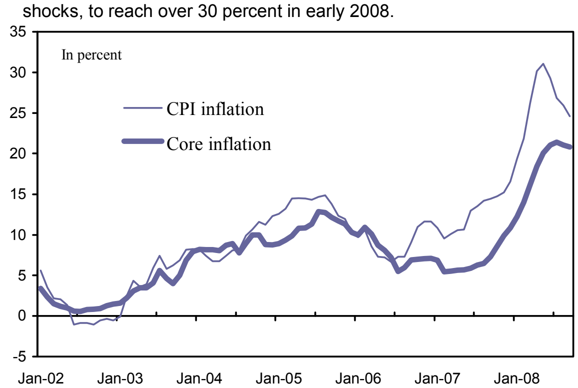


Figure 1. Ukraine: Recent macroeconomic developments

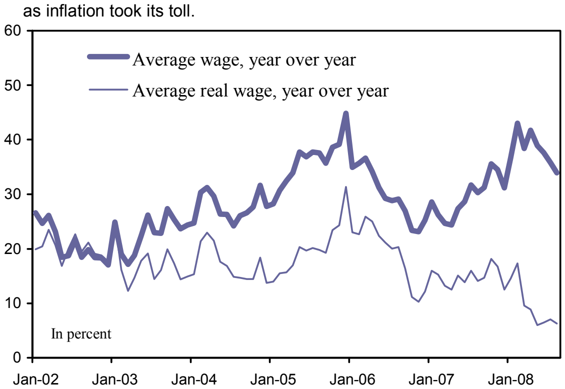
The economy has been showing signs of overheating since the beginning of 2007.



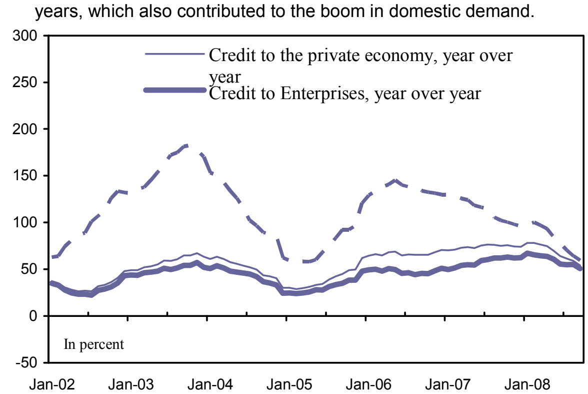
Inflation increased sharply, in part due to unfavorable supply shocks, to reach over 30 percent in early 2008.



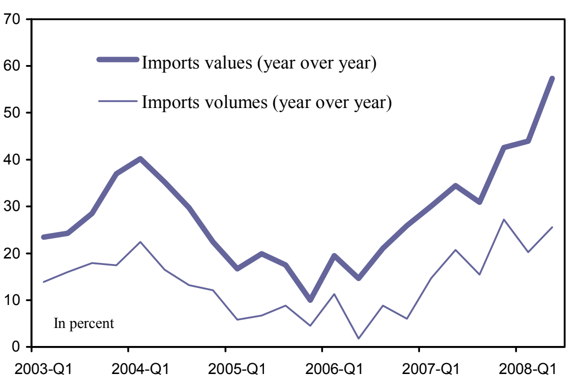
Nominal wages accelerated markedly. Real wage decelerated of late, as inflation took its toll.



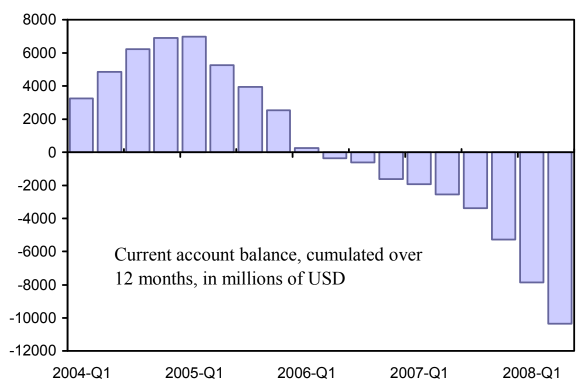
Annual credit growth has averaged 70 percent in the last three years, which also contributed to the boom in domestic demand.



The consumption boom resulted in a surge in imports, and import values increased by about 60 percent on the year to Q2-08.

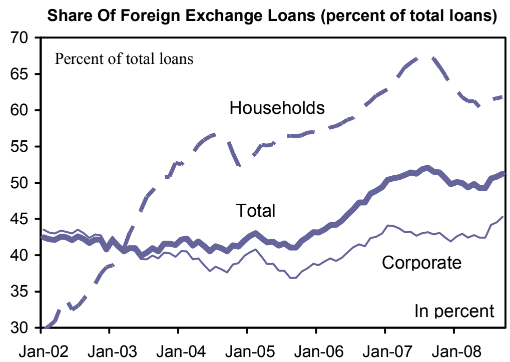


Against this background, the current account balance has worsened rapidly.

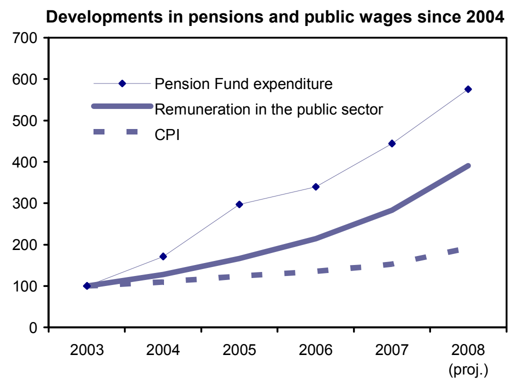


Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.

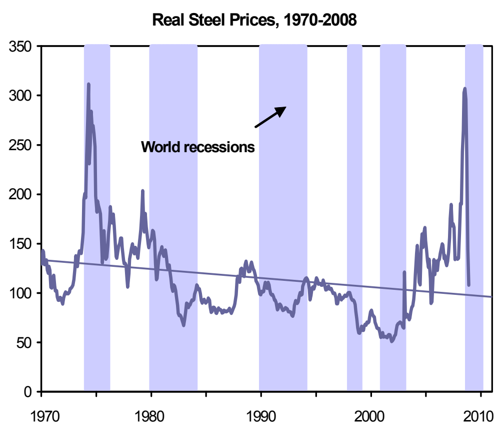
- **Household and corporate balance sheets** weakened, with increased borrowing from banks in foreign currency, encouraged by low interest rates and a rigidly managed exchange rate regime. Many corporates, however, are thought to be hedged by large export revenues and significant (and under reported) foreign assets.



- The **underlying fiscal position** deteriorated sharply (Table 6, Figure 2). Windfall revenues from the commodity boom were spent largely on higher wages and social transfers, propelling them some 220 percent higher over 2004–08. Measures of the deficit, adjusted for the terms of trade, showed an underlying deficit of some 6 percent of GDP by 2008.



4. **The long-anticipated shock to Ukraine's terms of trade has materialized, with considerable impact on the real sector.** On the export side, the price of steel has declined by 65 percent since early July, to real levels associated with past global recessions. On the import side, Russia signaled its intention to phase out remaining gas subsidies (Ukraine currently pays $180/tcm, or $6.5 billion for gas imports, versus an expected transit-adjusted European equivalent of $330/tcm in 2009). While year-over-year GDP growth remained positive in September, at 5.5 percent, and growth through three quarters is estimated at 6.9 percent, the manufacturing sector is now contracting sharply (–5 percent in September).



5. **Ukraine has been subject to a sharp reversal of external capital flows in the context of the deepening global financial turmoil**. Ukraine has been shut out of the international capital markets, although direct credit lines have been for the most part rolled over. Sovereign CDS spreads now stand at about 2,300 bps, while corporate EMBI spread

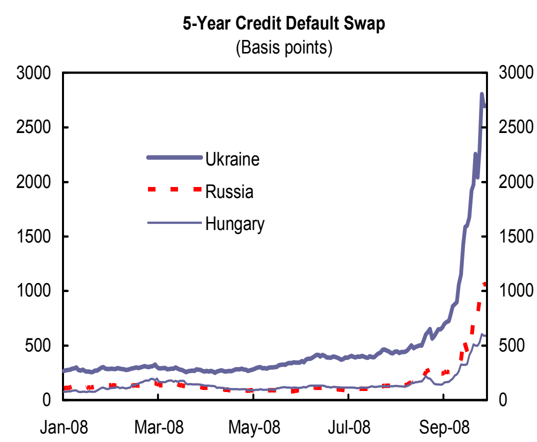
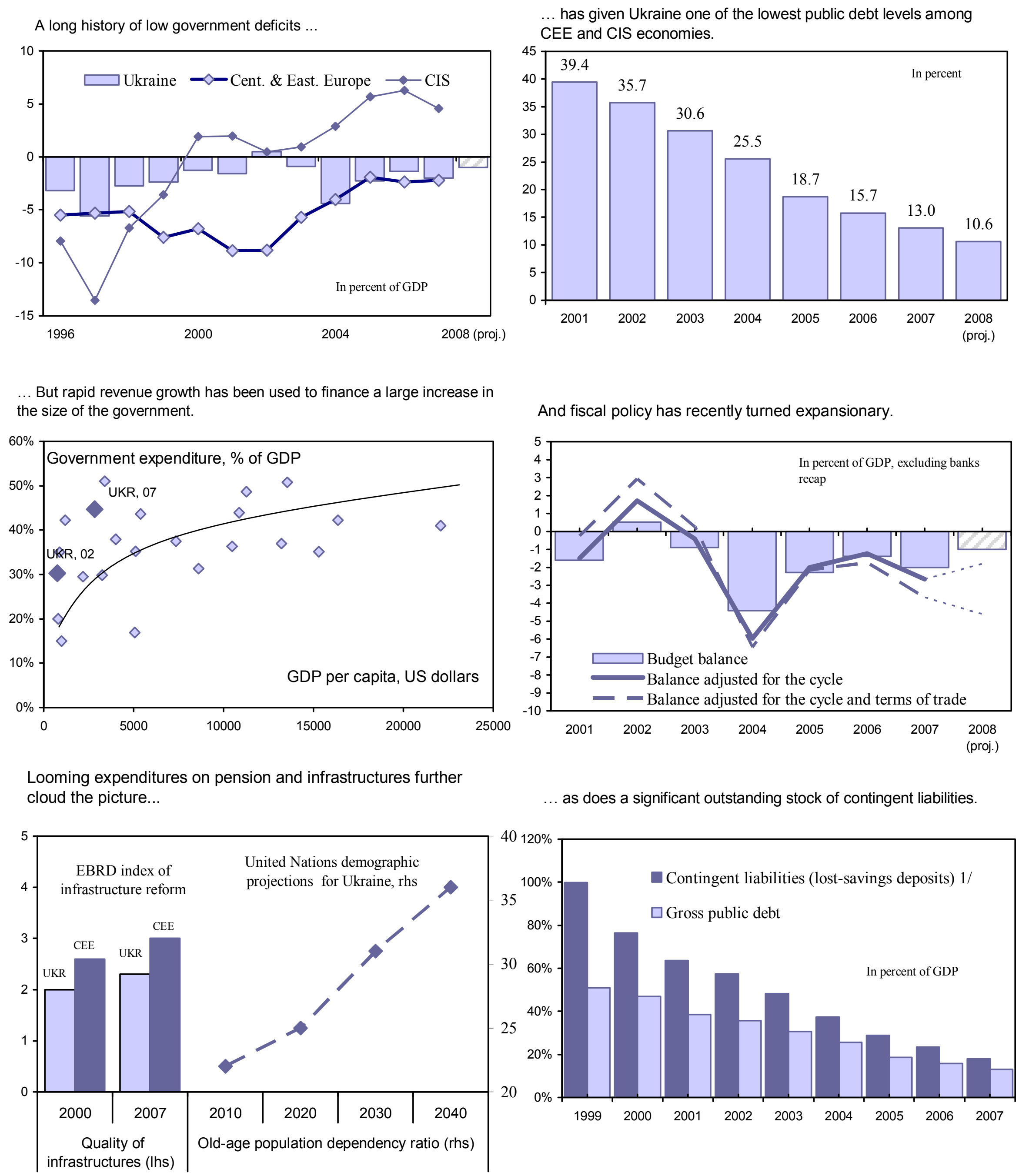


Figure 2. Ukraine: Fiscal Policy Indicators



Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.
1/ Estimated contingent liabilities from the so-called lost-savings deposits.

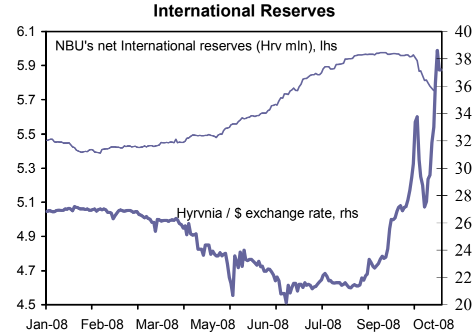
exceed 4,000 bps. Fitch and S&P have both downgraded Ukraine (keeping it on negative outlook), while Moody's has also just downgraded a number of Ukrainian enterprises, and placed the sovereign on negative outlook.

6. **Political instability began to increasingly affect perceptions about the course of policies in 2008**. The prospect for Presidential election (scheduled for January 2010) and the call for early parliamentary elections (scheduled for December 2008) have exacerbated concerns that policies would not be used to reign in demand, or that as in recent election campaigns expensive promises would be made that would prove difficult to reverse.

7. **These developments and the intervention of the sixth largest bank in October significantly undermined confidence in the banking system and the currency:**

- **Major strains are showing in the banking system**. After the sixth largest bank was put under receivership, a more widespread outflow began, with at least $3 billion (4 percent of deposits) withdrawn during the first three weeks of October. The authorities responded by imposing limits on early withdrawal of time deposits (including non-resident deposits) which slowed the outflow, but confidence remains very fragile. The NBU has injected some 2½ percent of GDP in liquidity since late August (reserve requirements have been effectively eliminated, while refinancing has been allowed against an expanded collateral list).

HRV / $ Exchange Rate and NBU's International Reserves



- **The confidence crisis has spread to the foreign exchange market**. Intervention by NBU has amounted to over $4 billion in October (from reserves of $38 billion). Early in the month the intervention was often at non-market rates (at times deviating from the market rate by more than two percent). This temporarily kept the currency inside the weak end of a Hrv/$4.55–$5.35 band. However, increasing reserve losses have forced the NBU to step back and the currency is trading around Hrv/$5.90. The authorities also imposed a set of exchange controls to help stem outflows (Box 1).

Box 1. Ukraine: Exchange Controls Introduced in Response to the Crisis [1/]

1. Restriction on early withdrawal of time deposits (applies to both residents and non-residents).

2. Prohibition of early repayment of foreign exchange loans by banks.

3. Limitation on purchases of foreign currency by banks, in order to discharge foreign exchange loans due, to amounts within their open foreign exchange limit.

4. Controls over advanced payments for imports that do not enter the territory of Ukraine (subsequently repealed).

5. Six-day delay for investors wishing to convert hryvnia profits, revenues, or the sale of assets into foreign currency.

6. Ceiling for a monthly wiring by natural persons of foreign currency out of the country in the equivalent of Hrv 15,000 if no supporting documents are presented; Hrv 75,000 otherwise.

7. Limitation on payment order execution to one day within branch, two days within bank, and three days across banks.

8. Limitation of exchange market transactions limited to specific currency pairs.

9. Limitation on ceiling between bid and ask exchange rates to at most 5 percent.

10. Requirement that the foreign exchange open position of banks be calculated for each currency separately.

11. Requirement that hard currency foreign exchange deposits of banks abroad, be restricted to banks resident in the group of hard currency countries.

12. Limitation on hryvnia transactions by non-resident banks except for transactions in export-import operations.

Source: NBU Resolutions 319, 328 and 336.

1/ As stated in paragraph 15, staff is still assessing whether any of these controls give rise to exchange restrictions subject to Article VIII, Section 2(a).

8. **The banking sector will need additional capital to help withstand the shocks faced**. Preliminary scenario analysis suggests that capital would be almost wiped out if the currency were to depreciate substantially and growth to slow significantly (both expected outcomes in the face of a terms-of-trade shock). This implies a capitalization need of at least 8 percent of 2008 GDP ($12 billion), including 4½ percent of 2008 GDP ($6–$9 billion) in recapitalization needs for foreign-owned banks (Box 2). It is expected that most banks, especially the large banks (most of which are foreign owned), will be able to raise capital on their own. However, there may be a need for the authorities to provide financial support to

Box 2. Banking-Sector Structure, Risks, and Scenario Analysis

The Ukrainian banking sector has experienced a formidable growth over the last four years, including through increased presence of foreign banks. With a market share of 50 percent, the top 10 banks consist of 5 domestic and 5 foreign banks, including Raiffeisen, BNP Paribas, Unicredit, OTP and Alfa Bank. ROA are notably higher for larger banks. A key advantage of foreign banks is their access to cheaper funding relative to local banks, which is mainly driven by the comparatively higher rating of the parent banks. The marked differences in profitability create incentives for further foreign-bank participation and consolidation of small size institutions, which are considerably less profitable.

Large banking-sector risks were built as a result of the exceptionally rapid credit growth with the loan-to-deposit ratio rising to 140 percent. Part of the foreign currency inflows into the system were used to fund corporate loans (some of which without natural currency hedges) and long-term foreign currency retail loans (mortgage and car loans) exposing the system to significant currency-induced credit risk. A rapid increase in long-term retail loans, in part funded through short-term foreign funds, raised asset-liability maturity mismatches. Significant sectoral risk concentration has also developed. Banks are highly exposed to metal-related industries, trade and consumer business, and construction (accounting for 72 percent of total loans). While it is difficult to document, market participants also raised concerns about high levels of related-party lending, especially in some domestic banks.

Under expected adverse macroeconomic conditions in 2009, current capital buffers are likely to be fully absorbed by the deterioration in banks' portfolios. A drop in real GDP growth of 9 percentage points, a nominal depreciation, high interest rates, and a sharp drop in real prices, will result in a sharp increase of bad loans (category 5 loans), which are estimated to rise to 15 percent by end 2009 (in mid-2008, they stood at 1 percent). As a result, the capital buffers of most banks would be wiped out.

The required capital injection to return to minimum CAR levels is estimated to be about Hrv 78 bn, corresponding to over 8 percent of 2008 GDP (Hrv 34 bn for domestic banks and 44 bn for foreign banks). The large impact on banks' portfolio is the result of several risk factors including (i) over 63 percent of retail loans are denominated in foreign currency, of which the majority are to unhedged borrowers; (ii) the high concentration of corporate loans in sectors which are expected to suffer a large contraction in 2009; and (iii) a large external debt rollover risk for the corporate sector in the amount of $30 bn in 2009.

viable banks through a bank recapitalization scheme which will help to shield the real economy from a potential credit crunch (see below). Furthermore, it is likely that the authorities will need to inject capital to the sixth largest bank which was intervened in early October (the authorities estimate a financing need of about Hrv 8 billion).

II. The Authorities' Program

A. Objectives and Strategy

9. **The authorities' program aims to restore financial and macroeconomic stability and thereby facilitate better confidence.** To restore financial stability, measures are specified regarding (i) appropriate liquidity support and expansion of deposit guarantees; (ii) a stronger bank resolution framework, including availability of public funds for recapitalization; and (iii) a stronger framework for resolution of household and enterprise sector debts.

10. **To facilitate adjustment to potentially large external shocks and allow a gradual reduction of inflation**, the program supports several changes in Ukraine's macroeconomic policy framework, many of which the authorities were already pursuing to varying degrees. These include (MEFP ¶4): (i) a flexible exchange rate policy, supported by base money targets and an appropriate intervention strategy; (ii) transition to inflation targeting (as a new nominal anchor); (iii) resetting incomes policy in line with targeted inflation, while protecting the most vulnerable; (iv) maintaining a prudent fiscal stance; and (v) bringing energy sector prices more in line with costs. Output risks are addressed by fiscal contingency plans, and private sector debt resolution measures.

11. **The program is set up to respond flexibly to economic developments** (MEFP ¶7). Upside risks, such as a recovery of steel prices and/or resumption of capital inflows, would be met with higher reserve accumulation and adjustments to monetary policy (to safeguard inflation objectives). On the other hand, a substantial undershoot of commodity prices or longer loss of access to capital markets would be cushioned by the robust policy framework, especially the flexible exchange rate and the funds available for bank recapitalization. However, the authorities indicated that they stood ready to take additional measures if needed.

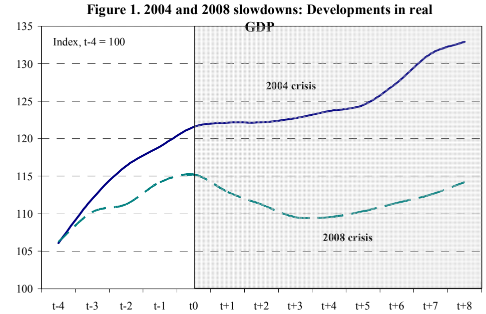
B. Macroeconomic Framework

12. **The program establishes conservative macroeconomic targets for 2009** (Table 7) (MEFP ¶5). The projections assume a global recession and continued deleveraging in international credit markets in 2009, implying a recession in Ukraine with deteriorating exports, limited external finance and a credit crunch. The projected impact on output—a 3 percent decline—is consistent with Ukraine's experience under similar circumstances (Box 3). The projected inflation rate for 2009 is 17 percent, reflecting currency depreciation (in real effective terms the hryvnia is projected to decline to its equilibrium level) and pass

Box 3. Calibrating the Current Slowdown: A Comparison With 2004–2005

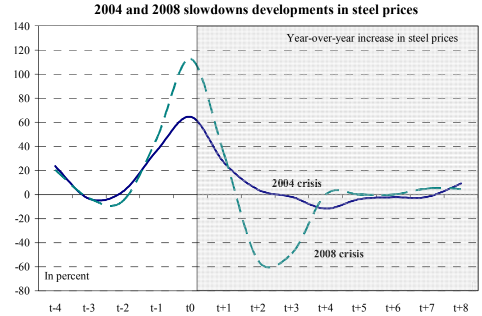
Ukraine experienced a sharp economic slowdown earlier in the decade. In late 2004, as the Orange revolution gathered steam, political instability led the country close to a financial crisis. A run on the banking system and currency took place and, over two months, 13 percent of system wide deposits were withdrawn. A significant growth slowdown followed, which was amplified by a 30 percent fall in steel prices in the first half of 2005. The year-on-year real GDP growth rate declined from 14 percent in Q3–04 to 2 percent one year later.

Figure 1. 2004 and 2008 slowdowns: Developments in real GDP



Staff has calibrated its forecast against the 2004 episode. Compared to 2004, staff expects the slowdown to be more pronounced and persistent. While real GDP growth remained positive in 2004–05, output is expected to fall during the three quarters to Q3–09. The larger slowdown would reflect several factors:

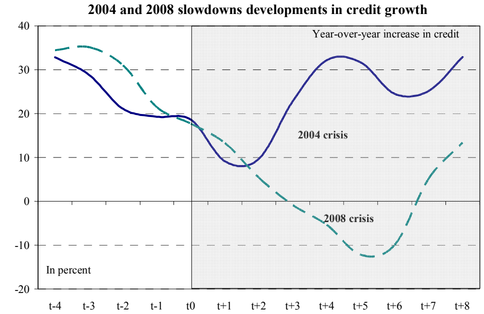
2004 and 2008 slowdowns developments in steel prices



- **A much less favorable external environment.** The price of Ukraine's main export has fallen much more in the second half of 08 than during the 2004 episode (65 percent from peak to trough, against 30 percent). And while Ukraine's trading partners were growing by over six percent a year in 2004–05, their growth should not exceed 3½ percent in 2009.

- **Tighter global financing conditions.** The 2004–05 short-lived slowdown in credit growth is unlikely to be repeated. The ongoing global deleveraging, difficult access of Ukraine to international markets, and loss of confidence in the banking system should result in a much more persistent credit crunch this time.

2004 and 2008 slowdowns developments in credit growth



- **Constrained fiscal policy.** In 2004–05, a large fiscal loosening—the deficit worsened by 4 percent of GDP in the second half of 2004—cushioned the impact of adverse shocks. Given the tight financing constraints faced by Ukraine, both domestically (liquidity shortages in the banking system, paralysis of the privatization process) and externally, such room does not exist at present.

- **Negative balance sheet effects**. The ongoing depreciation of the hryvnia affects households' balance sheets. This depresses consumption directly (income effect) and indirectly (confidence effect). On the corporate side, while exporters are naturally hedged, domestic-oriented businesses should be affected.

through of imported gas prices (see below). The current account would compress to a deficit level of about 2 percent of GDP, with currency depreciation and slower growth bringing it into line with the sharp projected decline in available private external financing.

13. **Assuming a global recovery in the second half of 2009, the Ukrainian economy could be back at its estimated potential growth rate by 2011** (5–6 percent; Table 7, Figure 3) (MEFP ¶6). The rising investment ahead of the Euro 2012 football championships would complement the potential impact of improvements in competitiveness fostered by continued implementation of a flexible exchange rate regime. Inflation could return to 5–7 percent by late 2011, helped by continued transition to inflation targeting and prudent incomes policies. However, the precise pace will depend on the path of administered price adjustments. Current account deficits are projected to remain small in 2010, in light of the weak economy, and to be moderate thereafter, allowing reserves to rise.

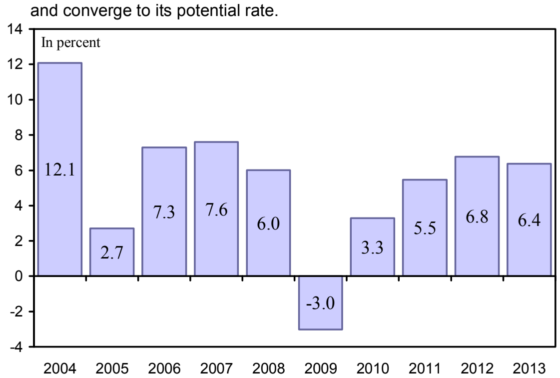
C. The Program for 2009

Monetary and Exchange Rate Policy

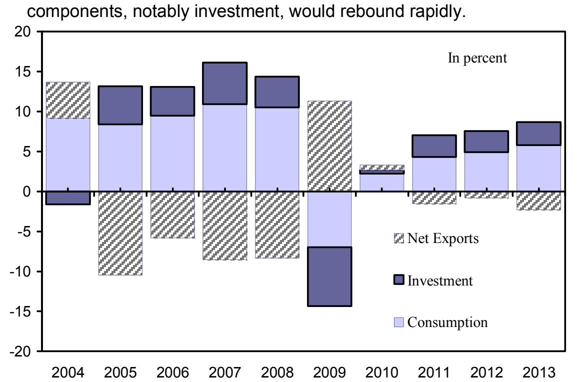
14. **The program supports implementation of a flexible exchange rate regime** (MEFP ¶8**.** The authorities introduced the first steps toward a managed float in March 2009, and agree that greater exchange rate flexibility will help them better absorb the external shocks they now face. Other strategies, including a step devaluation and a re-peg or a gradually widening band, were considered risky given the uncertainty about the size of the external shocks and given the level of reserves. Discussions focused on effective communications and implementation of an effective reserve management strategy. On the former, the authorities amended NBU documents to eliminate reference to a band, and announced that the official exchange rate would be aligned with market rates. Regarding reserve management, the authorities indicated that interventions at non-market rates would be discontinued, including for transactions with the government. Instead they would focus on pre-announced regular auctions guided by the NIR targets.

Figure 3. Ukraine: Medium-term outlook

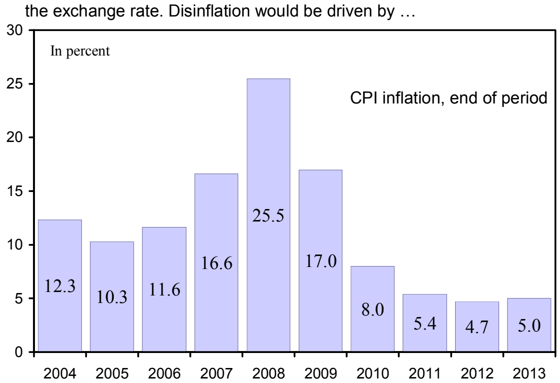
After the 2009 adjustment, real GDP growth would gradually recover and converge to its potential rate.



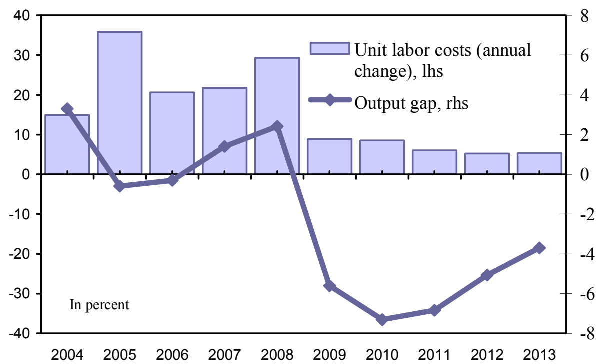
The recovery would initially be driven by net exports, but domestic components, notably investment, would rebound rapidly.



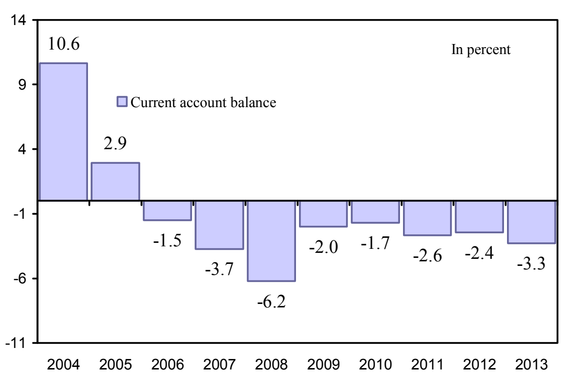
Inflation would decline in 2009, despite the expected depreciation of the exchange rate. Disinflation would be driven by …



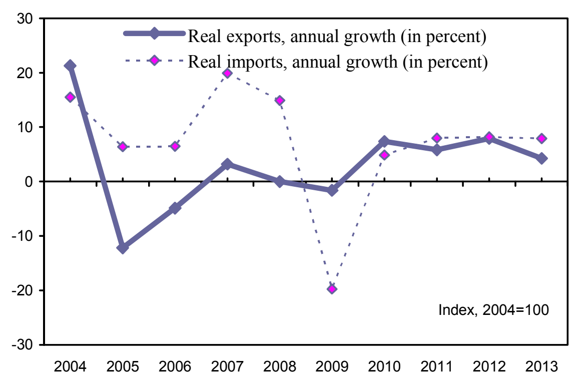
… the opening of a large negative output gap and policies consistent with moderate increases in unit labor costs.



After the sharp correction of 2009, the current account balance would remain at sustainable levels over the projection period.



Real exports would accelerate, while real imports follow a more sustainable growth trend.



Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.

15. **Staff and authorities agreed that it would be important to avoid disorderly exchange market developments, and to eliminate exchange controls as soon as possible** (MEFP ¶9). The key concern about a sharp depreciation of the exchange rate, as highlighted by stress tests (see Box 1) is the impact on balance sheets of households and corporates that have borrowed heavily in foreign currency. The expectation is that the confidence effect of a comprehensive program, the impact of supporting fiscal policy measures, and the maintenance of reserve buffers to create a credible threat of intervention (in line with the NIR targets) should help avoid a sharp overshooting of the exchange rate. Exchange controls (see Box 1) could only, at most, be a temporary solution, given circumvention and distortionary impacts, and could magnify pressure for outflows. The authorities recognize the need to remove these controls as confidence rebuilds. By the time of the first review, staff will complete the assessment of whether any of these exchange controls give rise to exchange restrictions subject to Article VIII, Section 2(a) of the Fund's Articles and whether such restrictions warrant temporary approval by the Executive Board.

16. **Base money will become the near-term anchor for monetary policy until an inflation targeting regime (IT) can be put into place** (MEFP ¶11). The authorities have publicly committed to an IT regime, and have progressed in their preparations. However, much work remains, including developing domestic debt and capital markets, reforming internal NBU decision-making processes, and improving public communications (Table 8). Realistically, and assuming further technical assistance, full IT implementation will not be feasible before 2010. For 2009, IT progress would focus on enhancing NBU independence, both by limiting political influence (reforming the Council, which has high parliamentary representation) and strengthening the NBU's financial flexibility to conduct monetary operations. An inflation anchor would be provided by monetary base targets. In this context, while the program assumed some increase in velocity, the authorities and staff agreed that base money demand would need to be revisited during the program's frequent reviews.

17. **Monetary policy will shift to a tighter stance** (MEFP ¶10**)**. Systemic liquidity is high at the moment in the wake of the NBU's appropriate efforts to inject liquidity to relieve banking system stress associated with the increase in deposit withdrawals. The authorities and staff shared the assessment that at some point high demand for currency (by the population) and reserves (by banks) would unwind which, combined with an expected increase in velocity, would require removal of excess liquidity. A strong signal of this process would be exchange market pressures. Against this background, it was agreed that an increase in the NBU's low deposit interest rates—now 6–10 percent—would be needed in the near future. Staff stressed that in implementing this increase it would be important to make deposit auctions more regular and focused around one maturity—perhaps two weeks—to generate a clearer signal to markets about policy. The authorities requested technical assistance on monetary operations to facilitate this shift in operational strategy. It was also recognized that reserve requirements would need to be restored (i.e., no longer counting cash in vault) and that this could prove a particularly effective way of quickly mopping up liquidity. As regards the refinance rate, which stands at 15 percent, the authorities and staff

recognized that the inflation objective of 17 percent called for an increase. This would be implemented as soon as financial stability considerations permitted.

Financial sector policy

18. **The program supports a strategy to restore confidence in the near term** (MEFP ¶12)**.** In particular:

- The authorities and staff agreed that a wide range of admissible collateral for repo operations would remain appropriate to ensure that viable banks have **access to liquidity**. The NBU monitors daily banks' liquidity positions and their profile of asset liability maturity, and provides liquidity as needed. The authorities agreed to rapidly phase out bank shares from their list, in light of risks posed to the NBU's balance sheet, and to ensure that the liquidity support did not unintentionally evolve into support for insolvent institutions. Looking forward, the bank recapitalization program will improve the profile of available collateral and will lead to additional refinancing by the NBU. Staff and authorities agreed that the NBU would take the necessary measures (as discussed in paragraph 17) to ensure that the overall systemic liquidity remains at appropriate levels.

- The **deposit insurance** strategy faced an important constraint. A blanket guarantee of all bank liabilities (including corporate deposits and interbank liabilities) is unlikely to be credible, given past failures to honor such commitments.[1] The Ukrainian deposit insurance scheme only covers retail deposits. To help instill confidence among depositors the authorities have increased deposit insurance coverage from the current Hrv 50,000 on retail deposits to Hrv 150,000 (about €20,000) with additional resources provided to the Deposit Insurance Fund. This implies a coverage of about 99 percent of individual accounts and is in line with the limits imposed by most countries in the region (although some countries have higher limits of up to €50,000). The authorities also committed to lift the restriction on early withdrawal of term deposits, once deposit outflows subside.

- The authorities are strengthening the **monitoring of banks**, including via enhanced cross-border supervisory cooperation. The authorities are in the process of concluding MoUs with six home supervisors, covering most of the large foreign-owned banks. Given the external environment, the NBU will regularly monitor parent bank funding to Ukrainian subsidiaries, and develop joint contingency plans for debt rollover.

[1] A total of 15 percent of GDP remains outstanding to about half the population from a commitment made during the early 1990s, after the break-up of the Soviet Union (see Working Paper 08/159).

- The authorities and staff agreed that prompt **resolution of Prominvest Bank**, currently under temporary administration, would be key to restoring confidence. It is critical that this systemic bank (sixth largest) is resolved in a transparent manner. The options discussed included either a sale to a private investor or a merger with a state-owned bank. The authorities are also discussing financing options with the EBRD and IFC.

19. **The program supports the implementation of a comprehensive bank resolution strategy** (MEFP ¶13)**:**

- The authorities will conduct a **diagnostic study** of the large and systemically important banks, involving outside experts and reputable audit firms approved by the NBU and paid by the banks. It was agreed that the final TORs for the diagnostic study would be designed jointly with teams from the IMF and the World Bank to ensure, among other key elements, that asset valuation will be done according to international best practices. It is expected that the diagnostic study would be completed for systemically important banks by December 15, 2008. The NBU has recently completed on-site inspections of most of the large banks which will form the starting point for the diagnostic work and allow for on-time completion.

- The diagnostic phase is to be followed by **recapitalization** of viable banks, to commence in the first quarter of 2009. Viable banks will be asked to inject capital to ensure adequate capitalization levels. It is expected that most of the large institutions, including foreign banks, should be able to raise capital on their own to minimize the cost for the government.[2] However, if needed, banks could apply for public recapitalization funds, available to both domestic and foreign banks, in the context of an acceptable business plan and conditionality. Establishing capital buffers at viable banks will help cushion the economy from a severe credit crunch. The conditionality associated with the access to public funds (including pari-passu contribution, government representation, and limits on activities) will be specified in an NBU regulation, with support from the IMF/WB teams. The authorities agreed that insolvent or nonviable banks would not have access to the recapitalization funds and would be nationalized (if systemically important) or liquidated.

- The **legal framework** to resolve banks has been amended to facilitate prompt and cost-effective bank resolution. The legal changes, adopted by the Parliament in the context of the anti-crisis legislation, include measures that allow NBU to place a bank under temporary administration and conduct purchase and assumption sale of part or

[2] Government participation in banks will be divested over time, as financial conditions stabilize. It is to be expected that the future sale of government shares will allow a partial or full recovery of the recapitalization costs.

whole of a bank, and to reduce the value of the existing shareholders' equity to absorb the losses incurred in the resolution process.

20. **The authorities agreed to adopt international best practices for the disclosure of detailed bank-by-bank financial information**. Greater transparency is needed to maintain confidence in the banking system, access to capital markets, and low borrowing costs.

Fiscal policy

21. **The program supports the authorities' intention to achieve a prudent fiscal stance even while accounting for the need for recession-related social expenditures** (MEFP ¶14). The terms-of-trade shock implies a need for much lower real demand growth, and the discussions revolved around the size of potential demand compression and the scope for financing a higher deficit due to the decline in expected revenues. The size and phasing of fiscal tightening under the program—a 1 percent of GDP deficit in 2008 and balance in 2009—are built primarily on (i) inertial considerations in 2008 (there is limited scope to adjust with two remaining months) and (ii) financing considerations (at present the government can only count on limited treasury bill issuance and some use of its NBU deposits). Staff sees the fiscal targets as attainable, even accounting for a substantial increase in social spending during the recession (0.8 percent of GDP). Important savings can be generated by the incomes and energy policy measures discussed below, but also other measures considered by the authorities (an increase in excise duties, removal of VAT privileges for agriculture in line with WTO commitments), specific measures that staff discussed with the authorities (reducing coal sector subsidies, reducing untargeted transfer programs) and the implementation of last year's nominal budget during the first quarter, since the election will delay passage of the 2009 budget.

22. **It was agreed that, given the uncertainties on economic prospects and the availability of financing, the authorities should stand ready to adjust the fiscal targets as needed** (MEFP ¶15)**.** The final decision on the fiscal stance would need to await the second review, when the 2009 budget will likely be considered. At that time, more information about macroeconomic developments and financing prospects will be available. In the meantime, proactive efforts are needed to develop financing sources, for example, via efforts to develop a primary dealer system for government debt. On a contingent basis, the authorities have started identifying possible fiscal stimulus measures (focused on capital spending) in case GDP would fall more than expected and financing were available. The authorities are also preparing additional tightening measures in case of tax revenue shortfalls (the authorities and staff agreed that there were important downside revenue risks) and/or financing that turned out to be lower than projected.

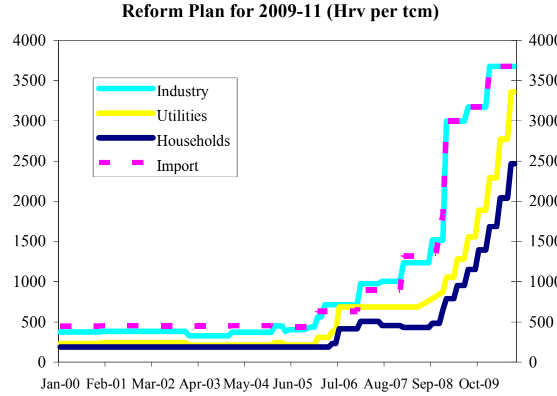
23. **The authorities saw a more balanced incomes policy as key to achieving the fiscal targets** (MEFP ¶16)**.** Implementing existing policy plans would have led to an increase of 33 percent in the minimum wage and 20–34 percent for pensions and other social

payments. Against slow 12 percent nominal GDP growth (due to the terms of trade shock), this would have put heavy pressure on corporate margins (where the minimum wage often binds, at least for tax purposes) and on the budget (squeezing capital and current spending). The authorities' measures are designed to deliver growth of incomes in line with inflation to protect the population while also allowing for competitiveness gains. The absence of such policies would represent a serious risk to program objectives and would not help wage earners: the likely result would be higher inflation and depreciation as the economy endogenously eliminated unsustainable real wage imbalances.

24. **The authorities were also determined to correct energy sector pricing policies** (MEFP ¶17). Consumers in Ukraine now pay only 10–40 percent of the international price of gas. This subsidization encourages overuse (Ukraine is among the least energy-efficient countries), expands the need for very costly imports, and through the required budget subsidy (or unpaid taxes) distorts spending and taxation. The authorities plan to phase out the direct subsidy to consumers over a three year period, and the indirect subsidy (through energy transformers who use gas) by mid-2010. To signal their determination, they announced a 35 percent price increase for December 1. They intend to protect their schedule by reforming the regulatory framework to reduce political influence, in consultation with the World Bank. The policy will add about 1 point to CPI inflation in 2008, and about 4 percent in 2009. However, it will reduce the fiscal subsidy by 0.4 percent of GDP in 2009.

25. **The social safety net was viewed as broadly adequate to protect the vulnerable against adjustment policies, and would be expanded if the need arises** (MEFP ¶18). Unemployment insurance is available to many who could lose jobs. The system covers about 20 million people and provides monthly cash transfers for up to one year, at a minimum benefit of about 60 percent of the minimum wage. The authorities indicated that they would appropriate more funds to this area. Housing and utility allowances are available to those who spend more than 20 percent of their income (15 percent for pensioners) on utilities. Gas tariffs are already set to provide a "lifeline" to smaller users (indeed, half the population falls into this category), which differentiation can be maintained. Finally, there is a program to provide income support to poor households. The World Bank considers this as one of the best targeted programs in Ukraine, and while small (with just 200,000 beneficiaries), it can be expanded simply by raising the low eligibility threshold and by allocating more funding to these programs.

Ukraine: Domestic Gas Tariffs under the Authorities' Reform Plan for 2009-11 (Hrv per tcm)



Ukraine: Various Social Safety Net Programs Currently in Place

	Coverage 1/ (in millions)	Size 2/ (percent of GDP)	Income Threshold 3/ (Hrv per month)
Unemployment insurance	20	0.5	...
Housing and utility allowance	1	0.4	700
Lifeline gas tariffs	7	0.3	...
Income support to poor households	0.2	0.2	350 (working-age) 133 (not working-age)

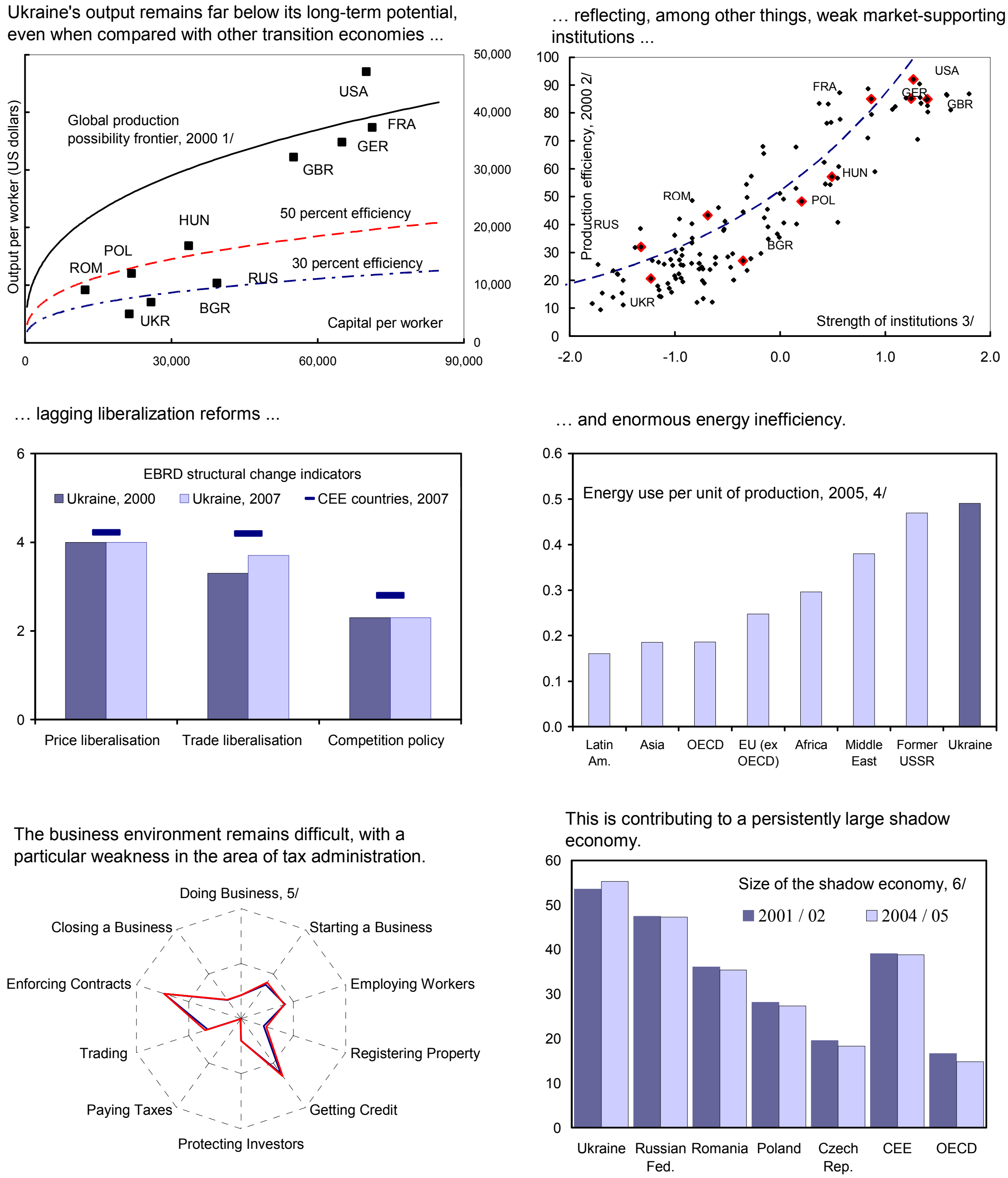
1/ The coverage estimates reflect number of individuals for unemployment insurance and households for other programs.
2/ The size estimates are made by staff based on available data for 2007.
3/ The threshold is based on the average income per person in the household.

The private sector

26. **The resolution of potential corporate and household debt problems was a key concern for the authorities** (MEFP ¶19)**.** Two approaches were considered to address risks stemming from balance sheet exposure to foreign exchange risk, falling demand and a potential credit crunch. There was agreement that a government-facilitated voluntary framework for restructuring debts could prove useful, as in other countries, given the costs of bankruptcy. Regarding the bankruptcy framework, the assessment in the recent FSAP Update provided some guidance, singling out delays in the process as a costly problem. The authorities saw the need to review the legislation, but noted that changes would need to await a resumption of parliamentary activity in the spring.

27. **The authorities also saw it as important to reignite structural reforms to spur new investment and growth** (Table 9, Figure 4) (MEFP ¶20). They expected the recently adapted law on joint stock companies to improve the business environment, and signaled a

Figure 4. Ukraine: Potential output and structural reforms



Sources: Ukrainian authorities; IMF *World Economic Outlook;* International Energy Agency; and staff estimates.

1/ The frontier represents the implicit output level that could be obtained if a country were to employ all its resources efficiently, using global best practices.
2/ Measures how closely (in percent) a country operates to the global production-possibility frontier.
3/ Measured using the principal component of indices compiled from the World Bank Governance Database (ranging from -2.5 to +2.5), comprising rule of law, political stability, control of corruption, government effectiveness, and regulatory quality.
4/ Measured in kilotonnes of oil equivalent per unit of purchasing-power-parity-adjusted GDP.
5/ World Bank Doing Business indicators. Ukraine's rank was transformed into an index, with 10 as the best and 0 as the lowest value.
6/ According to the estimates of Schneider, 2007.

determination to move forward with land reform (opening up the key agricultural sector to additional investment). They expressed a desire to accelerate the privatization of public enterprises despite difficult market conditions. They recognized that a reformed procurement law could unlock foreign financing (including the next tranche of the World Bank's Development Policy Loan). Staff encouraged progress in these areas and additional dialogue with the World Bank.

III. Program Modalities

Program financing

28. **Ukraine faces very large financing needs during the program period.** The staff estimates that at a constant current account deficit, and with debt amortizations totaling some $40 billion (including $13½ in trade credits), gross external financing requirements would amount to about $64 billion in 2009 and only slightly less in 2010.

Table. Ukraine: Gross Financing Requirements and Financing Gaps, 2006-2010
(In millions of U.S. dollars)

	2006	2007	2008	2009	2010
Gross external financing requirements	26,771	40,027	54,460	63,829	62,226
Current account deficit (assumed constant from 2008)	1,617	5,272	*11,686*	*11,686*	*11,686*
Amortization of private sector debt	12,583	18,953	28,762	38,172	39,415
Amortization of public debt	1,692	1,525	1,198	1,448	1,576
Short-term capital outflows	10,880	14,277	12,814	12,523	9,550
Available financing	27,201	40,455	50,105	44,769	50,727
FDI	5,740	9,221	11,659	9,204	10,120
Portfolio flows	2,822	4,423	64	614	1,064
Debt financing	20,680	36,241	38,245	34,233	43,621
Implied rollover rate (percent)	*145*	*177*	*128*	*85*	*106*
Reserve accumulation (- denotes increase)	-1,999	-8,980	138	718	-4,077
Current account adjustment (Cumulative) 1/	0	0	0	8,983	9,153
Remaining financing gap = net use of fund resources	-430	-428	4,355	10,077	2,346
Memorandum items					
Gross Reserves (US$ million)	22,256	32,463	31,445	30,727	34,804
Gross Reserves (in percent of ST debt)	109	108	79	75	78

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

1/ Note that this is an underestimation of the actual current account adjustment since the assumption that the deficit would stay at its 2008 level already implies full adjustment to the large terms-of-trade shocks that Ukraine faces.

29. **In the current climate of global deleveraging, these financing requirements are unlikely to be fully met**. Several groups are expected to have high annual debt rollover rates, including multinationals (intra-company credit lines), and Ukrainian-owned corporates who borrow from related entities offshore. Banks with foreign parents are expected to face moderate reductions in available financing (although some amount for bank recapitalization needs is expected to help prevent a steep drop in FDI). Other banks and corporates are

assumed to face much more significant refinancing problems in the period ahead. For 2009 as a whole, aggregate debt rollover would be 85 percent, a sharp drop from the net financing of previous years (and within year, the pattern is even more pronounced, since annual data obscures peak assumed effects in 2008Q4 through 2009Q2). In dollar terms, expected available external financing amounts to under $45 billion, versus the close to $50 billion in 2007–08 (abstracting from reserve movements).[3] Looking towards 2010, provided that global financial conditions improve, rollover problems should ease, although only limited amounts of net new financing are likely, at least in the first half of the year.

30. **The large financing gaps due to debt rollover complications can only be partially met by substantial domestic adjustment and funding from other sources**. The current account position is expected to adjust sharply under the program scenario, closing about $9 billion of the financing gap in 2009. Flows from other IFIs may help to reduce the gap further. In particular, the World Bank supports Ukraine under a Country Assistance Strategy that makes up to $1.5 billion per year available, while the EBRD also has extensive operations in Ukraine (Informational Annex II-III). Nonetheless, a sizable gap would remain, which, absent Fund financing, would cause official foreign exchange reserves to fall to far below the desirable minimum level, in particular given the large external financing risks associated with adverse global financial conditions.

31. **Against this background, the authorities are requesting a two-year Stand-By Arrangement in the amount of SDR 11 billion (802 percent of quota)**. Fund financing will contribute to covering Ukraine’s balance of payments needs. Following expected initial reserves losses, associated with tactical interventions aimed at facilitating an orderly adjustment of the exchange rate, the financing will be utilized to build Ukraine’s gross international reserves back to a level that is sufficient to cover at least 75 percent of short-term debt obligations. The authorities and the staff concur that such coverage will be crucial for bolstering the confidence of foreign investors in Ukrainian banks and corporates’ ability to honor their international obligations. The arrangement is subject to exceptional access policy. An evaluation of the four substantive criteria for exceptional access in capital account crises is presented in Box 4.[4]

32. **It is proposed that exceptional access be provided on SBA terms.** There is a presumption that exceptional access in capital account crises will be provided using resources of the Supplemental Reserve Facility (SRF) where SRF conditions apply. While Ukraine is

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[3] As discussed below in paragraph 34, rollover assumptions should also be considered relative to program buffers, including conservative assumptions about high energy prices in 2009. Adjusting for the latter, and placing energy prices at what the market considers recession levels ($50 per barrel of oil), would allow for an aggregate rollover rate as low as 75 percent, or gross financing around $40 billion, while maintaining the same financing gap.

[4] The Executive Board discussed a preliminary report on exceptional access on 13 October.

experiencing a capital account crisis, it is also facing a massive terms of trade shock that requires large current account adjustment, as well as substantial problems in the banking sector. The SRF is geared towards "large short-term financing need resulting from a sudden and disruptive loss of confidence reflected in pressure on the capital account and the member's reserves." But in the case of Ukraine effects may not be short lived. Moreover, international financing conditions are such that market access for emerging market economies is subject to large uncertainties. Thus the pressures on the capital account in Ukraine could have a longer duration than envisaged by the SRF. Staff therefore proposes a two-year arrangement with exceptional access under credit tranche terms. Table 12 puts this access in the context of other recent exceptional access requests.

Box 4. Exceptional Access Criteria

Staff assesses that Ukraine meets the criteria for exceptional access:

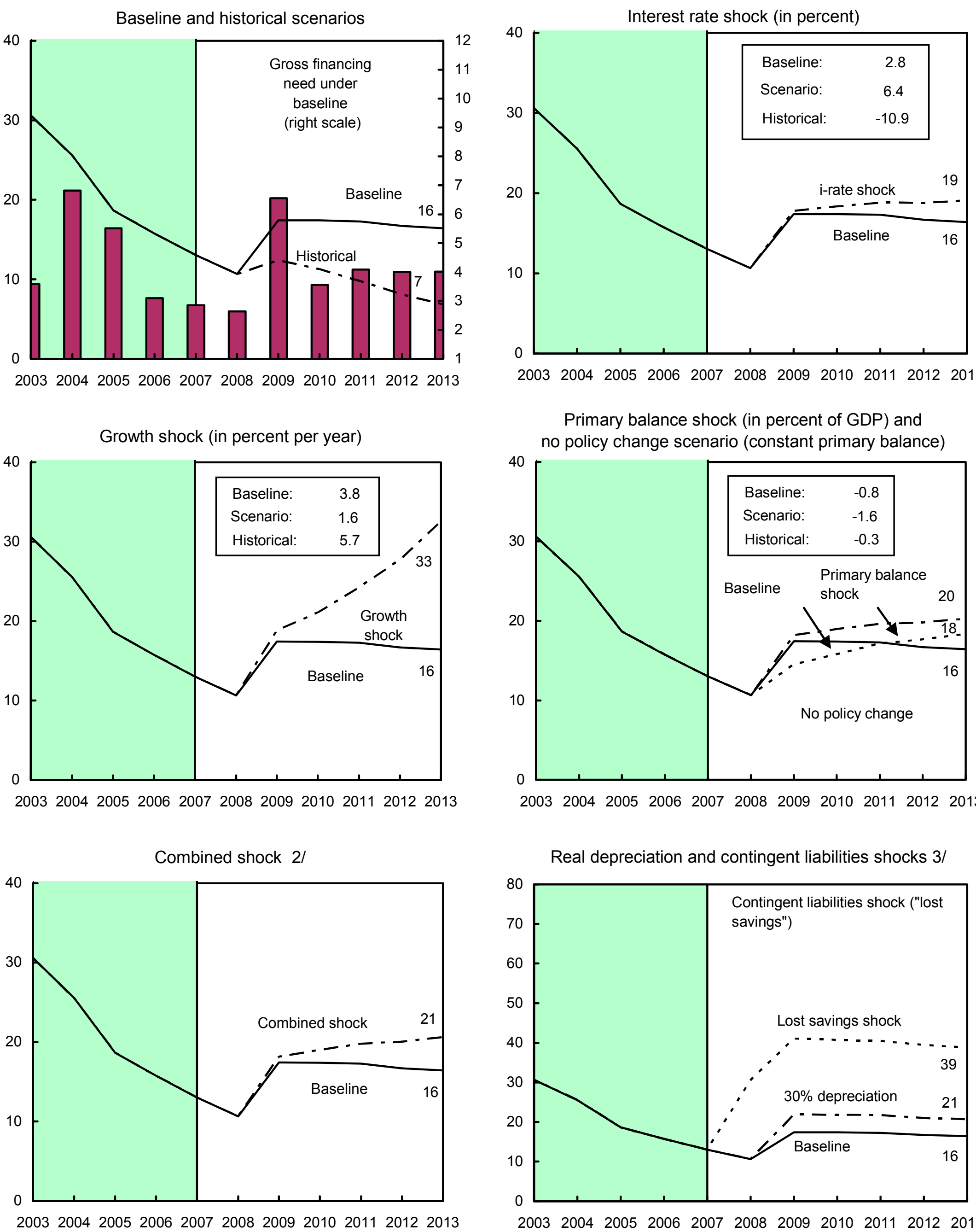
- **Criterion 1—exceptional balance of payments pressure in the capital account.** Ukraine is experiencing both a current and a capital account crisis. The current account is under tremendous pressure due to adverse terms-of-trade developments, and the capital account is being undermined by external financing shortfalls, exacerbated by a banking crisis and related deposit run.

- **Criterion 2—sustainable debt position.** Preliminary calculations by staff indicate that there is a high probability that debt will remain sustainable. Total external debt, at about 50 percent of GDP in 2008, will initially rise due to valuation effects. However, thereafter, external debt is projected to show very favorable dynamics as the current account adjusts and access to debt financing remains curtailed. Stress tests show that external debt would remain sustainable under a variety of shocks, although it would remain at higher levels in the event of substantial further shocks to the current account. Ukraine's low public debt—less than 10 percent of GDP—allows the government to absorb considerable foreign and domestic liabilities, particularly from the banking sector, without threatening fiscal sustainability (Tables 10–11, Figures 5–6).

- **Criterion 3—access to private capital markets.** Ukraine has reasonable prospects to regain access to private capital markets by mid 2010. Global credit-crisis uncertainties notwithstanding, the program would restore the banking sector to health (eliminating a major impetus to outflows), end currency overvaluation, restore competitiveness and unlock investment opportunities (all encouragements for FDI).

- **Criterion 4—strong policy reform program.** The policies outlined above suggest a reasonably strong prospect for success. The authorities would be taking strong and difficult policy measures, many of which upfront, and tailored directly to Ukraine's problems, as explained above. The upfront package would demonstrate decisively that despite political instability, the authorities have the institutional and political capacity to deliver. The core elements of the program have been explained to the leaders of the main political parties, and they have committed to support them.

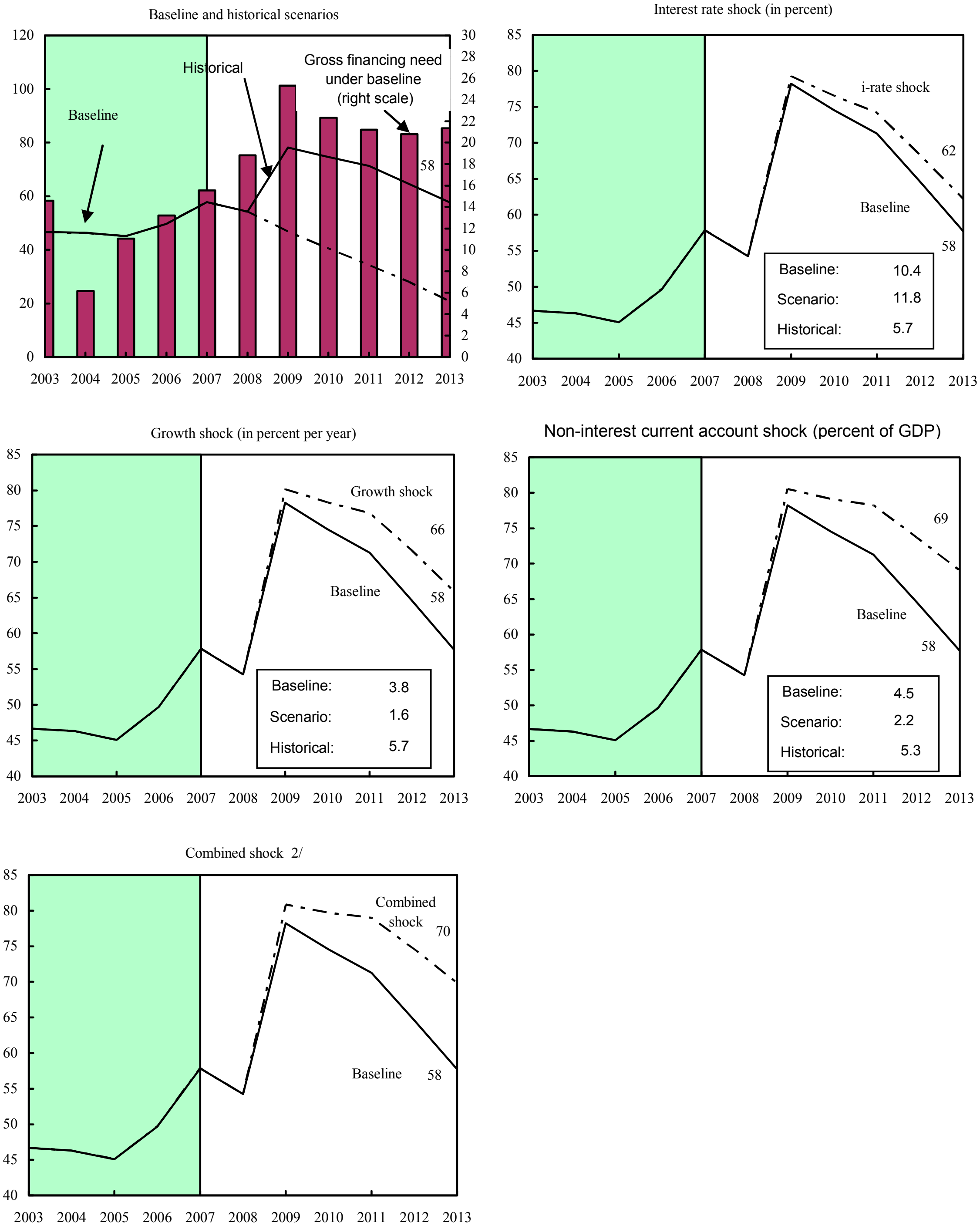
Figure 5. Ukraine: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 20 percent of GDP shock to contingent liabilities occur in 2008 associated with lost savings in USSR's Savings Bank, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 6. Ukraine: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Capacity to repay the Fund and financial risks to the program

33. **Staff believes that the program would leave Ukraine in a position to discharge its obligations to the Fund in a timely manner** (Table 13**).** Fund credit outstanding would peak in 2010 at 47 percent of Ukraine's gross reserves. Peak payments would be in 2012–13, at a manageable 9 and 16 percent of reserves, respectively. The authorities past record provides additional reason for comfort: they have almost completely repaid past loans, taken under programs that originated around the extraordinarily difficult times of Ukraine's last crisis (1998).

34. **Despite the authorities' strong commitment and policy package, there are considerable downside risks to the program**.

- **First, the exchange rate may overshoot**. Despite the room for tactical interventions that has been build into the program, there are no guarantees that the exchange rate will not depreciate beyond its estimated equilibrium level in a short period of time, which would pose risks for households and banks. The upfront banking recapitalization provides a cushion for this.

- **Second, external economic and financial developments are highly uncertain**. Worse than expected outcomes for the world economy or international financial markets could affect the program through various channels. In particular, a greater slowdown of trading partner growth and/or a significant further decline in steel prices would lead to a further deterioration of the outlook for the current account. A further deepening, or exceptionally long duration, of the ongoing process of deleveraging in financial markets could well reduce prospects for a return to market access.

- **Third, the outlook for external debt is subject to risks**. The DSA analysis indicates that there is a high likelihood for debt to remain sustainable, even under a variety of possible further shocks. Nonetheless, further adverse current account developments, exchange rate overshooting, or possible shortfalls in FDI, could negatively affect the outlook for external debt. It should also be noted that there may be adverse consequences on access to markets and the costs for such access given the likelihood of some private sector defaults.

- **Fourth, the political situation in Ukraine remains challenging**. Domestically, Ukraine's turbulent politics pose risks, in particular in view of possible early parliamentary elections in December and presidential elections slated for January 2010. In this context, the mission team explained the core elements of the program to the leaders of the main opposition parties, and they have committed to support the policies underlying the program.

35. **Upside risks include commodity price developments, or faster resumption of external financing access**. Baseline assumptions on oil and gas import prices are

substantially higher than many market estimates of prices under a scenario of global recession; conversely, if there is no global recession, steel prices are likely to higher than assumed. This suggests that there is a reasonable chance of a better-than-projected current account position in 2009. And of course financing could resume at a faster-than-expected rate. In that case, the program would then call for some further reserve build up. To the extent growth began to recover faster than expected, this would inform decisions about the fiscal stance.

Program monitoring

36. **The program will cover two years and be subject to quarterly reviews.** The arrangement will be considerably frontloaded, in light of the expected large financing gaps early on in the program, with an initial disbursement of SDR 3 billion. In line with the procedures of the emergency financing mechanism, staff intends to inform the Executive Board on initial policy responses and the reaction of markets to these policies within one to two months of the approval of the program.

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

Review	Date Available	Purchases In millions of SDRs	Purchases In percent of quota	Conditions include
	November 2008	3,000	218.7	Board approval of arrangement
First Review	15 February 2009	1,250	91.1	Observance of end-December performance criteria and completion of the first review
Second Review	15 May 2009	2,500	182.2	Observance of end-March performance criteria and completion of the second review
Third Review	15 August 2009	750	54.7	Observance of end-June performance criteria and completion of the third review
Fourth Review	15 November 2009	2,000	145.8	Observance of end-September performance criteria and completion of the fourth review
Fifth Review	15 February 2010	375	27.3	Observance of end-December performance criteria and completion of the fifth review
Sixth Review	15 May 2010	375	27.3	Observance of end-March performance criteria and completion of the sixth review
Seventh Review	15 August 2010	375	27.3	Observance of end-June performance criteria and completion of the seventh review
Eighth Review	15 October 2010	375	27.3	Observance of end-September performance criteria and completion of the eighth review
Total		11,000	802	

Source: IMF staff calculations.

37. **The authorities are undertaking several prior actions to support their request for the arrangement** (Box 5). These include measures to clarify the flexible exchange rate regime; resolve the sixth largest bank which has been intervened; and the legal amendments to allow for allocation of funding for the bank recapitalization scheme and prompt and cost-effective resolution of problem banks.

38. **Performance will be monitored by quarterly quantitative performance criteria and structural performance criteria and benchmarks**. They include the diagnostic of large and systemically important banks by December 15, 2008 (first review), the passage of a program-consistent budget by end April (second review), and the resolution of all problem banks by end June 2009 (third review). Quantitative performance criteria include a ceiling on base money (with leeway to accommodate management of liquidity pressures in the banking system); a ceiling on the budget deficit of the general government with adjusters for non-project financing and the cost of the bank recapitalization; and a floor for net international reserves. Regarding the latter, 70–75 percent reserve coverage of short-term debt is the target

Box 5: Rationale for the Proposed Structural Conditionality under the Stand-By Arrangement

Monetary and Exchange Rate Policies

On top of an already large current account deficit, Ukraine faces a large terms-of-trade shock owing to falling steel prices, and expected increases in gas import prices. More exchange rate flexibility is crucial to facilitate adjustment to this shock. For this reason, implementing actions in support of a flexible exchange rate regime is made a prior action (A1, MEFP ¶8).

Two further structural benchmarks pertain to key supporting measures for the operations of the flexible exchange rate regime. First, to facilitate unimpeded foreign exchange transactions, it is important that the foreign exchange tax be abolished (benchmark for the second review, B4, (MEFP ¶8)). Second, it is key that the central bank has sufficient independence in its conduct of monetary and exchange rate policies. Strengthening the NBU's independence, including by reforming the NBU council, is therefore a benchmark for the third review (B6, MEFP ¶10).

Banking Sector Issues

Major strains are showing in the banking sector, and urgent and decisive actions are needed to restore confidence in the banking system. Against this background, issuing a Law or a Decree laying out the terms of financial support to banks (A2, MEFP ¶12) is a prior action. The completion of a diagnostic study by December 15, 2008 covering NBU's group 1 banks—indispensable to identify the key problem areas in the banking system—is a performance criterion for the first review (B1, MEFP ¶12). And decisive follow up by resolving all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated, is a performance criterion for the third review (B2, MEFP ¶12).

The problems at Prominvest bank—Ukraine's sixth largest bank—are known, however, and have been casting a shadow over the banking system in recent weeks. A decisive, immediate resolution of this bank is crucial to begin restoring confidence, and is therefore also a prior action (A4, MEFP ¶11).

To effect these actions, it is essential that the central bank has the appropriate powers and tool set to undertake quick action. For this reason, a making the necessary legal amendments authorizing the NBU to undertake the necessary bank resolution process is also a prior action (A3, MEFP ¶12).

Fiscal Policies

While government debt is low, spending increases have been very high and the underlying fiscal deficit has been deteriorating sharply in recent years. With financing in short supply, it is inevitable that government spending be brought back to more sustainable levels. For this reason, passing a program-consistent 2009 Budget consistent with a general government deficit target of a zero overall balance, is a performance criterion for the second review (B3, MEFP ¶13).

for 2009, and this will rise slowly thereafter (allowing some leeway for tactical interventions). While ideally higher reserves would be desirable to provide assurances in the present international environment of deleveraging, the move to a flexible exchange rate creates an important buffer.

39. **Safeguards**. To comply with the safeguards policy, an update safeguards assessment will need to be completed by the first review of the proposed arrangement. In this context, the authorities need to provide a range of documentation that includes some confidential information, and to work with a separate FIN mission.

IV. Staff Appraisal

40. **The Ukrainian economy and the banking system have been hit very hard by the sharp decline in steel prices and the reversal of capital flows**. Falling prices for Ukraine's major export, steel, have led to a rapid deterioration in Ukraine's current account outlook. This shock, along with existing vulnerabilities—high inflation, high short-term external debt relative to reserves, high exposure of banks to foreign funding, balance sheet mismatches, and a weak underlying fiscal position—have also made the country a target for a sudden stop in capital flows.

41. **The authorities' new two-year program, for which they are seeking support under a Fund arrangement, lays out a strategy to restore financial and macroeconomic stability**. The program employs a multi-sector strategy covering exchange rate, monetary, banking sector and fiscal policies. Resolute implementation should help restore growth to Ukraine's estimated potential rate by mid-2011, bring inflation back into single digits in late 2010, keep external deficits manageable, and preserve international reserves at safe levels.

42. **Continued implementation of the flexible exchange rate regime should help cushion the economy against the terms-of-trade shock**. The measures adopted in late October 2008, including unification of official and market exchange rates, are expected to increase clarity about the regime and will be complemented by a transparent intervention strategy grounded in appropriate reserve targets. The authorities will also accelerate progress towards a new nominal anchor for monetary policy—inflation targeting—with a near-term focus on enhancing the National Bank of Ukraine's independence.

43. **Monetary policy will need to be tightened going forward**. Financial stability needs predominate at present, and the strategy of liquidity provision through reductions in effective reserve requirements, and liberal collateral rules for refinancing should continue. However, refinancing against banks' own equity should be rapidly phased out, to contain risks to the central bank balance sheet. As liquidity pressures abate, higher interest rates and restoration of full reserve requirements will prove necessary to guard against inflation and currency depreciation.

44. **Actions taken to date provide a sound basis to restore confidence in the banking system, but more will need to be done**. The resolution of Prominvest Bank removes a major shadow hanging over the financial system. The increase in deposit insurance, backed up by new resources allocated to the Deposit Insurance Fund, is a credible signal to depositors. To guard against setbacks, the program envisages that the National Bank will enhance its high frequency monitoring system, step up targeted on-site inspections, and improve cross-border supervisory cooperation (to assess risks emanating from parents of major Ukrainian banks).

45. **A pre-emptive recapitalization program will help stabilize the financial system and alleviate credit-crunch pressures that could otherwise prolong and deepen the downturn in economic activity**. Recapitalization will be preceded by a diagnostic phase led by reputable auditors to lend credibility. Staff welcomes the legal changes passed by the authorities to allocate public funds to recapitalize banks and facilitate prompt bank resolution processes. Key changes include allowing purchase and assumption, sale of part or whole of a bank, and reduction in the value of the existing shareholders' equity to absorb losses incurred.

46. **A tight fiscal stance is needed in light of financing constraints, but this should be reviewed at the time of the budget.** For 2008, curtailed market access and the need to preserve government deposits at manageable levels place a limit of about 1 percent of GDP on the deficit that can be run. For 2009, uncertainties about available finance call for a balanced budget. This should be feasible through cuts in planned wage and transfer increases and reductions in subsidies. The new budget, not expected until the spring, will provide an opportunity to reassess the macroeconomic, financing, and revenue outlooks, and the appropriate policy stance.

47. **Fiscal adjustment policies need to be balanced against the need to protect the most vulnerable**. Nominal wage and transfer restraint along with energy tariff increases will be needed to reduce pressures for inflation and currency depreciation, and to contain large fiscal risks. But adjustment can be achieved by keeping incomes growth in line with targeted inflation, and by phasing in tariff increases while preserving a lifeline tariff. The population can also be protected by Ukraine's extensive social safety net, and in this context budget allocations should be increased for unemployment insurance and targeted income support.

48. **A proactive strategy will be needed to involve the private sector in resolving Ukraine's problems**. Fast resolution of any corporate and household debt problems would be important to prevent a deep output decline. Voluntary debt rescheduling frameworks and an amended bankruptcy framework should facilitate this objective. The private sector should also be encouraged to bring resources into Ukraine, and in this context, the structural reform agenda will need to be reinvigorated, with a near-term focus on key measures like establishing a functioning agricultural land market and reviving privatization.

49. **The exceptional level of access under the proposed arrangement (802 percent of quota) addresses Ukraine's balance of payments financing needs while keeping Fund**

exposure manageable. In the absence of Fund financing, capital account shortfalls would drive Ukraine's reserves to low levels, making roll over of external debts difficult, especially in the present environment of global deleveraging. The proposed level of access would leave external debt sustainable, and a resumption of market access is considered very likely by 2010. Through prior actions the authorities have shown their ability to deliver on their commitments. The Fund's exposure to Ukraine would remain under 50 percent of reserves.

50. **In view of Ukraine's balance of payments financing needs and the strong policies proposed by the authorities, the staff supports the authorities' request for an arrangement in the amount of SDR 11 billion**.

Table 1. Ukraine: Selected Economic and Social Indicators, 2004–09 1/ 2/ 3/

	2004	2005	2006	2007	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)						
Nominal GDP (billions of hryvnias)	345	441	544	713	993	1,112
Real GDP	12.1	2.7	7.3	7.6	6.0	-3.0
Contributions:						
Domestic demand	9.1	13.2	13.1	16.1	14.4	-14.3
Net exports	3.0	-10.5	-5.8	-8.5	-8.3	11.3
Unemployment rate (ILO definition; percent)	8.6	7.2	6.8	6.4	6.0	9.5
Consumer prices (period average)	9.0	13.5	9.1	12.8	25.6	21.0
Consumer prices (end of period)	12.3	10.3	11.6	16.6	25.5	17.0
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	37.1	10.5
Real monthly wages (average)	16.9	20.4	18.4	15.0	9.1	-8.7
Public finance (percent of GDP)						
Cash balance excluding banks. recap (both injection and interests)	-4.4	-2.3	-1.4	-2.0	-1.0	0.0
Augmented balance, including effects of banks recap. 3/	-4.4	-2.3	-1.4	-2.0	-2.0	-4.5
Privatization proceeds	3.1	5.0	0.4	0.6	0.2	0.1
Net domestic financing	-0.1	-3.3	-0.4	0.3	1.8	4.4
Net external financing	1.4	0.6	1.3	1.0	0.0	0.0
Public debt 3/	25.5	18.7	15.7	13.0	10.6	17.4
Of which: external debt (foreign currency denominated)	19.2	14.1	12.5	10.2	7.4	10.0
Money and credit (end of period, percent change)						
Base money	34.1	53.9	17.5	46.0	33.0	10.9
Broad money	31.9	54.4	34.5	51.7	37.2	9.4
Credit to nongovernment	30.2	61.8	70.6	74.0	40.9	-9.8
Velocity	2.7	2.3	2.1	1.8	1.8	1.9
Interbank overnight rate (annual average, percent)	6.3	4.2	3.6	2.3	…	…
Balance of payments (percent of GDP)						
Current account balance	10.6	2.9	-1.5	-3.7	-6.2	-2.0
Foreign direct investment	2.6	8.7	5.3	6.5	6.2	6.8
Gross reserves (end of period, billions of U.S. dollars)	9.5	19.4	22.3	32.5	31.4	30.7
In months of next year's imports of goods and services	2.6	4.4	3.7	4.0	5.1	4.5
Debt service (in percent of exports of goods and services)	5.3	4.9	5.1	3.9	2.8	4.2
Goods exports (annual volume change in percent)	18.2	-8.5	2.7	3.2	0.3	0.8
Goods imports (annual volume change in percent)	13.8	13.0	12.5	20.3	16.0	-19.7
Goods exports	51.5	40.7	36.1	35.2	35.3	39.9
Goods imports	45.8	42.0	40.9	42.7	44.8	46.4
Share of metals in merchandise exports (percent)	39.0	40.1	42.2	41.7	44.5	30.3
Net imports of energy (billions of U.S. dollars)	6.0	6.1	8.1	11.5	17.2	16.0
Goods terms of trade (percent change)	9.6	6.2	-0.2	9.0	7.8	-14.5
Goods and services terms of trade (percent change)	7.8	4.9	1.5	7.4	8.9	-10.5
Exchange rate						
Exchange rate regime	*de facto peg*				*managed float*	
Hryvnia per U.S. dollar, end of period	5.3	5.0	5.0	5.0	…	…
Hryvnia per U.S. dollar, period average	5.3	5.1	5.1	5.0	…	…
Real effective rate (CPI, percent change)	-1.4	12.0	4.8	2.6	…	…

Social indicators

Per capita GDP: US$ 3035 (2007); Poverty (percent of population): 8.0 (2006; World Bank estimate);
Life expectancy at birth: 68.3 years (2007); Infant mortality (per 1,000): 11.0 (2007); Gross primary enrollment (percent net): 90.2 (2007)

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Policies assumed here include: (i) increased exchange rate flexibility as from 2008; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2010; (iii) full pass-through of rising energy import prices in 2009; (iv) public-financed recapitalization of banks for a total amount of Hrv 54 bln (10 bln by end-2008 and 44 bln in the first half of 2009).
2 The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
3/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises.
Debt figures do not include IMF money.

Table 2. Ukraine: Selected Vulnerability Indicators, 2004–08

	2004	2005	2006	2007	2008	Latest observation
Financial Market Indicators						
Short-term (ST) interest rate (in percent) 1/	16.3	2.9	2.1	3.8	15.0	24-Oct-08
EMBI secondary market spread (bps, end of period)	264	184	172	303	2,250	24-Oct-08
Foreign currency debt rating 2/	B1	B1	B1	B1	B1	24-Oct-08
Exchange rate NC/US$ (end of period)	5.3	5.1	5.1	5.1	5.9	24-Oct-08
Stock market index (PFTS)	260.1	353.0	498.9	1,174.0	230.9	24-Oct-08
Broad money to gross reserves (percent)	249.1	198.2	232.3	241.7	224.6	24-Oct-08
External Sector						
Exchange rate regime	de facto peg to U.S. dollar				managed float	
Current account balance (percent of GDP)	10.6	2.9	-1.5	-3.7	-6.2	Proj
Net FDI inflows (percent of GDP)	2.6	8.7	5.3	6.5	6.2	Proj
Exports (percentage change of US$ value, GNFS)	40.8	4.8	11.2	28.0	33.4	Proj
Real effective exchange rate (percent change) 3/	-1.4	12.0	4.8	2.6	12.2	Proj
Gross international reserves (GIR) in US$ billion	9.5	19.4	22.3	32.5	31.5	Proj
GIR in percent of ST debt at remaining maturity (RM)	87.4	161.0	108.7	108.3	79.4	Proj
GIR in percent of ST debt at RM and banks' FX deposits	57.3	92.0	79.0	84.7	57.3	Proj
Net international reserves (NIR) in US$ billion	7.9	18.2	21.4	32.0	26.7	Proj
Total gross external debt (ED) in percent of GDP 4/	46.3	45.1	49.7	57.8	54.3	Proj
o/w ST external debt (original maturity, in percent of total ED)	35.0	28.2	28.4	27.5	29.6	Proj
ED of domestic private sector (in percent of total ED)	57.2	65.2	72.3	81.0	80.9	Proj
ED to foreign official sector (in percent of total ED)	17.8	16.2	11.0	7.4	6.0	Proj
Domestically issued public debt held by non-residents (in percent of GDI	0.6	1.5	0.6	0.6	0.3	Proj
Total gross external debt in percent of exports of GNFS	74.4	87.1	106.8	128.0	121.4	Proj
Gross external financing requirement (in US$ billion)	6.4	14.1	16.2	18.7	26.4	Proj
Public Sector (PS) 6/						
Overall balance (percent of GDP)	-4.4	-2.3	-1.4	-2.0	-2.0	Proj
Debt-stabilizing primary balance (percent of GDP) 5/	-5.9	-5.4	-2.9	-3.4	-3.0	Proj
Gross PS financing requirement (in percent of GDP) 7/	7.6	3.6	2.4	3.0	3.1	Proj
Public sector gross debt (PSGD, in percent of GDP) 8/	25.5	18.7	15.7	13.0	10.6	Proj
o/w Exposed to rollover risk (in percent of total PSGD)	42.8	51.1	54.2	56.4	52.9	Proj
Exposed to exchange rate risk (in percent of total PSGD)	75.2	75.6	79.1	78.6	69.3	Proj
Public sector net debt (in percent of GDP)	23.3	13.9	11.7	10.3	9.2	Proj

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

1/ Overnight interbank rate. Monthly average for December or month of latest observation.
2/ Moody's Investors Service. Note that Fitch and Standard & Poor's upgraded Ukraine from B+ to BB- in January and May 2005, respectively.
3/ Period averages; (+) represents real appreciation; based on CPI and INS trade weights (1999-2001).
4/ June 2006 private sector debt is estimated.
5/ Does not include domestically issued public debt held by nonresidents.
6/ Public sector covers the consolidated government. It excludes public enterprises. Public debt also includes arrears and debt by the central bank.
7/ Overall balance plus debt amortization.
8/ Public debt figures exclude IMF money.

Table 3. Ukraine: Medium-Term Balance of Payments, 2006–13 1/ 2/ 3/
(In million of U.S. dollars, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012	2013
Current account balance	-1,617	-5,272	-11,686	-2,703	-2,534	-4,352	-4,564	-6,969
Merchandise trade balance	-5,194	-10,572	-17,779	-8,725	-7,829	-8,584	-9,609	-11,017
Exports	38,949	49,840	66,490	54,201	61,591	68,138	75,001	81,985
Imports	-44,143	-60,412	-84,269	-62,926	-69,420	-76,722	-84,610	-93,002
Services (net)	2,126	2,420	3,475	5,419	5,843	5,332	6,556	4,933
Receipts 2/	11,290	14,161	17,669	17,072	18,110	18,430	20,774	20,321
Payments	-9,164	-11,741	-14,194	-11,653	-12,267	-13,098	-14,218	-15,388
Income (net)	-1,722	-659	-1,311	-3,606	-5,138	-6,098	-6,944	-6,781
o/w: Interest on public debt 3/	-892	-1,001	-1,144	-1,555	-1,896	-1,894	-1,913	-1,870
Current transfers (net)	3,173	3,539	3,928	4,209	4,590	4,998	5,432	5,896
Financial and capital account	4,088	15,130	7,193	-8,092	4,265	9,439	14,103	18,020
Direct investment and capital transfers (net)	5,740	9,221	11,659	9,204	10,120	11,089	12,573	13,777
Portfolio investment (excluding government bonds)	2,822	4,423	64	614	1,064	1,464	2,164	2,564
Bonds and medium and long-term loans (net)	6,406	15,763	8,284	-5,386	2,630	4,480	5,999	7,472
Private sector loans	5,797	13,931	8,757	-5,380	2,420	3,320	4,120	4,920
Bonds and loans (official)	609	1,832	-473	-6	210	1,160	1,879	2,552
o/w: Disbursements	3,239	4,244	389	1,351	1,786	2,497	2,682	3,099
Repayments 2/ 3/	-2,630	-2,412	-862	-1,358	-1,576	-1,337	-802	-547
o/w: Foreign-currency	1,158	1,654	-203	119	-29	885	1,435	2,135
Domestic -currency	-549	178	-270	-125	239	275	444	417
Short-term capital (net)	-10,880	-14,277	-12,814	-12,523	-9,550	-7,594	-6,633	-5,793
Errors and omissions	-42	-450	0	0	0	0	0	0
Overall balance	2,429	9,408	-4,493	-10,795	1,731	5,087	9,538	11,051
Gross official reserves (- is increase)	-1,999	-8,980	138	718	-4,077	-5,087	-5,432	-3,182
Net use of IMF resources	-430	-428	4,355	10,077	2,346	0	-4,106	-7,869
Memorandum items:								
Total external debt 3/	53,633	81,939	102,218	106,171	111,566	117,067	120,470	121,922
Total external debt (In percent of GDP)	49.7	57.8	54.3	78.2	74.6	71.3	62.4	52.1
Current account (in percent of GDP)	-1.5	-3.7	-6.2	-2.0	-1.7	-2.6	-2.4	-3.3
Excluding transfers	-4.4	-6.2	-8.3	-5.1	-4.8	-5.7	-5.4	-6.1
Debt service ratio (in percent of exports of goods and services) 2/ 3/	5.1	3.9	2.8	4.2	4.4	3.7	7.1	10.1
o/w: Interest payments	1.8	1.6	1.4	2.2	2.4	2.2	2.0	1.8
Gross international reserves (end of period)	22,256	32,463	31,445	30,727	34,804	39,891	45,323	48,505
In months of next year's imports of goods and services	3.7	4.0	5.1	4.5	4.6	4.8	5.0	4.9
Over next year's official debt service	5.8	-13.8	10.5	8.9	10.8	5.8	4.4	...
Merchandise export values (percent change)	11.2	28.0	33.4	-18.5	13.6	10.6	10.1	9.3
Merchandise import values (percent change)	22.1	36.9	39.5	-25.3	10.3	10.5	10.3	9.9
Merchandise export volume (percent change)	2.7	3.2	0.3	0.8	10.7	8.0	7.6	6.9
Merchandise import volume (percent change)	12.5	20.3	16.0	-19.7	5.0	8.3	8.3	8.0
Goods terms of trade (percent change)	-0.2	9.0	7.8	-14.5	-2.3	0.4	0.5	0.4
Goods and services terms of trade (percent change)	1.5	7.4	8.9	-10.5	-0.2	0.9	0.8	0.8

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

1/ Recommended policies include increased flexibility of the hryvnia/U.S. dollar exchange rate, which would hold GIR above 3 months of imports.
2/ Includes lease receipts and offsetting repayments under the Black Sea Fleet debt swap agreement.
3/ Public and publicly-guaranteed debt, on a residency basis.

Table 4. Ukraine: Monetary Accounts, 2004–10 1/

	2004 Dec.	2005 Dec.	2006 Dec.	2007 Dec.	2008 Dec.	2009 Dec.	2010 Dec.
			(In millions of hryvnias)				
Monetary Survey							
Net foreign assets	43,877	81,842	66,717	50,978	-17,080	-91,422	-94,120
Net domestic assets	81,828	112,229	194,346	345,179	560,607	685,773	794,226
Domestic credit	107,923	144,892	247,037	436,285	636,387	669,238	775,759
Net claims on government	13,509	-7,180	-7,821	-6,658	12,482	106,301	117,800
Credit to the economy	89,195	144,277	246,156	428,347	603,346	544,386	636,277
Other claims on the economy	5,220	7,796	8,702	14,597	20,560	18,551	21,682
Other items, net	-26,095	-32,663	-52,691	-91,107	-75,780	16,536	18,467
Broad money	125,705	194,071	261,063	396,156	543,527	594,352	700,106
Currency in circulation	42,345	60,231	74,984	111,119	160,994	172,317	199,366
Total deposits	83,138	132,914	184,430	280,154	375,833	414,708	492,109
Domestic currency deposits	52,835	87,296	114,274	190,287	221,228	241,729	279,997
Foreign currency deposits	30,303	45,617	70,155	89,867	154,605	172,979	212,112
Money market instruments	222	925	1,650	4,884	6,700	7,327	8,630
Accounts of the National Bank of Ukraine							
Net foreign assets	43,573	94,016	110,916	164,859	193,374	141,553	165,050
Net international reserves 2/	43,127	91,472	106,938	157,948	186,374	134,553	158,050
Net domestic assets	10,190	-11,256	-13,702	-22,958	2,394	74,766	86,407
Net domestic credit	15,089	-10,266	-8,127	-7,856	18,265	36,467	33,166
Net claims on government	12,736	-8,149	-8,949	-6,274	-1,090	-1,887	-11,188
Claims on government	18,001	10,315	9,676	9,058	9,058	9,058	9,058
Liabilities government	5,264	18,464	18,625	15,332	10,147	10,945	20,246
Net claims on the economy	41	76	169	165	165	165	165
Net claims on banks	2,312	-2,193	653	-1,748	25,189	40,189	45,189
Other items, net	-4,899	-991	-5,575	-15,102	-15,870	38,299	53,240
Base money	53,763	82,760	97,214	141,901	188,768	209,319	244,457
Currency in circulation	42,345	60,231	74,984	111,119	160,994	172,317	199,366
Banks' reserves	11,418	22,528	22,231	30,782	27,774	37,002	45,090
Cash in vault	3,324	5,178	7,150	11,352	14,924	16,797	19,932
Required reserves	5,862	9,853	4,080	9,683	0	10,368	12,303
Excess reserves	2,232	7,498	11,001	9,748	12,850	9,838	12,856
Deposit Money Banks							
Net foreign assets	303	-12,175	-44,199	-113,882	-210,454	-232,975	-259,170
Net domestic assets	82,656	144,919	228,433	393,620	586,287	647,683	751,279
Domestic credit	97,564	169,322	268,275	459,600	642,088	666,294	782,584
Net claims on government	773	969	1,128	-384	13,571	108,188	128,988
Credit to the economy	89,050	144,129	245,973	428,146	603,145	544,185	636,076
Other claims on the economy	5,220	7,796	8,702	14,597	16,786	15,108	16,618
Banks' reserves	11,418	22,528	22,231	30,782	27,774	37,002	45,090
Other items, net	-14,908	-24,402	-39,842	-65,981	-55,802	-18,612	-31,305
Banks' liabilities	82,959	132,745	184,234	279,738	375,833	414,708	492,109
Demand deposits	31,593	48,115	61,136	90,364	...	...	...
Time deposits	51,366	84,629	123,098	189,374	...	...	...
Memorandum items:							
			(Percentage change year-over-year)				
Base money	34.1	53.9	17.5	46.0	33.0	10.9	16.8
Broad money	31.9	54.4	34.5	51.7	37.2	9.4	17.8
Credit to the economy 3/	30.2	61.8	70.6	74.0	40.9	-9.8	16.9
			(Ratio)				
Velocity of broad money 4/	2.75	2.27	2.08	1.80	1.83	1.87	1.87
Money multiplier	2.34	2.34	2.69	2.79	2.88	2.84	2.86
			(In percent)				
Foreign currency loans to total loans	42.1	43.2	49.4	49.8	57.5	60.0	53.5
Foreign currency deposits to total deposits	36.4	34.3	38.0	32.1	41.1	41.7	43.1

Sources: National Bank of Ukraine and IMF staff calculations.

1/ Program scenario. See policy assumptions in footnote 1 of Selected economic Indicators Table.
2/ Projected NIR are at projected exchange rates.
3/ Adjusting for projected loan write-offs in 2009, the growth rate would be about 8 percent.
4/ Based on nominal GDP over the last four quarters.

Table 5. Ukraine: Financial Soundness Indicators for the Banking Sector, 2006–08
(In percent, unless otherwise indicated)

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08
Ownership								
Number of banks	170	173	173	174	175	176	178	181
Private	168	171	171	172	173	174	176	179
Domestic	133	131	129	128	126	127	127	129
Foreign	35	40	42	44	47	47	49	50
o/w: 100% foreign-owned	13	18	17	16	17	17	18	18
State-owned	2	2	2	2	2	2	2	2
Foreign-owned banks' share in statutory capital	27.6	29.8	32.8	35.0	35.0	36.7	40.5	39.8
Concentration								
Share of assets of largest 10 banks	52.4	53.0	52.5	51.6	49.7	49.8	49.4	...
Share of assets of largest 25 banks	74.3	74.6	75.4	75.2	75.2	75.0	74.9	...
Number of bank with assets less than $150 million	109	113	100	97	85	86	83	...
Capital Adequacy								
Regulatory capital to risk-weighted assets	14.2	14.0	14.0	13.9	13.9	13.3	13.4	13.6
Capital to total assets	13.3	12.9	12.4	12.5	12.5	13.1	12.9	13.0
Asset Quality								
Credit growth (year-over-year)	70.7	73.0	75.6	75.1	74.1	76.2	64.1	54.1
Credit to GDP ratio	45.2	47.7	51.6	55.6	60.1	62.7	60.8	63.1
Change of loan to GDP ratio (percentage points)	12.6	13.3	14.3	14.6	14.9	15.0	9.2	9.3
NPLs to total loans 1/ 2/	17.8	17.6	16.5	14.8	13.2	13.1	13.6	14.5
NPLs (excl. part of timely serviced substandard loans) 1/ 3/	4.2	4.2	3.7	3.3	3.2	3.2	3.7	3.6
NPLs net of provisions to capital	93.6	99.1	94.2	82.2	72.9	70.6	74.4	78.1
Specific provisions to NPLs 4/	23.1	20.8	23.7	25.9	26.3	26.7	26.3	26.0
Specific provisions to total loans	4.8	4.7	4.7	4.5	4.2	4.1	4.1	4.3
Foreign Exchange Rate Risk								
Loans in foreign currency to total loans	49.4	50.8	51.2	51.5	49.8	49.4	49.3	51.2
Deposits in foreign currency to total deposits	38.1	38.8	36.5	34.6	32.1	33.1	32.5	31.8
Foreign currency loans to foreign currency deposits	173.3	183.7	206.0	220.8	237.2	238.8	245.5	269.2
Total net open positions in foreign currency to regulatory capital	8.4	9.3	9.1	8.7	7.0	7.7	7.7	7.1
Banks net foreign assets to capital	-93.4	-100.5	-127.1	-137.7	-147.1	-143.8	-143.2	-160.7
Total foreign currency assets (incl. loans) to total foreign currency liabilities (incl. deposits)	106.3	108.3	106.4	107.6	105.3	106.3	107.7	107.5
Total short-term foreign currency assets (incl. loans) to total short-term foreign currency liabilities (incl. deposits)	158.6	149.7	129.7	131.5	115.6	130.7	133.6	158.5
Liquidity Risk								
Liquid assets to total assets	12.6	11.4	11.8	11.0	10.3	8.9	9.2	8.9
Customer deposits to total loans to the economy	74.9	71.2	67.9	67.2	65.3	62.4	61.8	59.8
Long-term assets to long-term liabilities	89.7	91.0	93.4	94.7	95.3	93.7	93.5	92.3
Short-term assets to short-term liabilities	120.6	118.2	112.9	110.7	110.0	114.2	114.2	119.4
Earnings and Profitability								
Return on assets (after tax; end-of-period)	1.6	1.6	1.4	1.4	1.5	1.4	1.3	...
Return on equity (after tax; end-of-period)	13.5	12.7	11.3	11.6	12.7	11.4	11.2	...
Net interest margin to total assets	5.3	4.9	4.9	4.9	5.0	4.8	5.0	...
Interest rate spreads (percentage points; end-of-period)								
Between loans and deposits in domestic currency	7.2	5.9	6.5	5.4	5.8	6.3	7.6	...
Between loans and deposits in foreign currency	5.4	5.6	5.5	5.5	4.9	5.2	8.3	...
Between loans in domestic and foreign currency	3.6	2.5	3.0	2.7	3.2	4.4	5.3	...
Between deposits in domestic and foreign currency	1.8	2.2	1.9	2.8	2.3	3.3	6.0	...
Number of banks not complying with banking regulations								
Not meeting capital adequacy requirements for Tier I capital	0	0	0	1	0	0	0	0
Not meeting prudential regulations	1	0	1	1	1	2	1	2
Not meeting reserve requirements	1	0	0	0	1	0	0	0

Sources: National Bank of Ukraine; and staff estimates.

1/ NPLs are those classified as substandard, doubtful, and loss.
2/ Increase in nonperforming loans (NPLs) in 2003 partly due to new classification rules.
3/ The NBU estimates that as of end-March 2004, 6.2 percent of loans classified as substandard were being timely serviced.
4/ About half of the drop in the provision to NPL ratio from end-2002 to end-2003 is due to new loan classification rules.

Table 6. Ukraine: General Government Finances, 2007–09 1/ 2/ 3/

	2007		2008	2008		2009	
			Budget	Staff's Proj.		Staff's Proj.	
	General Gov't	State	State	General Gov't	State	General Gov't	State
	(in millions of Hrv)						
Revenue	**301,618**	**163,073**	**214,850**	**424,931**	**234,353**	**469,048**	**257,825**
Tax revenue	263,394	133,930	178,005	379,088	199,391	418,263	217,508
Personal income tax	34,782	0	0	47,677	0	52,683	0
Enterprise profit tax	34,407	33,964	42,282	48,923	48,306	47,300	46,608
Payroll tax	82,733	0	0	114,318	0	126,725	0
Property tax	3,889	0	0	6,623	0	7,423	0
VAT	59,383	59,383	86,069	97,610	97,610	108,835	108,835
Other taxes on goods and services	25,844	22,933	27,017	33,411	29,204	41,395	36,102
Taxes on international trade	10,038	10,038	12,590	14,432	14,432	15,678	15,678
Other taxes	12,317	7,613	10,048	16,094	9,839	18,224	10,285
Non-tax, capital revenue, and grants	38,224	29,143	36,844	45,843	34,961	50,785	40,317
Expenditure	**315,852**	**175,755**	**234,022**	**444,861**	**253,882**	**519,498**	**308,179**
Current expenditures	275,594	148,407	204,179	380,135	207,139	420,270	228,088
Wages	72,677	32,576	42,996	100,189	45,597	108,190	47,534
Goods and services	45,991	29,621	37,829	58,523	37,385	59,112	36,703
Subsidies	19,921	14,582	19,743	28,947	21,235	27,163	19,224
Transfers	133,326	68,278	98,132	186,544	97,519	208,853	108,719
Interest	3,679	3,350	5,480	5,932	5,403	16,953	15,908
Capital spending	38,683	25,829	27,723	57,086	39,182	92,957	73,906
Net lending	1,575	1,519	1,650	5,570	5,491	5,571	5,484
Unallocated spending	0	0	470	2,070	2,070	700	700
Augmented balance, incl. banks recap. costs	**-14,233**	**-12,682**	**-19,172**	**-19,930**	**-19,530**	**-50,450**	**-50,354**
Cost of banks recap: upfront cost				10,000	10,000	44,000	44,000
Cost of banks recap: interests				0	0	6,450	6,450
Overall cash balance (excludes upfront recap. cost)	**-14,233**	**-12,682**	**-19,172**	**-9,930**	**-9,530**	**-6,450**	**-6,354**
Balance, net of all costs of banks recap.	**-14,233**	**-12,682**	**-19,172**	**-9,930**	**-9,530**	**0**	**96**
Financing	**13,450**	**12,601**	**19,172**	**19,930**	**19,530**	**50,450**	**50,354**
External	7,007	5,558	5,757	62	-424	185	-598
Disbursements	10,640	9,154	8,098	2,526	2,003	9,652	8,832
Amortization	-3,633	-3,595	-2,341	-2,464	-2,427	-9,467	-9,430
Domestic	2,235	4,583	4,515	17,782	17,968	48,853	49,839
Net Borrowing	1,385	1,712	4,162	12,599	12,009	49,650	49,575
Borrowing	3,881	4,079	7,821	16,405	15,681	62,655	62,331
Amortization	-2,496	-2,367	-3,659	-3,807	-3,672	-13,005	-12,755
Other, incl. deposit finance	850	2,871	353	5,183	5,959	-798	263
Privatization	4,209	2,460	8,900	2,086	1,986	1,412	1,112
	(in percent of GDP)						
Revenue	**42.3**	**22.9**	**24.2**	**42.8**	**23.6**	**42.2**	**23.2**
Tax revenue	36.9	18.8	20.0	38.2	20.1	37.6	19.6
Personal income tax	4.9	0.0	0.0	4.8	0.0	4.7	0.0
Enterprise profit tax	4.8	4.8	4.8	4.9	4.9	4.3	4.2
Payroll tax	11.6	0.0	0.0	11.5	0.0	11.4	0.0
Property tax	0.5	0.0	0.0	0.7	0.0	0.7	0.0
VAT	8.3	8.3	9.7	9.8	9.8	9.8	9.8
Other taxes on goods and services	3.6	3.2	3.0	3.4	2.9	3.7	3.2
Taxes on international trade	1.4	1.4	1.4	1.5	1.5	1.4	1.4
Other taxes	1.7	1.1	1.1	1.6	1.0	1.6	0.9
Non-tax, capital revenue, and grants	5.4	4.1	4.1	4.6	3.5	4.6	3.6
Expenditure	**44.3**	**24.7**	**26.3**	**44.8**	**25.6**	**46.7**	**27.7**
Current expenditures	38.7	20.8	23.0	38.3	20.9	37.8	20.5
Wages	10.2	4.6	4.8	10.1	4.6	9.7	4.3
Goods and services	6.5	4.2	4.3	5.9	3.8	5.3	3.3
Subsidies	2.8	2.0	2.2	2.9	2.1	2.4	1.7
Transfers	18.7	9.6	11.0	18.8	9.8	18.8	9.8
Interest	0.5	0.5	0.6	0.6	0.5	1.5	1.4
Capital spending	5.4	3.6	3.1	5.7	3.9	8.4	6.6
Net lending	0.2	0.2	0.2	0.6	0.6	0.5	0.5
Unallocated spending	0.0	0.0	0.1	0.2	0.2	0.1	0.1
Augmented balance, incl. banks recap. costs	**-2.0**	**-1.8**	**-2.2**	**-2.0**	**-2.0**	**-4.5**	**-4.5**
Cost of banks recap: upfront cost				1.0	1.0	4.0	4.0
Cost of banks recap: interests				0.0	0.0	0.6	0.6
Overall cash balance (excludes upfront recap. cost)	**-2.0**	**-1.8**	**-2.2**	**-1.0**	**-1.0**	**-0.6**	**-0.6**
Balance, net of all costs of banks recap.	**-2.0**	**-1.8**	**-2.2**	**-1.0**	**-1.0**	**0.0**	**0.0**
Financing	**1.9**	**1.8**	**2.2**	**2.0**	**2.0**	**4.5**	**4.5**
External	1.0	0.8	0.6	0.0	0.0	0.0	-0.1
Disbursements	1.5	1.3	0.9	0.3	0.2	0.9	0.8
Amortization	-0.5	-0.5	-0.3	-0.2	-0.2	-0.9	-0.8
Domestic	0.3	0.6	0.5	1.8	1.8	4.4	4.5
Net Borrowing	0.2	0.2	0.5	1.3	1.2	4.5	4.5
Borrowing	0.5	0.6	0.9	1.7	1.6	5.6	5.6
Amortization	-0.4	-0.3	-0.4	-0.4	-0.4	-1.2	-1.1
Other, incl. deposit finance	0.1	0.4	0.0	0.5	0.6	-0.1	0.0
Privatization	0.6	0.3	1.0	0.2	0.2	0.1	0.1

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

1/ Based on implementation of IMF policy advice, staff macroeconomic and revenue estimates, and IMF staff estimatesof budget transfers necessary to fill financing gaps in the pension and social funds. The aggregates for the general government cover the whole of the general government sector, including local authorities and the social funds. The differences between staff's and the authorities' public finances numbers and deficit estimates (for both the State and general government) reflect accounting treatments to ensure consistency with international accounting rules, and a different economic classification of revenue and expenditure.

2/ State revenue are adjusted for the non-cash property income paid by Russia in exchange for amortization of Ukraine's debt to Russia.

3/ The forecast assumes a public-financed recapitalization of banks for a total amount of Hrv 54 bln (10 bln by end-2008 and 44 bln in the first half of 2009).

Table 7. Ukraine: Medium-Term Macroeconomic Framework, 2004-13 1/

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Program scenario					
Output and prices										
Nominal GDP (billions of hryvnias)	345	441	544	713	993	1112	1309	1478	1682	1909
Real GDP growth (percent change)	12.1	2.7	7.3	7.6	6.0	-3.0	3.3	5.5	6.8	6.4
Output gap	3.3	-0.6	-0.3	1.4	2.4	-5.6	-7.3	-6.8	-5.1	-3.7
Real domestic demand growth (percent change)	8.8	15.3	13.8	15.5	12.8	-12.0	2.4	6.5	7.0	8.0
Consumer prices (percent change; end of period)	12.3	10.3	11.6	16.6	25.5	17.0	8.0	5.4	4.7	5.0
Consumer prices (percent change; average)	9.0	13.5	9.1	12.8	25.6	21.0	12.5	6.7	5.1	4.9
Core inflation (end of period) 2/	12.0	13.8	7.2	13.4	22.0	13.1	7.0	5.5	5.0	5.0
Wages										
Minimum wage (percent change; average)	15.5	39.3	21.4	17.9	23.8	16.7	12.5	12.0	11.0	10.5
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	37.1	10.5	11.8	11.3	11.0	11.1
Real monthly wages (average)	17.1	20.4	18.4	15.0	9.1	-8.7	-0.6	4.3	5.7	5.9
Public finances (percent of GDP)										
Augmented balance, including effects of banks recap. 3/	-4.4	-2.3	-1.4	-2.0	-2.0	-4.5	-2.1	-2.1	-2.1	-2.1
p.m. Balance excl. banks recap. (upfront cost and interests)	-4.4	-2.3	-1.4	-2.0	-1.0	0.0	-1.3	-1.3	-1.3	-1.4
Revenue and grants	37.1	41.8	43.7	42.3	42.8	42.2	41.5	41.3	41.3	41.2
Expenditure and net lending (cash basis)	41.5	44.1	45.1	44.3	43.8	42.2	42.8	42.6	42.7	42.5
of which: current expenditure	35.0	39.9	40.5	38.7	38.3	37.2	37.2	36.6	36.3	36.7
Privatization receipts	3.1	5.0	0.4	0.6	0.2	0.1	0.5	0.5	0.5	0.6
Net domestic financing	-0.1	-3.3	-0.4	0.3	1.8	4.4	1.0	0.8	0.9	0.8
Net external financing	1.4	0.6	1.3	1.0	0.0	0.0	0.5	0.7	0.7	0.7
Public debt (in percent of GDP; end of period) 4/	25.5	18.7	15.7	12.5	10.6	17.4	17.4	17.3	16.7	16.4
Domestic	6.3	4.6	3.3	2.7	3.3	7.4	8.0	8.2	8.2	8.2
External (foreign currency denominated)	19.2	14.1	12.5	9.8	7.4	10.0	9.4	9.0	8.5	8.2
Money and credit										
Base money (percent change, eop)	34.1	53.9	17.5	46.0	33.0	10.9	16.8	13.1	13.9	12.9
Credit to nongovernment (percent change, eop)	31.6	61.9	70.7	74.0	40.9	-9.8	16.9	13.8	15.7	15.1
Share of fx credit in total credit	42.1	43.2	49.4	49.8	57.5	60.0	53.5	53.6	53.4	53.2
External sector										
Current account balance (percent of GDP)	10.6	2.9	-1.5	-3.7	-6.2	-2.0	-1.7	-2.6	-2.4	-3.3
Total external debt (percent of GDP)	46.3	45.1	49.7	57.8	54.3	78.2	74.6	71.3	64.6	57.7
Goods exports, value (percent change)	40.8	4.8	11.2	28.0	33.4	-18.5	13.6	10.6	10.1	9.3
Goods imports, value (percent change)	23.7	21.8	22.1	36.9	39.5	-25.3	10.3	10.5	10.3	9.9
Foreign direct investment (percent of GDP)	2.6	8.7	5.3	6.5	6.2	6.8	6.8	6.8	6.7	6.5
Gross official reserves (end of period)										
In billions of U.S. dollars	9.5	19.4	22.3	32.5	31.4	30.7	34.8	39.9	45.3	48.5
In months of imports of goods and services	2.6	4.4	3.7	3.9	5.1	4.5	4.6	4.8	5.0	4.9
External debt service (in percent of exports of goods and servic	5.3	4.9	5.1	3.9	2.8	4.2	4.4	3.7	7.1	10.1
Hryvnia per U.S. dollar (end of period)	5.3	5.0	5.0	5.0	…	…	…	…	…	…
Goods terms of trade (percent change)	9.6	6.2	-0.2	9.0	7.8	-14.5	-2.3	0.4	0.5	0.4
Goods and services terms of trade (percent change)	7.8	4.9	1.5	7.4	8.9	-10.5	-0.2	0.9	0.8	0.8
Savings-Investment Balance (percent of GDP)										
Foreign savings	-10.6	-2.9	1.5	3.7	6.2	2.0	1.7	2.6	2.4	3.3
Gross national savings	31.8	25.6	23.3	23.2	20.9	21.2	21.1	21.3	22.6	23.0
Nongovernment	33.2	25.8	22.4	22.6	19.5	18.6	19.9	20.0	21.3	21.7
Government	-1.4	-0.3	0.9	0.7	1.4	2.6	1.2	1.3	1.2	1.2
Gross investment	21.2	22.6	24.8	26.9	27.0	23.2	22.7	23.9	25.0	26.3
Nongovernment	18.2	20.6	22.5	24.3	24.6	20.6	20.2	21.4	22.5	23.8
Government	3.0	2.0	2.2	2.7	2.4	2.6	2.6	2.6	2.6	2.6

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Policies assumed here include: (i) increased exchange rate flexibility as from 2008; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2010; (iii) full pass-through of rising energy import prices; (iv) a public-financed recapitalization of banks for a total amount of Hrv 54 bln (10 bln by end-2008 and 44 bln in the first half of 2009).
2/ Inflation excluding extreme price movements in the CPI components. The concept used here is the 65th percentile of the distribution of the monthly price changes.
3/ The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.
4/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises. Debt figures do not include IMF money.

Table 8. Ukraine: Moving to Inflation Targeting: Progress Report

Preconditions	Key Achievements in 2007-08	Further Steps Needed 1/
Institutional framework	• Published a draft Green paper, soliciting public input on options for NBU mandate and independence.	• Finalize the Green paper, and translate this into an Action Plan for 2008-09. • Adopt further amendments to the NBU Act that would provide the NBU with a clear mandate to achieve price stability and allow for greater NBU independence.
Exchange rate flexibility	• Gradually allow greater exchange rate flexibility, within a narrow but, over time, widening exchange rate corridor.	
Monetary policy instruments	• Introduced more active use of deposit facility, focused around two week CDs.	• Identify key policy rate; and actively steer the policy rate within a gradually narrowing interest rate corridor. • Apply monetary instruments in a consistent, transparent, and market-oriented manner.
Capacity to model and forecast	• Regular preparation of a macroeconomic survey assessing short term outlook, including under different monetary policy actions. • Developed an exclusion-based core inflation indicator, and began publishing this from January 2008 • Refined quarterly projection model and quarterly business outlook survey.	• Integrate macroeconomic survey into monetary policy decision making. • Develop full range of core inflation indicators.
Communication of monetary policies	• Introduced more frequent public discussion of monetary policy. • Outreach to financial sector and academia on IT	• Issue an Inflation Report. • Further modernize the NBU website. • Conduct press conferences and issue press releases on inflation targeting.
Financial market development	• Foreign exchange turnover tax reduced to 0.5 percent in 2008 budget. • Prepared a concept note, and draft legislation, on foreign exchange market liberalization	• Abolish the foreign exchange turnover tax. • Develop benchmarks for government securities. • Simplify procedures for working in the foreign exchange market.
Banking sector stability		• Gradually implement more risk-based supervision. • Further tighten banking supervision, regulation, and legislation.

1/ Steps identified in the NBU's 2006 Action Plan and Fund recommendations.

Table 9. Ukraine: Structural Reforms

Areas	Main Achievements since 2000	Key Outstanding Reforms 1/
Business climate	• Leveled playing field by eliminating tax preferences (2004-05). • Reviewed over 9,000 business regulations and repealed and amended nearly 5,000 (2005-06) • Adopted Joint Stock Company Law (2008.	• Abolish anachronistic Economic Code and improve the market-oriented Civil Code. • Amend legislation on protection from unfair competition. • Adopt International Accounting Standards (IAS) for large corporates. • Lift the moratorium for the resale of agricultural land; remove current restrictions in Land Code on non-agricultural land ownership; establish registries for real estate and agricultural land property rights. • Implement reform of the court system to ensure independence and impartiality. • Re-launch transparent privatization program.
Trade policy	• Received market economy status from the EU and the United States (2006). • Slashed average import tariffs from 7.7 to 5.1 percent (2005). • Completed the main steps leading to WTO accession (2007-08).	• Progress in the negotiations of a EU-Ukraine trade agreement.
Energy sector	• Eliminated the culture of non-payment in the energy sector (2000-2002) • Adopted legislation to mutually offset and restructure debts in the energy sector (2005) • Adopted cash payments for gas transits through Ukraine, rather than payments in kind (2005).	• Implement strategy to make Naftogaz internationally competitive. • Implement Ukraine's coal mine restructuring plan. • Enhance independence of National Electricity Regulatory Commission. • Stimulate energy savings by allowing prices to reflect costs.
Fiscal-structural reforms	• Adopted a budget code establishing a solid legal framework for budget management and many of the budget execution and reporting functions (2001)	• Implement comprehensive reform for State Tax Administration. • Bring the State Tax Administration and Customs under the control of the Ministry of Finance.* • Implement a medium-term budget framework. • Bring public procurement legislation in line with EU legislation. • Set up a monitoring and oversight system for financial risks in state-owned enterprises. • Reform the system of unfunded social mandates and replace it with a targeted social protection system. • Reduce tax rates over time, but subject to expansion of the tax base and/or reductions in government spending.

1/ Measures include those listed in the Ukraine-EU Action Plan, and World Bank, OECD, and Fund recommendations

* denotes measures which are not part of the government programme.

Table 10. Ukraine: Public Sector Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	30.6	25.5	18.7	15.7	13.0	**10.6**	**17.4**	**17.4**	**17.3**	**16.7**	**16.4**	**-0.8**
o/w foreign-currency denominated	21.6	19.2	14.1	12.5	10.2	7.4	10.0	9.4	9.0	8.5	8.2	
2 Change in public sector debt	-5.1	-5.1	-6.9	-2.9	-2.7	-2.4	6.8	0.0	-0.1	-0.6	-0.3	
3 Identified debt-creating flows (4+7+12)	-5.7	-5.6	-9.0	-2.3	-2.5	-0.9	7.2	-1.1	-0.5	-0.5	-0.4	
4 Primary deficit	-0.1	3.5	1.5	0.7	1.5	1.4	3.0	0.2	0.2	0.3	0.4	
5 Revenue and grants	38.0	37.1	41.8	43.7	42.3	42.8	42.2	41.5	41.3	41.3	41.2	
6 Primary (noninterest) expenditure	37.9	40.6	43.3	44.5	43.8	44.2	45.2	41.7	41.5	41.6	41.6	
7 Automatic debt dynamics 2/	-4.6	-6.0	-5.6	-2.7	-3.3	-3.1	0.4	-0.8	-0.1	-0.3	-0.3	
8 Contribution from interest rate/growth differential 3/	-4.6	-6.0	-4.8	-2.7	-3.4	-3.1	0.4	-0.8	-0.1	-0.3	-0.3	
9 Of which contribution from real interest rate	-1.7	-3.1	-4.3	-1.6	-2.5	-2.5	0.1	-0.3	0.7	0.7	0.6	
10 Of which contribution from real GDP growth	-2.9	-2.9	-0.5	-1.1	-0.9	-0.6	0.3	-0.5	-0.8	-1.0	-0.9	
11 Contribution from exchange rate depreciation 4/	0.0	-0.1	-0.7	0.0	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	-1.1	-3.1	-5.0	-0.4	-0.6	0.8	3.8	-0.5	-0.5	-0.5	-0.6	
13 Privatization receipts (negative)	-1.1	-3.1	-5.0	-0.4	-0.6	-0.2	-0.1	-0.5	-0.5	-0.5	-0.6	
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	1.0	4.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.6	0.6	2.1	-0.6	-0.3	-1.5	-0.5	1.1	0.4	-0.1	0.2	
Public sector debt-to-revenue ratio 1/	80.6	68.8	44.6	36.0	30.8	24.9	41.3	42.0	41.9	40.4	39.9	
Gross financing need 6/	3.6	6.8	5.5	3.1	2.9	2.6	6.6	3.6	4.1	4.0	4.0	
in billions of U.S. dollars	1.8	4.4	4.7	3.3	4.0	5.0	8.9	5.3	6.7	7.5	8.5	
Scenario with key variables at their historical averages 7/						**10.6**	**12.4**	**11.3**	**9.8**	**8.1**	**6.8**	**-1.5**
Scenario with no policy change (constant primary balance) in 2008-2013						**10.6**	**14.5**	**15.8**	**17.2**	**17.7**	**18.4**	**-0.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.6	12.1	2.7	7.1	7.6	6.0	-3.0	3.3	5.5	6.8	6.4	
Average nominal interest rate on public debt (in percent) 8/	3.3	3.9	3.8	4.2	4.3	6.4	16.0	12.5	12.1	11.6	11.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.7	-11.2	-20.8	-9.5	-18.9	-25.0	0.5	-1.5	5.0	5.1	4.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.5	5.1	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.0	15.2	24.6	14.9	21.8	31.4	15.5	14.0	7.1	6.5	6.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	21.4	20.2	9.6	9.9	5.9	7.0	-0.9	-4.7	5.0	7.1	6.3	
Primary deficit	-0.1	3.5	1.5	0.7	1.5	1.4	3.0	0.2	0.2	0.3	0.4	

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

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

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

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

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

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

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

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

Table 11. Ukraine: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	46.7	46.3	45.1	49.7	57.8	**54.3**	**78.2**	**74.6**	**71.3**	**64.6**	**57.7**	**-9.4**
2	Change in external debt	-5.4	-0.3	-1.2	4.6	8.2	-3.6	24.0	-3.7	-3.3	-6.7	-6.9	
3	Identified external debt-creating flows (4+8+9)	-14.9	-27.1	-26.3	-16.3	-18.6	-2.4	-2.8	-8.1	-9.5	-10.6	-9.1	
4	Current account deficit, excluding interest payments	-7.2	-11.9	-4.6	-0.8	2.2	2.7	-4.5	-5.1	-4.5	-4.8	-3.4	
5	Deficit in balance of goods and services	-2.6	-7.7	-0.8	2.8	5.8	7.6	2.4	1.3	2.0	1.6	2.9	
6	Exports	57.8	63.6	51.5	46.5	45.2	44.7	52.5	53.3	52.7	51.3	48.4	
7	Imports	55.2	56.0	50.7	49.4	50.9	52.3	55.0	54.6	54.7	53.0	51.3	
8	Net non-debt creating capital inflows (negative)	-1.0	-5.8	-11.9	-8.6	-10.6	-6.1	-7.1	-7.4	-8.4	-8.8	-8.7	
9	Automatic debt dynamics 1/	-6.7	-9.3	-9.8	-6.8	-10.3	0.9	8.7	4.5	3.5	3.0	3.1	
10	Contribution from nominal interest rate	1.4	1.3	1.6	2.3	1.5	3.5	6.5	6.8	7.2	7.2	6.7	
11	Contribution from real GDP growth	-4.2	-4.4	-0.9	-2.6	-2.9	-2.6	2.3	-2.3	-3.7	-4.2	-3.6	
12	Contribution from price and exchange rate changes 2/	-3.8	-6.2	-10.5	-6.5	-8.9	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	9.5	26.7	25.1	20.8	26.8	-1.1	26.8	4.4	6.2	4.0	2.2	
	External debt-to-exports ratio (in percent)	80.8	72.8	87.5	106.8	128.0	121.4	149.0	140.0	135.2	125.8	119.2	
	Gross external financing need (in billions of US dollars) 4/	7.3	4.0	9.5	14.3	22.0	35.4	34.4	33.4	34.8	38.8	45.0	
	in percent of GDP	14.6	6.2	11.0	13.2	15.5	18.8	25.3	22.3	21.2	20.8	21.3	
	Scenario with key variables at their historical averages 5/						**54.3**	**46.8**	**40.5**	**34.3**	**27.9**	**20.7**	**-5.3**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	9.6	12.1	2.6	7.3	7.6	6.0	-3.0	3.3	5.5	6.8	6.4	
	GDP deflator in US dollars (change in percent)	7.9	15.5	29.4	16.9	21.9	25.4	-25.7	6.7	4.1	6.4	6.4	
	Nominal external interest rate (in percent)	3.1	3.5	4.6	6.5	3.9	8.1	8.6	9.6	10.6	11.5	11.8	
	Growth of exports (US dollar terms, in percent)	24.0	42.6	7.5	13.2	27.4	31.5	-15.3	11.8	8.6	10.6	6.8	
	Growth of imports (US dollar terms, in percent)	28.7	31.3	20.4	22.0	35.4	36.5	-24.3	9.5	10.0	10.0	9.7	
	Current account balance, excluding interest payments	7.2	11.9	4.6	0.8	-2.2	-2.7	4.5	5.1	4.5	4.8	3.4	
	Net non-debt creating capital inflows	1.0	5.8	11.9	8.6	10.6	6.1	7.1	7.4	8.4	8.8	8.7	

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

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

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

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

Table 12. Ukraine: Proposed Access, 2008-2010

	Proposed Arrangement	High-Access Cases 1/ Proposed Arrangement (Percentile)	20th Percentile	80th Percentile (Ratio)	Average	Normal Access Cases Proposed Arrangement (Percentile)	20th Percentile	80th Percentile (Ratio)	Average
Access									
In millions of SDRs	11,000	64.2	2,894	14,635	9,157	100	36	409	359
Average annual access	401	82	119	358	249	100	20	50	39
Total access in percent of: 2/									
Actual quota	802	82	272	790	611	100	30	75	62
Gross domestic product	8.7	76	2.8	8.3	6.5	100	0.7	2.7	1.8
Gross international reserves	52	52	27	121	97	84	5	41	41
Exports of goods and nonfactor services	19	36	11.1	46.4	35.2	95	1.9	7.0	5.5
Imports of goods and nonfactor services	17	30	14.4	64.8	36.9	96	1.6	6.4	4.8
Total debt stock									
Of which: Public	83	100	6	16	15	...	...	...	...
External	20	89	5	15	11	98	2	6	4
Short-term	41	63	19	51	45	...	...	...	...
M2	16	65	5	24	29	85	1	12	102

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include all available data at approval and on augmentation for the 25 requests to the Board since 1994 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables.

3/ Phasing is based on program years.

4/ Amounts include augmentations.

Table 13. Ukraine: Indicators of Fund Credit, 2006-2013

	2006	2007	2008	2009	2010	2011	2012	2013
			projections					
Existing and prospective Fund credit 1/ 2/								
In millions of SDRs	552	273	3,057	9,500	11,000	11,000	8,313	3,281
In percent of exports of goods and services	2	1	6	21	22	20	14	5
In percent of public sector external debt	6	3	25	50	54	52	42	20
In percent of gross reserves	3	1	15	48	49	43	29	11
In percent of quota	40	20	223	692	802	802	606	239
Existing Fund credit 1/ 2/								
In millions of SDRs	552	273	57	0	0	0	0	0
In percent of exports of goods and services	2	1	0	0	0	0	0	0
In percent of public sector external debt	6	3	0	0	0	0	0	0
In percent of gross reserves	3	1	0	0	0	0	0	0
In percent of quota	40	20	4	0	0	0	0	0
Prospective Fund credit 1/ 2/								
In millions of SDRs	0	0	3,000	9,500	11,000	11,000	8,313	3,281
In percent of exports of goods and services	0	0	6	21	22	20	14	5
In percent of public sector external debt	0	0	24	50	54	52	42	20
In percent of gross reserves	0	0	15	48	49	43	29	11
In percent of quota	0	0	219	692	802	802	606	239
Repurchases and charges due from existing and prospective drawings 2/ 3/								
In millions of SDRs	315	304	239	315	501	552	3,200	5,338
In percent of exports of goods and services	1	1	0	1	1	1	5	8
In percent of public sector external debt service 4/	18	18	17	19	23	27	73	81
In percent of gross reserves	1	1	1	2	2	2	11	17
In percent of quota	23	22	17	23	36	40	233	389
Repurchases and charges due from existing drawings 2/								
In millions of SDRs	315	304	224	58	0	0	0	0
In percent of exports of goods and services	1	1	0	0	0	0	0	0
In percent of public sector external debt service 4/	18	18	15	3	0	0	0	0
In percent of gross reserves	1	1	1	0	0	0	0	0
In percent of quota	23	22	16	4	0	0	0	0
Repurchases and charges due from prospective drawings 2/ 3/								
In millions of SDRs	0	0	16	257	501	552	3,200	5,338
In percent of exports of goods and services	0	0	0	1	1	1	5	8
In percent of public sector external debt service 4/	0	0	2	16	23	27	73	81
In percent of gross reserves	0	0	0	1	2	2	11	17
In percent of quota	0	0	1	19	36	40	233	389

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

1/ End of period.
2/ Existing drawings are under the expectations schedule. Prospective drawings are under the obligations schedule.
3/ Excluding commitment charges
4/ Public sector debt service including debt service from prospective drawings.

Kyiv, October 31, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington D.C. 20431 U.S.A.

Dear Mr. Strauss-Kahn:

The attached Memorandum of Economic and Financial Policies (MEFP) describes the economic policies and objectives of the Government of Ukraine for the remainder of 2008 and for 2009-10. Based on our balance of payments needs, and our strengthened policies described below, we request the approval of a Stand-By Arrangement (SBA) in an amount equivalent to SDR 11,000 million (800 percent of our quota) for the period November 2008 through October 2010.

We believe that the policies described in the memorandum will promote sustainable and equitable long-term growth, lower inflation and continued external viability, despite the current difficult external environment. The core elements of the program have been explained to the leaders of the main political parties, and they have committed to support them.

In addition to the policies outlined in the attached MEFP, the government stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives. We will consult with the Fund on adoption of new measures and provide the Fund with the information it requests for monitoring progress during program implementation. We will also consult with the Fund on our economic policies after the expiration of the arrangement, in line with the Fund's policies on such consultations, while we have outstanding purchases in the upper credit tranches. The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks. The reviews will be held first in January 2009, and quarterly thereafter for the duration of the arrangement.

Yours sincerely,

/s/
Viktor Pynzenyk
Minister of Finance

/s/
Volodymyr Stelmakh
Governor of the National Bank of Ukraine

/s/
Yulia Tymoshenko
Prime Minister of Ukraine

/s/
Victor Yushchenko
President of Ukraine

Memorandum of Economic and Financial Policies

V. Background

51. **Ukraine's tremendous growth performance of late was unfortunately accompanied by rising vulnerabilities.** Growth averaged over 7 percent since 2000, rapidly lifting Ukrainian living standards. However, by late 2007 the economy was overheating, with a high inflation rate that we considered unacceptable, rapid growth of nominal wages and asset values, and a burgeoning current account deficit. Behind these developments lay a favorable external environment that saw our export prices rising to very high levels and capital inflows surge into Ukraine. Some of the capital inflow was foreign direct investment—attracted by Ukraine's enormous potential—but a significant portion was debt inflows, often at short-term maturities into the corporate sector and the banking system. The banking system onlent funds in foreign exchange to domestic borrowers, creating largely unhedged exposures.

52. **We recognized these problems, and by early 2008 began to vigorously address them.** The fixed exchange rate regime which served us well in the past was no longer well suited to address the new challenges. Thus the National Bank accelerated the planned transition to a flexible exchange rate: beginning in March 2008, the Hryvnia was allowed to fluctuate within a wider band. The National Bank also took steps from late 2007 to eliminate incentives for banks to fund themselves abroad with short-term debt.

53. **However, the deepening global financial turmoil and plunge in commodity prices have undermined confidence and necessitated a more rapid adjustment than planned.** Substantial problems in our large steel sector (due to sharply lower external demand), growing concerns about ability of banks and corporates to roll over existing credit lines, and problems at Ukraine's sixth largest bank, have weakened confidence in our banking system and currency. We expect most of our banks' direct credit lines from foreign banks continue to be rolled over, but our access to international capital markets has become limited. We have stabilized the domestic situation by providing liquidity to the banking system and placing temporary restrictions on early withdrawal of term deposits. However, during the program period, we expect the combination of weaker demand in our trading partners, falling export prices and rising energy import prices, and reduced access to international financial markets to weaken growth prospects. Thus, overall financing needs for the program period are very large: after taking into account the planned strong policy measures under the program and prospective financing from the private sector and possibly other international financial institutions (such as the World Bank), there remains a residual gap of about $16½ billion.

VI. Program Objectives

54. **Our program aims to restore confidence in Ukraine's macroeconomic and financial stability.** The program will first address financial sector problems by: (i) appropriate liquidity support and expansion of deposit guarantees; (ii) a stronger bank resolution framework, including availability of public funds; and (iii) a stronger framework for resolution of household and enterprise sector debts. Second, the program will facilitate adjustment to potentially large external shocks and reduce inflation by adapting the

macroeconomic policy framework. This will be accomplished by: (i) a flexible exchange rate policy, supported by base money targets and an appropriate intervention strategy; (ii) planned transition to inflation targeting; (iii) bringing incomes policy in line with targeted inflation, while protecting the most vulnerable; (iv) maintain a prudent fiscal stance; and (v) bringing energy sector prices more in line with costs.

55. **For 2009 our macroeconomic objectives are set conservatively, reflecting the fact that due to external shocks, the Ukrainian economy, much like the rest of Europe, may face a recession**. We have calibrated expected impacts on growth from the experience of 2004-05, when we were hit with a similar set of shocks, albeit from a different base. We hope to do better than implied by that episode, particularly if the global environment improves, but also due to our confidence in the underlying dynamism of Ukraine's rapidly transitioning economy. Our objective for 2009 will be to limit inflation to at most 17 percent, a target which will be shared by all government agencies and the National Bank. This target will be kept under review, particularly as the 2009 budget is prepared, since we hope to achieve a better result. The continued high inflation rate, notwithstanding the economic slowdown, reflects among other things our intention to bring gas prices paid by consumers more in line with costs. We expect the current account deficit to compress to 1-2 percent of GDP, particularly due to a slowdown in credit-sensitive imports like machinery. International reserves should remain around present levels.

56. **In the medium term, we expect the economy to gradually recover.** A recovery should start sometime in the second half of 2009, and we should be back at our estimated potential growth rate (5-6 percent) by mid-2010, driven in particular by rising investment ahead of the Euro 2012 football championships, and improvements in competitiveness fostered by continued implementation of a flexible exchange rate regime. Inflation should return to single digits by late-2010, helped by continued transition to inflation targeting and continued prudent incomes policies, and will be anchored around 5-7 percent from 2011. Current account deficits should remain small and readily financeable, helped by continued fiscal prudence, with reserves rising and at safe levels. The full macroeconomic and policy program for 2010 will be discussed during the fourth review, in October 2009.

57. **We are prepared to respond flexibly to economic developments**. Economic prospects for Ukraine depend on the depth and duration of the international deleveraging process and the accompanying global economic slowdown. If our balance of payments outcomes are better than projected, we would allow a build-up of foreign exchange reserves and adjust monetary policy to safeguard the inflation objective. Should the overperformance be large and persist, we would also be prepared to make repayments of Fund resources ahead of schedule, or refrain from drawing scheduled disbursements. In the event that developments are less favorable than expected, buffers built into our policy framework—including a flexible exchange rate and amounts available for bank recapitalization—provide a cushion, but we stand ready to take additional measures as necessary.

VII. Policies For 2009

A. Monetary and Exchange Rate Policy

58. **We will implement a flexible exchange rate regime.** A flexible exchange rate will provide a buffer to the economy against external shocks and give us more scope to control inflation. To clarify this change in our policy regime we will revise the *Monetary Policy Guidelines* for 2009 to: (i) abolish the exchange rate band; (ii) base the official rate on the preceding day's market exchange rate (with intra-day adjustments if necessary to keep it within 2 percent of the market rate); and (iii) commit in revised *Guidelines* to a transparent intervention strategy via pre-announced regular auctions and guided by net international reserve targets (**quantitative performance criterion**), with separate provisions covering the NBU's role as an agent for government foreign exchange needs. We will not have an opportunity to issue revised guidelines until the cabinet revises the 2009 macro framework, but in the interim the NBU Council will take and publicize a decision eliminating the exchange rate band and the NBU Board will change the definition of the official rate (in the manner described in (ii) above) (**prior action**).

59. **NBU actions and regulations concerning the foreign exchange market will be designed to enhance the market mechanism**. Any foreign exchange operations with the government and private agents will be carried out at the market exchange rate. While we expect the exchange rate to fluctuate, we will not tolerate abrupt and disorderly movements. We will support the new policy regime with measures to improve the operation of the foreign exchange market, including cancellation of the foreign exchange transactions tax (**structural benchmark** for the second review). As part of our initial response to the crisis, we have imposed a number of exchange controls, including delays on transferability of Hryvnia profits, limitations on early repayments of foreign exchange loans, and limitations on advance payments. We have eliminated the restriction on advance payments and we will discuss with IMF staff the removal of any remaining exchange restrictions and, following agreement on a timetable for removal, will request IMF Board approval at the time of the first review. We will consult with the Fund on any further measures that we may undertake regarding the working of the foreign exchange market.

60. **The main goal for monetary policy will be to reduce CPI inflation to 17 percent by end-2009**. The NBU will achieve this goal by using targets on the level of base money (**quantitative performance criterion**). In particular, we will target base money growth to be about 11 percent in 2009, in light of our expectation that nominal growth of the economy will amount to about 12 percent, and that money demand will decline slightly. In line with this target, but only as financial market stresses abate, we will need to withdraw liquidity. In part this will come by restoring previous reserve requirement rules, but we will also raise interest rates on deposits at the NBU, to bring them closer to the refinance rate. We will continue to conduct deposit auctions, at regular intervals. We will also aim to enhance the quality of the NBU's balance sheet by reviewing the list of acceptable collateral, notably rapidly phasing out bank shares from this list. Since the demand for base money is difficult to predict, during program reviews an assessment of base money demand will be a focus area, with targets adjusted should money demand show signs of deviating markedly from program projections.

In such assessments, indicators such as dollarization of deposits, velocity, and currency movements will be used.

61. **Our medium-term goal is to re-anchor monetary policy with an inflation targeting regime**. We are well advanced in work towards this, to continue progress we intend to enhance the NBU's regularly published Monetary Review by expanding it to also cover inflation developments and prospects (in line with international practice on Inflation Reports), and to reform internal NBU decision-making processes to refocus around inflation forecasts and risks. We also intend to strengthen NBU independence. To this end, we will: reform the NBU council, transforming it into a narrower technical body in line with best practice; prolong the term of the governor; and provide more financial flexibility to the NBU (government debt to the NBU will be securitized, all liquidity operations centralized in the NBU, and profit transfer arrangements brought into line with best international practice (**structural benchmark**). We will implement a primary dealer system to facilitate the development of the government securities market. As part of the transition toward IT, we will enhance the NBU's communications with the public regarding its policy objectives and actions.

B. Financial Sector Policy

62. **Our key near-term priority is to restore stability and confidence.** To restore financial stability, our priorities are to (i) stabilize the banking system through a flexible provision of liquidity by the National Bank, (ii) enhance daily monitoring of banks' liquidity condition, and (iii) ensure bank solvency through strengthened on- and off-site supervision. To this end, we intend to move expeditiously in several areas:

- The National Bank's will implement safeguards in the provision of liquidity support, including by strengthened monitoring and supervision, to ensure that such support is adequately flexible, yet not excessive or unintentionally evolving into solvency support. Looking forward to 2009, the National Bank stands ready to refinance bank recapitalization bonds, and will ensure that this does not effect the overall system wide level of liquidity.

- The government will enact the proposal to raise deposit insurance (which covers both Hryvnia and foreign exchange deposits) to Hrv 150,000 from the current Hrv 50,000. As deposit outflows subside, we will remove administrative restrictions on early withdrawals of term deposits.

- We will establish a high-frequency bank-by-bank monitoring system of assets and liability maturity profiles, including deposits, liquid assets, interbank transactions, foreign credit lines, and debt rollovers. If financial conditions in any bank appear to be deteriorating, we will initiate a special on-site inspection, diagnose the causes of the financial difficulties, and agree with bank management on a restructuring plan to resolve the underlying problems.

- The National Bank of Ukraine banking supervision department will initiate close contacts with home supervisors of foreign banks and agree to share information on

the activities of the foreign banks under their supervision. In cooperation with foreign banks and home supervisors, it will also assess the parent bank funding to Ukrainian subsidiaries, and make joint contingency plans for debt rollover risks.

- We will promptly finalize the resolution of the Prominvestbank **(prior action).**

- The National Bank will enhance the disclosure of detailed bank-by-bank financial information to meet international best practices (**structural benchmark**). The financial information will include, among other items, detailed balance sheets and income statements at a monthly and quarterly frequency.

- We will address key recommendations of the May 2008 FSAP Update related to the shift of banking supervision to a consolidated basis, the licensing of cross-bank equity holdings, and the criteria for and transparency of bank investments in non-banks.

63. **We are also preparing a comprehensive bank resolution strategy**. In particular:

- We will conduct a diagnostic study and targeted examination of the banking sector, starting with the large and systemically important banks (comprising 60 percent of the banking system assets). The scope of the examination will be clearly defined to include assessment of asset quality, liquidity position, off-balance sheet items, risk management and capital position. The diagnostic work will be coordinated by the NBU with participation of several reputable audit firms (**structural performance criterion**). Upon completion of the diagnostic study, we will resolve problem banks, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated (**structural performance criterion**).

- We will provide financial support to viable banks in the form of recapitalization, to cushion the real economy from a potential credit crunch. The terms of this support will be laid out in a Law or in a Decree (**prior action**) and the details will be developed in a regulation to be issued by the NBU.

- We will make the necessary legal amendments to facilitate bank resolution (**prior action**). These changes will allow the NBU to undertake the necessary bank resolution processes, including, purchase and assumption, sale of part or whole of a bank, and reduction in the value of the existing shareholders' equity to absorb the losses incurred in the resolution process.

C. Fiscal Policy

64. **We intend to keep the general deficit at low levels in 2008 and 2009.** Achievement of our fiscal targets will be monitored by a **quantitative performance criterion..** In 2008, the deficit would not exceed 1 percent of GDP, a small deterioration from the existing budget position, which reflects already committed expenditures and a projected loss of tax revenues due to the sharp slowdown of the economy in the last quarter of the year. For 2009, we are targeting a general government budget with a zero overall balance (including an adjuster to allow for potential bank recapitalization operations). This represents a tightening of the fiscal

stance compared to previous years, given that the economy is slowing. However, we believe that fiscal policy, which can be targeted, should contribute to reduce domestic demand and imports to a level consistent with external financing constraints, rather than having all of the adjustment fall on the exchange rate.

65. **A combination of factors places us in a good position to meet our fiscal targets**. The starting position is sound: we have a close-to-balanced budget to-date in 2008. Moderating public sector wage growth and gradually passing through imported gas prices increases to consumers will generate savings. We will pass a 2009 budget consistent with our general government deficit target of a zero overall balance when parliament resumes (**structural performance criterion**), and until such time last year's budget will apply (constant expenditures in nominal terms). We will identify and legislate any additional fiscal measures that may be needed. We will keep fiscal targets as a special focus of each review, and may provide additional fiscal stimulus if financing through privatization or other sources becomes available. To strengthen our financing strategy, we will implement a primary dealer system to facilitate the development of the government securities market.

66. **We will change the course of our incomes policies.** Our recent minimum wage, pension, and social transfer increases helped to lift many out of poverty, an important achievement. However, the boom in our trade prices, which allowed us to fund these increases, is now expected to reverse. Still, the strong underlying trend of productivity growth in Ukraine offers some margin for us to adjust while broadly preserving past gains. Our adjustment strategy will thus be to limit the increase in both minimum and average public wage and pensions, and other social transfers, in line with projected inflation in 2009 (average and end-period basis). This will include the following measures: (i) in December 2008-January 2009, the wage level for the first grade public sector employees will remain constant; (ii) postponing for two years the planned equalization of the minimum wage with the much higher minimum subsistence level; and (iii) revising backward-looking indexation arrangements for various social transfers (and refocusing increases on forward-looking inflation measures).

67. **In the broader public sector, we consider it very important to secure greater transparency and financial stability in Naftogaz**. Naftogaz will publish audited 2007 accounts as soon as feasible, with the aim to eliminate the technical default on its eurobond. To assure sound finances going forward, and bring Naftogaz' financial relations with the budget onto a more orderly basis, we will unify the price of domestic and imported gas by end-2011. The gradual phasing of this process will start on December 1, 2008. In parallel, price subsidies for imported natural gas consumed by communal heating entities will be reduced through quarterly tariff adjustments and be eliminated by July 1, 2010. We believe this measure is also important from a macroeconomic adjustment perspective, as it will help slow consumption and encourage faster adjustment to the permanent increase in the price of imported energy. Looking further forward, we intend to put in place a stronger regulatory framework, so that the process of tariff setting can be depoliticized. We plan to undertake changes in consultation with the World Bank.

68. **We would like to reassure that we have in place an effective safety net to help vulnerable groups that may be affected by the macroeconomic adjustment.** We can

assist those adversely affected through a number of programs, including unemployment insurance; an income support scheme; housing and utilities subsidies; and lifeline utility tariffs. The latter two of these programs will in particular assist those affected by rising energy prices. We will continue to review the effectiveness of these programs, in consultation with the World Bank, in particular to ensure that they are well targeted.

D. Private Sector Support Policies

69. **Our program recognizes the possible need to facilitate resolution of corporate sector debts.** We are conducting an in depth analysis of the implications of different economic projections and policy scenarios for risks of extensive private sector default. We will facilitate the establishment of a voluntary framework for restructuring debts. And we are carefully reviewing bankruptcy legislation, with a view to making needed amendments to streamline the process and eliminate delays, while preserving due process. Finally, we will enhance monitoring of external debt developments to ensure that policymakers can respond early to the risk of emerging peaks in external debt service.

70. **It is also important to emphasize that we have not lost sight of Ukraine's pressing structural reform needs.** Indeed action in several areas is all-the-more crucial to help expand external financing from the private sector during the difficult period ahead. We see several measures as crucial in the near term, including (i) the creation of a functioning market in agricultural land; and (ii) agreeing on a list of companies to be privatized, transparently, in 2009. We are also discussing these issues in the context of our World-Bank supported program.

E. Safeguards Assessment

71. We recognize the importance of completing an update safeguards assessment of the NBU by the first review of the standby arrangement. To facilitate this we will authorize the NBU's external auditors to provide IMF staff with all necessary information, including management letters for 2005-07, and to hold discussions directly with Fund staff. We also commit to receiving a safeguards mission, and to provide that mission with all necessary information requested without delay, including information related to correspondent banks and foreign reserve placements.

E. Program Monitoring

72. **The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks**. The phasing of purchases under the arrangement and the review schedule are set out in Table 1 of this memorandum; the quantitative targets for end-December 2008, end-March 2009, end-June 2009, end-September 2009 and end-December 2009, and continuous performance criteria, are set out in Table 2; and the prior actions, structural performance criteria and structural benchmarks as set out in Table 3. The understandings between the Ukrainian authorities and IMF staff regarding the quantitative

performance criteria and the structural measures described in this memorandum are further specified in the TMU attached to this memorandum.

73. **In addition to the policies outlined in this MEFP, the government stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives**. We will consult with the Fund on adoption of new measures, and in advance of revisions to the policies contained in this memorandum, and provide the Fund with the information it requests for monitoring progress during program implementation. We will also consult with the Fund on our economic policies after the expiration of the arrangement, in line with the Fund's policies on such consultations.

Table 1. Ukraine: Access and Phasing Under a Proposed Stand-By Arrangement

Date Available	In millions of SDRs	In percent of quota	Conditions include
November 2008	3,000	218.7	Board approval of arrangement
15 February 2009	1,250	91.1	Observance of end-December performance criteria and completion of the first review
15 May 2009	2,500	182.2	Observance of end-March performance criteria and completion of the second review
15 August 2009	750	54.7	Observance of end-June performance criteria and completion of the third review
15 November 2009	2,000	145.8	Observance of end-September performance criteria and completion of the fourth review
15 February 2010	375	27.3	Observance of end-December performance criteria and completion of the fifth review
Quantitative and structural performance criteria for remaining scheduled purchases in 2010 are expected to be established at the time of the third review.			
15 May 2010	375	27.3	Observance of end-March performance criteria and completion of the sixth review
15 August 2010	375	27.3	Observance of end-June performance criteria and completion of the seventh review
15 October 2010	375	27.3	Observance of end-September performance criteria and completion of the eighth review
Total	11,000	802	

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

	Stock	2008	2009			
	End-Sept.	Dec Prog.	Mar Prog.	June Prog.	Sept Prog.	Dec Prog.
I. Performance criteria						
Ceiling on the cash deficit of the general government (- implies a surplus) 2/ 3/ 4/	-4,994	9,930	0	-2,000	-5,000	0
Floor on net international reserves of the NBU (in millions of U.S. dollars)	37,530	26,700	21,800	18,700	16,600	14,900
Ceiling on base money	170,835	190,000	192,000	197,500	203,000	211,000
II. Continuous performance criteria						
Prohibition on the imposition or intensification of restrictions on the making of payments and transfers for current international transactions						
Prohibition on the introduction or modification of multiple currency practices						
Prohibition on the conclusion of bilateral payments agreements that are inconsistent with Article VIII						
Prohibition on the imposition or intensification of import restrictions for balance of payments reasons						
III. Adjusters						
Project financing 2/	284	1,468	1,045	2,091	3,136	4,182
Cost of bank recapitalizations 3/	0	0	0	0	0	0

Sources: Ukrainian authorities; and Fund staff estimates and projections.
1/ Definitions are specified in the Technical Memorandum of Understanding (TMU). Targets for 2010 will be set at the time of the third review.
2/ The ceiling on the cash deficit of the general government will be adjusted downward by the amount that project financing falls short of the projections shown in Section II above. The quarterly ceilings are set taking into account the seasonality of the deficit.
3/ The floor on the cash balance of the general government will be adjusted downward by 100 percent of the fiscal cost of banks recapitalizations. This cost includes the upfront cost for the budget implied by the recapitalization as well as associated subsequent interest payments.
4/ Data are cumulative flows from January 1 of the corresponding year.

Table 3: Prior Actions and Performance Criteria and Benchmarks
Under the Stand-by Arrangement

Prior Actions	*Status*
A1. Implement a flexible exchange rate regime. NBU Council to take and publicize a decision to abolish the exchange rate band, and NBU Board to define the official rate as the preceding day's market exchange rate (with intra-day adjustments if necessary to keep it within 2 percent of the market rate) (MEFP ¶8).	
A2. Issue a Law or a Decree laying out the terms of financial support to banks (MEFP ¶13).	
A3. Make the necessary legal amendments authorizing the NBU to undertake the necessary bank resolution process, including (i) purchase and assumption, (ii) sales of part or whole bank, and (iii) reduction in the value of the existing shareholders' equity and voting rights to absorb the losses incurred in the resolution process (MEFP ¶13).	
A4. Finalize the resolution of the Prominvest Bank (MEFP ¶12).	
Performance Criteria	***Date***
B1. Complete a diagnostic study by December 15, 2008 covering NBU's group 1 banks, coordinated by NBU and with participation of several reputable audit firms (MEFP ¶13).	Mid-December 2008
B2. Resolve all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated (MEFP ¶13).	End-June 2009
B3. Pass a 2009 Budget consistent with our general government deficit target of a zero overall balance. Consistency will be monitored through the target for the state budget deficit and the budgets for the social funds (MEFP ¶14).	End-April 2009
Structural Benchmarks	***Date***
B4. Cancel the foreign exchange transactions tax (MEFP ¶9).	End-April 2009
B5. NBU to adopt framework for publication, on monthly and quarterly basis, of detailed bank-by-bank financial information in line with international best practices, to include among other items, detailed balance sheets and income statements, information on bank capitalization and asset quality, with separate information for domestic and foreign currency assets and liabilities (MEFP ¶12).	End-January 2009
B6. Strengthen NBU independence: reform the NBU council, transforming it into a narrower technical body in line with best practice; prolong the term of the governor; and provide more financial flexibility to the NBU (securitize government debt to the NBU, centralize all liquidity operations in the NBU, and bring profit transfer arrangements into line with best international practice) (MEFP ¶11).	End-June 2009

UKRAINE—TECHNICAL MEMORANDUM OF UNDERSTANDING

OCTOBER 31, 2008

1. This memorandum sets out the understandings between the Ukrainian authorities and IMF staff regarding reporting requirements and definitions of quantitative targets and structural measures for the economic program supported under the standby arrangement, as described in the authorities' Letter of Intent dated October 31, 2008 and the attached Memorandum of Economic and Financial Policies (MEFP).

2. Quantitative performance criteria are shown in Table 2 of the MEFP. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. Prior actions, structural performance criteria, and structural benchmarks are listed in Table 3 of the MEFP, with corresponding definitions in Section II below. Reporting requirements are specified in Section III.

I. QUANTITATIVE TARGETS

A. Floor on net International Reserves of the National Bank of Ukraine

Definition

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

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

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

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

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

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

- all short-term liabilities of the NBU vis-à-vis non-residents with an original maturity of one year or less;
- the stock of IMF credit outstanding;
- the nominal value of all derivative positions[1] of the NBU and government, implying the sale of foreign currency or other reserve assets against domestic currency.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability[2]	NBU Balance Sheet Accounts
1. **Gross foreign reserves** *(in convertible currencies)*	
Monetary gold in vault	1100, 1107
Foreign exchange in cash, including Russian rubles	1011, 1017
Demand deposits at foreign banks	1201, 1202
Short-term time deposits at foreign banks	1211
Long-term deposits at foreign banks	1212
SDR holdings and Reserve Position in the IMF	IMF, Finance Department[3]
Securities issued by non-residents	1302, 1305, 1307, 1308, minus 1306
2. **Short-term liabilities to nonresidents** *(in convertible currencies)*	
Correspondent accounts of nonresident banks	3201
Short-term deposits of nonresident banks	3206, 3207, 3211
Operations with nonresident customers	3230, 3232, 3233, 3234
Use of IMF credit	IMF, Finance Department

5. For program purposes, the exchange rates used to evaluate reserve levels are the official exchange rates determined by the NBU as of September 30, 2008. In particular, the Swiss Franc is valued at 0.9056 dollar, the Euro is valued at 1.4349 dollars, Pound Sterling is valued at 1.8029 dollars, the Japanese yen at 106.1346 per dollar. The accounting exchange rate for the SDR will be 1.56407 per dollar. Official gold holdings were valued at 833.95 dollars per troy ounce. These program exchange rates are kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing

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

[2] The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on September 30, 2008. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

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

monetary aggregates does not imply that there is any target exchange rate for policy purposes.

B. Ceiling on Monetary Base of the NBU (Base Money)

Definition

6. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,[4] and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts 3230, 3232, 3233, 3234, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency (NBU liability account 3238).

C. Ceiling on Cash Deficit of the General Government

Definition

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

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

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

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

- total receipts from privatization received by the SPF and local governments; plus
- the difference between disbursements and amortization on any bond issued by the government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus
- the difference between disbursements of official foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of official foreign credits by the general government (including of on-lent project loans, and excluding offset-based amortization with Russia); plus
- the net change in government deposits in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the general government.

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

Adjustment mechanism

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

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

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

10. The ceiling on the cash deficit of the general government is subject to an automatic adjuster corresponding to the budgetary costs associated with the recapitalization of banks. These costs affect the cash deficit of the general government as defined above in two ways: first, through the upfront cost for the budget of the recapitalization; second, via the associated subsequent interest payments. These costs are excluded from the calculation of the fiscal targets defined in the program. Specifically, the ceiling on the consolidated general government deficit will be adjusted upward by 100 percent of this cost.

II. Prior Actions and Structural Measures

11. **Prior Action A1. Issue NBU resolutions laying out the specifics for implementing a flexible exchange rate regime (MEFP ¶8).**

12. The NBU council will abolish the exchange rate band and the NBU board will define the official rate as the preceding day's market exchange rate (with intraday adjustments if necessary to keep it within 2 percent of the market rate).

13. **Prior Action A2. Issue law or decree laying out the terms of financial support to banks (MEFP ¶12)**

14. The financial support will include the allocation of financial resources in the form of recapitalization bonds. Access to the recapitalization funds will be only for those banks evaluated as solvent and viable.

15. **Prior Action A3. Make the necessary legal amendments to facilitate bank resolution (MEFP ¶12).**

16. Adopt necessary legal amendments to facilitate bank resolution of viable but undercapitalized banks by authorizing the NBU to undertake the necessary bank resolution process, including purchase and assumption, sales of part or whole bank, and the reduction in the value of the existing shareholders' equity and voting rights to absorb the losses incurred in the resolution process.

17. **Prior Action A4. Finalize the resolution of the Prominvest Bank (MEFP ¶13).**

18. This measure requires a prompt resolution of Prominvest Bank following the intervention by the NBU in early October. The resolution requires either the sale of the bank to a strategic investor or a merger with a viable bank. However, if the ongoing deposit outflows were to impair its solvency, the bank should be rapidly liquidated.

19. **Structural Performance Criterion B1. Complete diagnostic study (MEFP ¶12).**

20. Complete diagnostic study of large systemic banks (NBU's group 1 banks) by December 15, 2008. NBU to initiate: (i) diagnostic studies and targeted examination of bank needs as a precondition for access to resources; (ii) the scope of such examination to include assessment of asset quality, liquidity position, off-balance sheet items, risk management and capital position; (iii) the coordination of the diagnosis by the NBU with participation of international experts and several reputable audit firms.

21. **Structural Performance Criterion B2. Complete resolution of problem banks (MEFP ¶12).**

22. Resolve all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are promptly liquidated.

23. **Structural Benchmark B5. Enhance the disclosure to the public and markets of detailed bank-by-bank financial information to meet international best practices (MEFP ¶11) .**

24. NBU to adopt framework for publication, on monthly and quarterly basis, of detailed bank-by-bank financial information in line with international best practices, to include among other items, detailed balance sheets and income statements, information on bank capitalization and asset quality, with separate information for domestic and foreign currency assets and liabilities.

III. Reporting Requirements

A. National Bank of Ukraine

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

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

27. The NBU will continue to provide on its web site the weekly report on the primary treasury bill market, reports on each treasury bill auction, and provide to the IMF the monthly report on treasury bills.

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

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

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

31. The NBU will provide to the IMF, on a monthly basis, a projection for external payments falling due in the next twelve months.

32. The NBU will provide to the IMF, on a quarterly basis, the stock of external debt for both public and private sector.

33. The NBU will provide to the IMF on a daily basis the standard daily data sheet on currency operations including Government foreign receipts and payments, breakdown of interbank market operations by currencies, explanations for main currency flows. The NBU will continue to provide daily information on exchange market transactions, including exchange rates.

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

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

36. The NBU will provide to the IMF consolidated banking sector data and aggregated data (without specifying the names of the banks) for the largest banks (accounting for at least 80 percent of the total banking system assets) on a quarterly basis, no later than 30 days after the end of the quarter: (i) balance sheet; (ii) loan classification (standard, watch, sub-standard, doubtful, loss); (iii) provisions for all assets (required and actual) (iv) foreign currency denominated lending and deposits; (v) capital adequacy ratios for normative and regulatory capital (Tier II and I), normatives H2 and H3; weighted averages based on banks' total assets; (vi) liquidity normatives H5 and H6; weighted averages based on banks' total assets.

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

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

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

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

B. Ministry of Finance

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

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

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

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

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

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

47. The Ministry of Finance will also provide, on a monthly basis, information on the borrowing (disbursements, interests and amortization) for the following state-owned companies: Naftogaz, UrkAvtoDor, UkrZaliznytsya, Ukrtelecom and Heteroatom.

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

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

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

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

52. The Ministry of Finance will provide data on the approved budgets and quarterly operational data (monthly for the Pension Fund only) on the revenue, expenditures, and arrears, and balance sheets of the Pension Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Social Insurance Fund, Employment Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Occupational Accident and Sickness Insurance Fund, and any other extrabudgetary funds managed at the state level no later than 25 days after the end of each quarter (each month in case of the Pension Fund). Any within-year amendments

to the budgets of these funds will be reported within a week after their approval. The Ministry of Finance will also report the annual financial statement including the final fiscal accounts of those funds at the end of each fiscal years, no later than April of the following year.

53. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central and local budgets, starting from January 2008. After any public sector wage increase, the Ministry of Finance will provide an estimate of its costs for the current and subsequent fiscal years, for the state and local government budgets.

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

C. State Tax Administration

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

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

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

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

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

59. The STA will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund

requests; (ii) refund requests paid in cash; (iii) netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock; and (vii) stock of end-of-period requests that are overdue in accordance with the VAT law (currently, refunds are overdue after 1 month for exporters and 3 months for other VAT taxpayers). It is understood that while monthly data could be operational, quarterly figures will be subject to verification and will be final.

D. Ministry of Economy and Ministry of Fuel and Energy

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

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

E. State Statistics Committee

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

INTERNATIONAL MONETARY FUND

UKRAINE

Request for Stand-By Arrangement
Informational Annex

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

November 3, 2008

Contents Page

APPENDIX I: UKRAINE—FUND RELATIONS
(As of September 30, 2008)

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

II. General Resources Account:	**SDR Million**	**Quota**
Quota	1,372.00	100.00
Fund holdings of currency	1,445.14	105.33
Reserve position in Fund	0.02	0.00

III. SDR Department:	**SDR Million**	**%Allocation**
Holdings	1.23	N/A

IV. Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
Extended arrangements	73.14	5.33

V. Financial Arrangements:

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

VI. Projected Payments to Fund (Expectations Basis)[1]
(SDR million; based on existing use of resources and present holdings of SDRs):

	2008	2009
Principal	15.85	57.28
Charges/Interest	1.16	0.96
Total	17.01	58.24

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

VII. Projected Payments to Fund (Obligations basis) [2] (SDR million; based on existing use of resources and present holdings of SDRs):

	2008	2009	2010	2011	2012
Principal	15.85	57.28	0.0	0.0	0.0
Charges/Interest	1.16	0.96	0.0	0.0	0.0
Total	17.01	58.24	0.0	0.0	0.0

VIII. Safeguards Assessments:

A new Safeguards Assessment is required by the time of the first review. The National Bank of Ukraine (NBU) was last subject to a safeguards assessment with respect to the Stand-By Arrangement approved on March 29, 2004. The safeguards assessment was completed on July 14, 2004. The assessment found that the NBU has made progress towards strengthening its safeguards framework. However, it noted the need for further improvements in some areas, notably the financial reporting and legal structure and independence areas. The main recommendations of the assessment include (i) full adoption of International Financial Reporting Standards (IFRS), (ii) a detailed review of the NBU Law, and other legislation that impinges on the central bank, in order to strengthen the NBU's independence, and (iii) semi-annual audits by the NBU's internal audit function of the monetary data reported to the Fund.

IX. Exchange Arrangements:

In September 1996, the authorities introduced the hryvnia (Hrv) at a conversion rate of karbovanets (Krb) 100,000 to HRV 1. The rate was initially informally pegged to the dollar. In September 1997, the peg was replaced by a formal band of Hrv 1.7–Hrv 1.9 per U.S. dollar. The limits of the band were moved on several occasions. Since March 19, 1999, the exchange rate for the hryvnia has been determined by the interbank market for foreign exchange. On February 22, 2000, the NBU officially confirmed its intention to allow the free float of the hryvnia, but intervened regularly to limit fluctuations to a small band, first around Hrv 5.33 per U.S. dollar, and from March 2005, around Hrv 5.05 per U.S. dollar. It was classified as a de facto peg. From April 2008, the exchange rate arrangement has been reclassified as a managed float. On October 28 , 2008 the interbank market rate stood at Hrv 6.1 per U.S. dollar.

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

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

May 1997. A number of new restrictions on current international transactions were introduced in September 1998, and were removed in March 1999.

In October 2008, a number of new exchange controls were introduced including: (i) restrictions on early withdrawal of time deposits by non-residents (and residents); (ii) prohibition of early repayment of foreign exchange loans by banks; (iii) limitation on purchases of foreign currency by banks, in order to discharge foreign exchange loans due, to amounts within their open foreign exchange limit; (iv) controls over advanced payments for imports that do not enter the territory of Ukraine; and (v) a six-day delay for investors wishing to convert hryvnia profits, revenues or the sale of assets into foreign currency (for details see Box 1). The fourth restriction has already been eliminated. By the time of the first review, staff will complete the assessment of whether any of these exchange controls give rise to exchange restrictions subject to Article VIII, Section 2(a) of the Fund's Articles and whether such restrictions warrant temporary approval by the Executive Board.

Article IV Consultation:

The discussions for the 2008 Article IV Consultation took place in Kyiv between March 20 and April 1, 2008. The concluding statement of the mission was posted at www.imf.org on April 16, 2008.

The IMF team comprised Messrs. Ford (Head), Flanagan, Moulin (all EUR), Mr. Driessen (MCM), Ms. Zakharova (FAD), Mr. Hofman (PDR), and Mr. Horvath, Resident Representative.

The mission met with NBU Governor Stelmakh, Finance Minister Pynzenyk, Economy Minister Danylyshyn, First Deputy Chief of Staff to the President Shlapak, other senior officials, representatives of parliament, the diplomatic community, financial sector, and think tanks. Mr. Yakusha (OED) attended the discussions.

A separately published *Selected Issues* Paper provides background on two topics: (1) Two Aspects of the Ukrainian's Business Cycle; (2) Strengthening Ukraine's Fiscal Framework. A *Working Paper* provides background on Resolving Large Contingent Fiscal Liabilities.

X. FSAP Participation

A joint World Bank-International Monetary Fund mission conducted an assessment of Ukraine financial sector as part of the Financial Sector Assessment Program (FSAP) between May 10–24, 2002. An update mission visited Ukraine between February 18–21, 2003, and the Financial Sector Stability Assessment (FSSA) report (IMF Country Report No. 03/340) was considered by the Executive Board on May 14, 2003. The observance of the following standards and codes was assessed: Basel Core Principles for Effective Banking Supervision; Code of Good Practices on Transparency in Monetary and Financial Policies; CPSS Core Principles for Systemically Important Payment Systems; OECD Principles for Corporate

Governance; Accounting and Auditing Practices; World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights System; and AML/CFT Methodology.

A further update mission visited Ukraine between June 11–22, 2007 and July 9–20, 2007. The observance of the following standards and codes was assessed: Basel Core Principles for Effective Banking Supervision; and IOSCO Core Principles of Securities Regulation. An updated Financial Sector Stability Assessment (FSSA) was considered by the Executive Board as part of the 2008 Article IV consultation.

XI. ROSCS

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

XII. Fund Technical Assistance Missions, 2003-08 (As of April 16, 2008)

Department	Type of Mission	Timing
FAD	Modernizing the State Tax Service	February 7–21, 2006
	Macro-fiscal Analysis	January 10–18, 2006
	Reform of the State Customs Service	December 2006
	Proposals to Reform the Tax System	October 5–18, 2005
	Customs Administration	June 7–21, 2005
LEG	Workshop on the Use of Cash Couriers and Cross-Border Operations for Money Laundering and the Financing of Terrorism	April 2007
	Workshop on Effective Enforcement of Criminal Justice Measures in Anti-Money Laundering and Combating the Financing of Terrorism	April 2005
MCM	Monetary policy operations	September 2008
	Monetary Policy Operations	March 27-April 4, 2008
	Monetary policy, banking supervision, and other core central bank functions.	November 5-11, 2007
	Operational Preparations for Exchange Rate Flexibility	September 3-10, 2007
	Monetary policy, banking supervision, and other core central bank functions.	July 14-17, 2007

	NBU Internal Audit and Financial Reporting	September 4–12, 2006
	Monetary Policy Communication Strategy	March 6–14, 2006
	Monetary Policy Operations	January 23–February 2, 2006
	Operational Preparations for Exchange Rate Flexibility	December 11–21, 2005
	Action Plan for Transition to Inflation Targeting	October 10–14, 2005
	Foreign Exchange Markets	July 20–28, 2005
	Debt Management Strategy (with ICM)	June 23–July 7, 2005
	Central Bank Accounting	June 1–15, 2005
	Implementing Effective AML/CFT Measures	May 11–20, 2005
	Management of Foreign Exchange Risk in Transitioning to Greater Exchange Rate Flexibility	April 18–29, 2005
	Dealing with Problem Banks	March 30–April 6, 2005
	Inflation Targeting	November 15–19, 2004
	Banking Supervision	October 25–November 12, 2004
	Banking Supervision, Monetary Framework and Operations, Government Securities Market	April 13–26, 2004
	Review of TA Needs	February 9–11, 2004
STA	External Sector Statistics	April 14-25, 2008
	Balance of Payments Statistics	June 29–July 12, 2005
	Real Sector Statistics	March 21–April 1, 2005
ICM	Management of External Debt	May 31-June 3, 2005

XII. Fund Resident Representatives and Advisors, 2003–08 (as of April 1, 2008)

Purpose	Representatives/Advisors	Assignment
Resident Representatives		
Senior Resident Representative	Mr. Franks	September 2004 – August 2007
	Mr. Figliuoli	August 2001–August 2004
Resident Representative	Mr. Horvath	Since October 2007
	Mr. Lissovolik	July 2001–January 2004

Advisors		
Advisor on Inflation Targeting to the National Bank of Ukraine	Mr. Vavra	Since January 2006, several visits. November 2004–November 2005
Macro Policy Advisor to the Ministry of Finance	Mr. Marion	2005–06
Banking Supervision Advisor at the NBU	Mr. Livesay	April 2005–October 2005

APPENDIX II: UKRAINE—RELATIONS WITH THE WORLD BANK

(October 2008)

Country Partnership Strategy

The World Bank Country Partnership Strategy (CPS) for Ukraine was endorsed by the Bank's Board of Directors on December 6, 2007. It covers fiscal years 2008–11, and its major focus is to support Ukraine's sustained growth by addressing 3 key challenges: improving competitiveness, reforming public finances and the public sector to improve service delivery and make growth socially inclusive. Taking into account Ukraine's substantial investment needs and the significant growth of the economy in recent years, the current CPS envisions a lending range of $2 to $6 billion over the four-year CPS period to be applied within a flexible operational framework based on the principles of selectivity, flexibility and partnerships. Up to 50 percent of this envelope is planned through direct budget support operations. This operational framework is built on lessons of the previous Country Assistance Strategy (CAS) and is consistent with emerging best practice in middle-income countries (MICs). In the context of the recent economic/financial situation, the World Bank may reevaluate the CPS priorities to better target assistance to emerging needs, including potential support to restructure the banking sector, deliver assistance to the most vulnerable and ensure continued financing of key infrastructure investments.

World Bank Program

There are 12 operations under implementation in the current project portfolio with total net IBRD commitments of $1.2 million.

The current series of **Development Policy Loans** was designed to integrate government and donor activities under three broad themes to improve public governance: investment climate; public administration and public finance management; and social inclusion. Development Policy Loan (DPL) 1 ($250 million) was disbursed in FY06 and DPL 2 ($300 million) in FY08. DPL 3 is under preparation and would be processed and approved once key structural measures are fulfilled by the government. The CPS envisages further DPLs during FY 2010–11 to support structural reforms that would help restore Ukraine rapidly to sustainable economic growth.

Among other projects in the **public sector** are a Public Finance Modernization Project ($50 million), a State Tax Service Modernization Project ($40 million), and a Statistical System Modernization Project ($32 million). In the area of **rural development**, the World Bank supports establishment of a secure registration system to enable land transactions to be efficiently processed and protected under the Rural Land Titling and Cadastre Development Project ($101.5 million).

The Bank's support for the **energy** sector has been significant and has increased with a sequence of sector investment loans. The Hydropower Rehabilitation Project ($106 million) was approved in June 2005 and the Power Transmission Project ($200 million) was approved in August 2007. Further investment operations are envisaged in support of a long-term

Energy Reform and Development Program based on the country's own action plan for stabilization in the energy sector.

In **infrastructure**, an Urban Infrastructure Project ($140 million), designed to provide financing to local governments and utilities for priority investments in water and wastewater, was approved in August 2007 and will soon commence implementation. Other projects in the pipeline include the Roads and Safety Improvement ($400 million) and Railways Modernization ($450 million) projects.

In the financial sector, the Access to Financial Services project ($150 million), aiming to provide for increased access by rural small and medium-sized enterprises to financial services, was approved June 2006, and a Second Export Development Project ($154 million), building on the success of the first project, continues to promote the Ukrainian economy's export capacity and to strengthen the institutional capacity of Ukreximbank since it was approved in July 2006. Additional operations may be initiated to deal with current situation in the banking sector.

The Bank has devoted considerable resources to **social sector** assistance. An Equal Access to Quality Education project ($86.6 million) aims to improve the efficiency and quality of the education system and to better prepare students to compete in a knowledge economy and the Bank has supported the modernization of administering social benefits through a Social Assistance System Modernization project ($99 million) since November 2005. A project supporting the country's fight against TB and HIV/AIDS will close in December 2008.

The Bank is also providing significant **non-lending support** in a number of sectors. In close partnership with USAID, the Bank has been supporting the Government and regulatory agencies to develop the securities market and non-banking financial institutions, in particular in preparation for the introduction of second-pillar pensions, through a Programmatic Technical Assistance Partnership (PTAP). The Bank has also provided direct sub-national assistance to the authorities and other stakeholders in Zaporizhiya oblast to collaboratively take action to reduce health impacts of air pollution caused by the largest industrial polluters in Zaporizhiya. The Bank also continues to assist the country to take advantage of benefits from transactions under International Emissions Trading and Joint Implementation resulting from the Kyoto Protocol.

The Bank also carries out an extensive program of **economic and sector work** in a broad range of areas, including expenditure policy (with particular emphasis on efficiency and budget reallocation issues), tax policy, tax administration, intergovernmental fiscal relations, agriculture, energy, and social sector expenditure and policy. The Bank has also undertaken analytical work on Ukraine's response to the global food crisis, specifically examining opportunities for agriculture producers as well as the potential impact on the poor, in addition to reviewing the competitiveness of the sector.

World Bank Contact: Martin Raiser, Country Director (Tel.:380-44 490-6671).

Appendix III: Ukraine—Relations with the EBRD
(September 2008)

Ukraine joined the EBRD in 1992 and since then the EBRD has been active in supporting Ukraine's transformation toward a market economy. Successive country strategies have focused on:

- Financing private sector projects, developing the financial sector and rehabilitating existing infrastructure (1992–93).
- Strengthening the financial sector and supporting the needs of SMEs; promoting the commercialization and structural reform of public utilities; and improving energy efficiency and supporting the transition of the enterprise sector, especially in agribusiness (2000).
- 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 and medium business sector (SMEs); and commencing funding for the agricultural sector through the provision of working capital (2004).
- Helping to improve the business climate and the competitiveness of the private sector; strengthening the institutional capacity of the financial sector and increasing the level of finance for micro enterprises and SMEs; and supporting the restructuring and modernization of Ukraine's road, railway, harbor, airport infrastructure, power and oil & gas sectors (2005).

The EBRD's main contribution has been the funding of projects in both the pubic and private sectors, including some equity investments. This has been supported by a range of technical cooperation activities and by engaging in policy dialogue with the government. The latter has included membership of the Foreign Investment Advisory Council, but more especially, and in a sector-focused manner, through the EBRD's co-chairmanship of the Energy Sector Task Force and the Transport Working group established between EBRD and the Ministry of Transport.

In 2007 Ukraine rose to become the Bank's 3rd largest exposure (after Russia and Poland), representing approximately 8.3 percent of the Bank's signed commitments as of July 1, 2007. This is significant in as much as during the two previous strategy periods Ukraine was ranking fifth in terms of exposure. As of December 31, 2007 the Bank had invested in 155 projects with a net cumulative business volume (the "NCBV") of €3,1 billion, with private sector projects representing 72 percent of the NCBV and non sovereign operations representing 67 percent of the NCBV. In terms of the sector distribution of Bank financing, 31 percent of the portfolio is in Infrastructure, some 21 percent in General Industries, 20 percent in Specialised Industries (mostly Agribusiness), 20 percent in Financial Institutions and the balance of 8 percent in Energy.

The **current country strategy**, approved in September 2007, outlines four main areas of operational focus: (i) promoting higher efficiency, competitiveness and corporate governance standards in the local private sector and assisting foreign direct investment; (ii) promoting the development of the domestic capital markets and providing continued support to micro, small and medium-sized private enterprises through dedicated long-term credit lines with partner banks; (iii) promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy; and (iv) improving efficiency and reliability of key infrastructure, power generation, transmission and distribution and of the oil and gas transport systems of Ukraine.

In terms of **developing the local private sector and encouraging FDI**, the Bank actively participated in financing key foreign investors such as IKEA, but also cross-border transactions with sponsors from countries of operations such as the Polish sanitary ware producer Cersanit and Serbian Agroinvest. In the retail sector the Bank supported the development of the leading local supermarket chain Furshet.

Program promoting the **development of domestic capital markets**, in 2007 the Bank launched its Hryvnia Lending Programme with the successful establishment of KievPrime, a credible local currency interbank index. The Bank completed successful syndications in favor of local commercial banks, such as Kreditprom bank. Provision of mortgage finance for Forum bank and finance for small and medium businesses continued through EBRD credit lines to Mega bank. The EBRD intensified significantly its investments in the property sector with loans to property developer Cantik and participation in two commercial property funds.

The strategic goal of supporting **environmental protection and energy efficiency and security** related projects was pursued in 2007 with the industrial energy efficiency credit line to UkrExim bank. The EBRD continued its support for local private business in the oil and gas sector by financing downstream operator Galnaftogas and the exploration company Cadogan Petroleum. A significant milestone in the activities of the Chernobyl Shelter Fund and the Nuclear Safety Account—two major donor-funded programs administered by the EBRD—was the signing of the contract for the construction of the new safe confinement for Unit 4 and the contract for the completion of the dry fuel storage facility at Chernobyl Nuclear Power Plant.

In the **infrastructure** area, important recent projects include the first municipal transport projects for the Kiev Metropolitan and the Kiev Municipal bus company and the first investment in the media and telecommunications sector in favor of Volia cable operator.

INTERNATIONAL MONETARY FUND

Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Adnan Mazarei

November 3, 2008

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Ukraine and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.** The authorities are requesting a 24-month SBA with access of SDR 11 billion (802 percent of quota). A front-loading of SDR 3 billion (219 percent of quota) would be made available upon approval of the arrangement; this would be followed by eight quarterly purchases providing access of SDR 6.5 billion (474 percent of quota) in 2009 and SDR 1.5 billion (109 percent of quota) in 2010, with the final purchase in October 2010 (Table 1).

Table 1. Ukraine: Proposed SBA—Access and Phasing

Availability	Date 1/	Purchases		
			Percent of quota	
		SDR mn	Annual	Cumulative
2008	November (approval)	3,000	218.7	218.7
2009	February	1,250	91.1	309.8
	May	2,500	182.2	492.0
	August	750	54.7	546.6
	November	2,000	145.8	692.4
2010	February	375	27.3	719.8
	May	375	27.3	747.1
	August	375	27.3	774.4
	October	375	27.3	801.7
	Total	11,000	801.7	801.7

Source: Finance Department.

1/ Starting in February 2009, purchases will depend on the completion of a review.

I. Background

2. **Ukraine has had an extensive financial relationship with the Fund since becoming a member in September 1992 (Table 2).** Obligations to the Fund (all GRA) peaked in 1999 at just over SDR 2 billion. Current credit outstanding is SDR 73.14 million. Ukraine's performance under its past programs with the Fund has been mixed. Most recently, the 2004 SBA arrangement, which was treated as precautionary upon approval, quickly went off-track. The 2005 Ex Post Assessment of Longer-term Program Engagement concluded that better program ownership, rooted in stronger political consensus, would be key in improving the chances of success for potential future program-based engagement.[1] Ukraine has repurchased Fund's resources in a timely fashion.

Table 2. Ukraine: IMF Financial Arrangements, Purchases and Repurchases, 1994–2015
(In millions of SDRs)

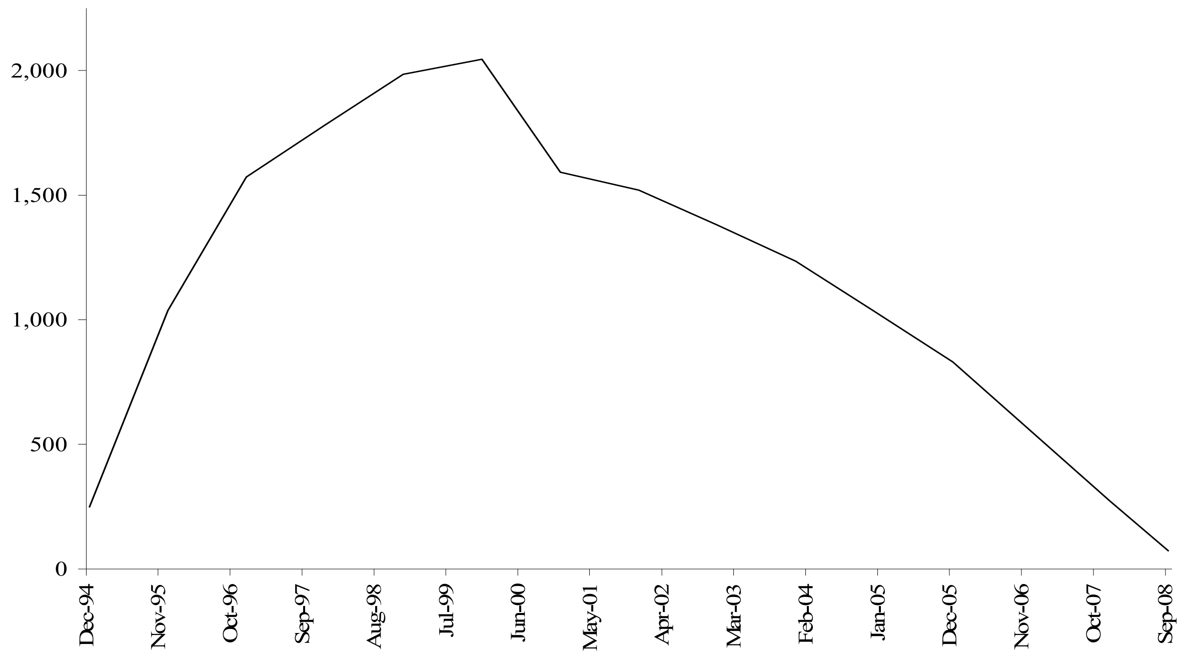
Year	Type of New Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Amount Drawn	Purchases	Repurchases	Fund Exposure 1/
1994	STF 2/	26-Oct-1994		498.6	498.6	249.3	0.0	249.3
1995	SBA	7-Apr-1995	6-Apr-1996	997.3	538.7	788.0 3/	0.0	1,037.3
1996	SBA	10-May-1996	23-Feb-1997	598.2	598.2	536.0	0.0	1,573.3
1997	SBA	25-Aug-1997	24-Aug-1998	398.9	181.3	207.3	0.0	1,780.6
1998	EFF	4-Sep-1998	3-Sep-2002	1,920.0	1,193.0	281.8	77.3	1,985.0
1999						466.6	407.0	2,044.6
2000						190.1	643.5	1,591.2
2001						290.8	361.2	1,520.7
2002						0.0	140.7	1,380.0
2003						0.0	144.5	1,235.5
2004	SBA	29-Mar-2004	28-Mar-2005	411.6	0.0	0.0	201.8	1,033.7
2005						0.0	202.8	830.9
2006						0.0	279.0	551.9
2007						0.0	279.0	272.9
2008 4/						0.0	199.8	73.1
2008 5/ 6/	*SBA*	*5-Nov-2008*		*11,000.0*	*11,000.0*	*3,000.0*	*215.6*	*3,057.3*
2009 6/						*6,500.0*	*57.3*	*9,500.0*
2010 6/						*1,500.0*	*0.0*	*11,000.0*
2011 6/						*0.0*	*0.0*	*11,000.0*
2012 6/						*0.0*	*2,687.5*	*8,312.5*
2013 6/						*0.0*	*5,031.3*	*3,281.3*
2014 6/						*0.0*	*2,812.5*	*468.8*
2015 6/						*0.0*	*468.8*	*0.0*

Sources: Finance Department.

1/ As of end December, unless otherwise stated.
2/ The Systemic Transformation Facility (STF) was created in April 1993 and allowed to lapse in April 1995.
3/ Includes a second drawing under the 1994 STF of SDR 249.3 million.
4/ As of end September.
5/ Projected as of end December
6/ Figures under the proposed program in italics.

[1] See *Ukraine—Ex Post Assessment of Longer-Term Program Engagement* (IMF Country Report No. 05/415).

Figure 1. Ukraine: IMF Credit Outstanding, 1994-2008
(In millions of SDRs)



3. **While public external debt remains low, Ukraine's total external debt has increased in recent years to relatively high levels (Tables 3 and 4)**. By end-2007, Ukraine's public external debt had declined to 11 percent of GDP, well below that of recent exceptional access cases, and lower than that of Iceland and Hungary.[2] However, total external debt reached 58 percent of GDP, over 80 percent of which was owed by the private sector. As a share of GDP, Ukraine's total external debt is higher than the corresponding ratios in three of the five recent exceptional access cases, but lower than that in both Iceland and Hungary.[3] [4]

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[2] See forthcoming staff reports for Iceland and Hungary.

[3] The exceptional access cases used as comparators in this paper are five of the six arrangements approved since the exceptional access procedures were put in place (Argentina, Brazil, Georgia, Turkey, and Uruguay). The 2008 extended arrangement for Liberia also involved exceptional access. However, this arrangement was different from other exceptional access cases since, in this case, exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

[4] The analysis in this supplement is based on information on Fund arrangements as of end-September 2008. Except where specifically noted, it does not take into account other arrangements that may be put forward for the consideration of the Board in the coming weeks.

Table 3. Ukraine: External Debt, 2005–08

	2005	2006	2007	2008 1/
	(In millions of U.S. dollars)			
Total External Debt	38,843	53,633	81,939	102,128
of which :				
Public	13,526	14,838	15,602	19,485
Private	25,317	38,795	66,337	82,644
	(In percent of total external debt)			
Total External Debt	100.0	100.0	100.0	100.0
of which :				
Public	34.8	27.7	19.0	19.1
Private	65.2	72.3	81.0	80.9
	(In percent of GDP)			
Total External Debt	45.1	49.7	57.8	54.3
of which :				
Public	15.7	13.7	11.0	10.4
Private	29.4	35.9	46.8	43.9

Source: Ukrainian authorities and IMF staff estimates.

1/ Projected to end-2008.

Table 4. Debt Ratios in Recent Exceptional Access Cases 1/
(In percent of GDP)

	Total External Debt	Public External Debt	Debt to IMF
Argentina (2003)	129.0	82.5	12.2
Brazil (2003)	38.6	21.5	5.1
Turkey (2005)	35.0	17.8	3.0
Uruguay (2005)	82.0	60.8	13.8
Georgia (2008) 2/	34.6	21.0	2.8
Ukraine (2008) 3/	*54.3*	*10.4*	*2.5*

Source: Board Documents and IMF staff estimates.

1/ Ratios for the year indicated in parenthesis. Year in parenthesis corresponds to the year of approval of the last IMF arrangement with each country.
2/ Projected for end-2008, including PRGF resources.
3/ Projected for end-2008, assuming first purchase under proposed SBA.

II. The New Stand-By Arrangement—Risks and Impact on Fund's Finances

A. Risks to the Fund

4. **Access under the proposed arrangement would far exceed that in previous arrangements with Ukraine, and would exceed both the annual and cumulative limits.** If all purchases are made as scheduled, Ukraine's outstanding use of Fund resources would rise from about 5 percent of quota currently to over 200 percent with the first drawing. Access would reach over 800 percent of quota in October 2010—well above Ukraine's historic peak exposure—and remain at this level through January 2012.[5] In terms of quota, this peak exposure would be larger than that in the recent exceptional access cases, except for Turkey (Figure 2).[6]

5. **The proposed SBA will take Ukraine's total outstanding use of Fund resources to 2.5 percent of GDP following the first purchase and 11.5 percent of GDP if fully disbursed (Tables 5 and 6).** Ukraine's outstanding use of Fund resources in terms of GDP would be significantly higher than the ratios for recent exceptional access cases, except for Liberia. Taking into account the first drawing under the program (as well as those under proposed programs for Iceland and Hungary), Ukraine would become the Fund's third largest user of Fund resources.

6. **The Fund's share of Ukraine's external debt and debt service would increase significantly if the SBA were fully drawn** (see Table 6)**.** Ukraine's outstanding use of Fund resources would account for half of Ukraine's projected public external debt by end-2009, and peak slightly above that by the end of the program. Ukraine's projected debt service to the Fund would peak in 2013 at about SDR 5 billion. Given the low public external debt, debt service to the Fund would reach over 70 percent of public external debt service in 2012 and over 80 percent in 2013.[7] In terms of exports of goods and services, external debt service to the Fund would exceed 5 percent in 2012 and 8 percent in 2013.

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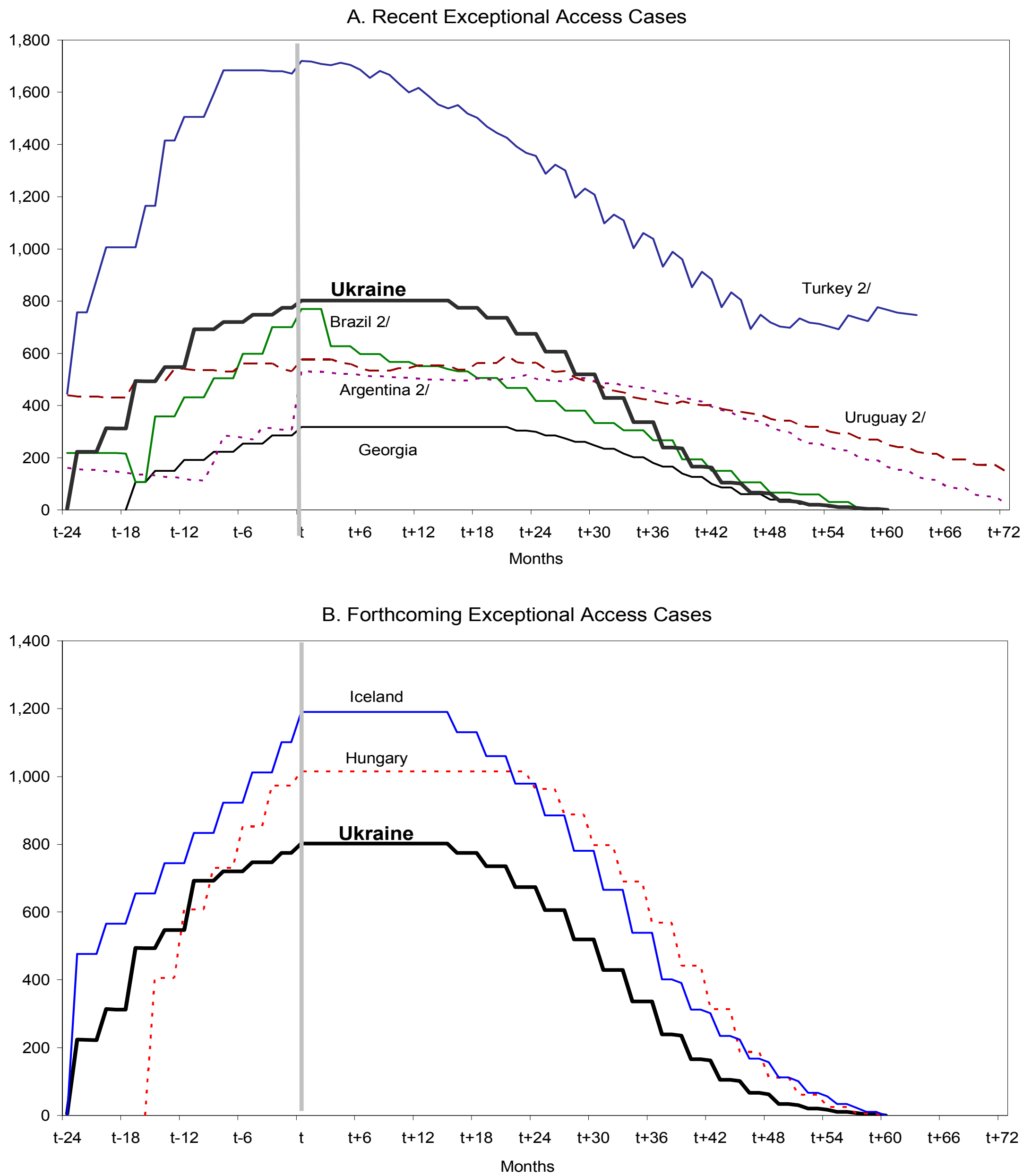
[5] The figures on debt service used in this report correspond to the schedule on an obligations basis, in line with the guidelines stipulated in *Review of Fund Facilities—Proposed Decisions and Implementation Guidelines* (http://www.imf.org/external/np/pdr/fac/2000/02/). Under the obligations schedule, the first repurchase is scheduled to take place in February 2012, 3¼ years after the first purchase under the arrangement. Under the policy on time-based repurchase expectations, there is an expectation that repurchases of holdings resulting from the purchases in the credit tranches and the EFF, including under exceptional access will adhere to the expectations schedule, and an extension from the expectations to the obligations schedule would require a decision by the Executive Board.

[6] Peak exposure as a share of quota would be smaller than that under the proposed arrangements for Hungary and Iceland, as shown in the second panel of Figure 2.

[7] Currency holdings resulting from scheduled purchases under the proposed SBA would be subject to level-based surcharges of 100 basis points over the basic rate of charge (adjusted for burdensharing) on credit outstanding exceeding 200 of quota from the time of approval of the arrangement through January 2014, and

(continued)

Figure 2. Fund Credit Outstanding in the GRA around Peak Borrowing 1/
(In percent of quota)



Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding for a member, in percent of quota. Month t represents the month of the highest historical credit outstanding (in percent of quota). For Argentina, t is September 2001; for Brazil, September 2003; for Turkey, April 2003; and for Uruguay, August 2004. For Georgia, t would be reached in February 2010. For the countries in Panel B, t would be reached in February 2010 in the case of Hungary, and October 2010 in the cases of Iceland and Ukraine. For comparability, projected repurchases are assumed to be on an obligations basis.
2/ Projected repurchases (on an obligation basis) as of May 2005. Schedules do not show large early repurchases made by Argentina, Brazil, and Uruguay in 2005-06.

surcharges of 200 basis points on credit outstanding exceeding 300 percent of quota from February 2009 to October 2013.

Table 5. Fund GRA Exposure

		In Percent of			
				Total GRA Credit	
	SDR Millions	Quota	GDP 3/	As of end-Sep. 2008	After approval of arrangements in panel B 4/
A. Top five borrowers as of end-September 2008					
Turkey 1/	5,898.7	495.1	1.2	77.9	38.4
Dominican Republic 1/	350.2	160.0	1.2	4.6	2.3
Liberia 1/	342.8	265.3	59.4	4.5	2.2
Sudan 1/	220.9	130.2	0.6	2.9	1.4
Georgia 1/	161.7	107.6	2.0	2.1	1.1
B. Forthcoming exceptional access cases					
Iceland 2/	560.0	476.2	5.1	…	3.6
Hungary 2/	4,215.0	405.9	4.2	…	27.5
Ukraine 2/	3,073.1	224.0	2.6	1.0	20.0

Sources: Finance Department and IMF staff estimates.

1/ Fund credit outstanding as of September 30, 2008.

2/ Fund credit outstanding after the first purchases of the proposed SBA. For Ukraine, includes credit outstanding as of end-September 2008.

3/ Staff projections to end-2008.

4/ Numerator is Fund credit outstanding as of end-September 2008 for countries in panel A, and Fund credit outstanding as of end-September 2008 plus the first purchase under the proposed SBA for countries in panel B. Denominator is the sum of total Fund GRA credit outstanding as of end-September 2008 and the first purchases of the three proposed arrangements in panel B.

B. Impact on the Fund's Liquidity Position and Risk Exposure

7. **The proposed arrangement would reduce Fund liquidity by about 9 percent.** Commitments under the proposed arrangement would reduce the one-year forward commitment capacity of SDR 127.6 billion as of end-September by SDR 11 billion (see Table 6).[8]

8. **Fund credit to Ukraine as a share of total current Fund credit from the GRA would increase to 20 percent with the first drawing, taking into account the proposed arrangements for Iceland and Hungary.** The share of the top five borrowers of total outstanding credit would remain virtually unchanged at about 92 percent taking all three potential programs into account (see Table 6).[9]

[8] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months. Following the creation of the Short-term Liquidity Facility (SLF), the calculation of the FCC will exclude repurchases falling due under the SLF—see *A New Facility for Market Access Countries—The Short-Term Liquidity Facility—Proposed Decision* (http://www.imf.org/external/np/pp/eng/2008/102708.pdf)

[9] Given the expectation for a number of new lending operations beyond that of Ukraine, Hungary, and Iceland, including a number that will involve exceptional access, the concentration of the Fund's lending portfolio is likely to change in coming months.

Table 6. Ukraine—Impact on GRA Finances
(In millions of SDRs, at end of period unless otherwise noted)

	2008	2009	2010	2011	2012	2013	2014
Exposure							
Fund GRA credit outstanding to Ukraine 1/	3,057.3	9,500.0	11,000.0	11,000.0	8,312.5	3,281.3	468.8
Fund GRA credit outstanding to Ukraine (percent of quota) 1/	222.8	692.4	801.8	801.8	605.9	239.2	34.2
Fund GRA credit outstanding to Ukraine (percent of total GRA credit outstanding) 2/	20.0	…	…	…	…	…	…
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 2/	91.9	…	…	…	…	…	…
Liquidity							
One-year Forward Commitment Capacity (FCC) 3/	127,615.8	…	…	…	…	…	…
Ukraine's impact on FCC 4/	(11,000.0)	…	…	…	…	…	…
Prudential measures							
Fund GRA credit outstanding to Ukraine (percent of current precautionary balances) 5/	44.1						
Debt and debt service ratios 6/							
Ukraine's GRA credit outstanding (percent of total public external debt)	24.5	50.3	53.6	51.7	41.9	19.9	…
Ukraine's GRA credit outstanding (percent of GDP)	2.5	10.9	11.5	10.5	7.0	2.4	…
Ukraine's GRA credit outstanding (percent of gross international reserves)	15.2	48.4	49.4	43.1	28.7	10.6	…
Ukraine's GRA debt service to the Fund (percent of exports of goods and services)	0.1	0.7	1.0	1.0	5.2	8.2	…
Ukraine's GRA debt service to the Fund (percent of total public external debt service)	2.1	16.4	22.6	26.7	73.4	81.2	…
Memorandum items							
Fund's precautionary balances 5/	6,938.6						
Fund's residual burden sharing capacity 7/	110.0						
Projected payment of charges to the Fund on GRA credit outstanding	16.2	257.9	500.7	551.8	513.0	306.7	78.7
Projected debt service payments to the Fund on GRA credit outstanding	32.0	315.2	500.7	551.8	3,200.5	5,337.9	2,891.2

Source: Ukrainian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Repurchases follow obligations schedule.
2/ Reflects Fund credit outstanding as of September 30, 2008, plus first purchases by Hungary, Iceland, and Ukraine.
3/ As of September 30, 2008. The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance.
4/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
5/ As of end-April 2008.
6/ Staff projections for total public external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA.
7/ Estimated based on end-September data and taking into account the first purchases of Hungary, Iceland and Ukraine under their proposed programs. Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

9. **Were Ukraine to accrue arrears on charges under the proposed arrangement, the Fund's burden sharing mechanism could be put under very serious strain.**[10] Charges on the new GRA obligations will be about SDR 250 million over the next year or more than twice the Fund's estimated residual burden-sharing capacity, taking into account the first purchases of the three forthcoming arrangements (see Table 6). However, the impact on the Fund's burden sharing capacity of potential arrears from this arrangement would decline if the Fund's loan portfolio were to expand.

10. **Potential GRA exposure to Ukraine would be substantial in relation to the Fund's current level of precautionary balances.** Outstanding GRA credit to Ukraine would be about 44 percent of the Fund's current level of precautionary balances upon approval (see Table 6).

III. Assessment

11. **There are considerable financial risks associated with the proposed arrangement for Ukraine.** The proposed access, and the substantial and front-loaded financing under the program aim to strengthen confidence in Ukraine's ability to address the effects of plunging commodity prices and the present environment of global deleveraging, bolstering reserves and providing breathing room for implementation of necessary adjustment under the proposed program (EBS/08/114, 11/3/08). However, the arrangement is large in terms of both available Fund resources and the debt service implications for Ukraine. Moreover, there are substantial downside risks to the baseline scenario, including:

- **a worsening of external financial conditions.** A further deepening, or exceptionally long duration, of the ongoing process of deleveraging in financial markets could delay access to international financial markets, affecting particularly the private sector, in the face of its large and increasing financing needs;

- **a possible overshooting of the exchange rate**. A significant exchange rate depreciation would exacerbate pressures on households and banks (with mixed effects on corporates);

[10] Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge. The adjustment for the SCA-1 was suspended, effective November 1, 2006, by the Executive Board (Decision No. 13858-(07/1), adopted January 3, 2007).

- **delays in moving forward with financial sector reforms and enactment of a comprehensive bank resolution strategy**. The upfront banking recapitalization provides for a strong start, but implementation of these reforms will require steady and decisive policy actions; and

- **a challenging political situation that could adversely affect program implementation and market confidence.** The Parliamentary passage of anti-crisis legislation and the commitment to the programmed reforms by both the ruling coalition and opposition leaders provide critical support in this regard. Nonetheless, the forthcoming parliamentary election and the presidential election in January 2010 could cloud the already fractious political environment, posing a potentially serious risk to program implementation.

12. **These risks may adversely affect Ukraine's capacity to repay the Fund.** The proposed access is significant in terms of both Fund resources and the debt service burden it generates in a medium-term context of demanding external financing requirements. As such, the authorities' commitment to firm implementation of the program (already demonstrated in the context of substantial prior actions), prompt response to changes in underlying conditions, and continued political support are key to mitigating these risks and safeguarding Fund resources.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 08/271
FOR IMMEDIATE RELEASE
November 5, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$16.4 Billion Stand-By Arrangement for Ukraine

The Executive Board of the International Monetary Fund (IMF) today approved a two-year Stand-By Arrangement (SBA) for SDR 11 billion (about US$16.4 billion) to help the authorities restore financial and economic stability and strengthen confidence. The SBA request entails exceptional access to IMF resources equivalent to 802 percent of Ukraine's quota in the Fund, and was approved under the Fund's fast-track Emergency Financing Mechanism. Today's approval enables the immediate disbursement of SDR 3 billion (about US$4.5 billion).

The authorities' program is designed to help stabilize the domestic financial system against a backdrop of global deleveraging and a domestic crisis of confidence, and to facilitate adjustment of the economy to a large terms-of-trade shock. The authorities' plan incorporates monetary and exchange rate policy shifts, banking recapitalization, and fiscal and incomes policy adjustments.

Following the Executive Board discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, issued the following statement:

"The Ukrainian economy, especially the banking system, is experiencing considerable stress. Falling prices for Ukraine's major export, steel, have led to a substantial deterioration in Ukraine's current account outlook. This terms-of-trade shock, along with existing vulnerabilities—high inflation, relatively low foreign exchange reserves compared with short-term external debt, significant exposure of banks to foreign funding, balance sheet mismatches, and a weak underlying fiscal position—interacted with the drying up of liquidity caused by the international financial crisis and led to a significant slowdown in capital inflows.

"The authorities' program, supported by the two-year Stand-By Arrangement with the IMF, aims to restore financial and macroeconomic stability by adopting a flexible exchange rate regime with targeted intervention, a pre-emptive recapitalization of banks, and a prudent fiscal policy coupled with tighter monetary policy. Resolute implementation of the program should help reduce inflation to single digits by the end of the program.

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"The flexible exchange rate regime, backed by an appropriate monetary policy and foreign exchange intervention, will help absorb external shocks and avoid disorderly exchange market developments. The recent unification of official and market exchange rates should increase clarity about the regime. Recently imposed exchange controls will be phased out as confidence rebuilds. Plans to accelerate progress towards inflation targeting and enhance the independence of the National Bank of Ukraine are important to provide the nominal anchor under the flexible exchange rate regime over the medium term. In the near term, as liquidity pressures diminish, tighter monetary policy will be necessary to guard against inflation.

"A pre-emptive bank recapitalization will alleviate a potential credit crunch that could prolong and deepen the downturn in economic activity. Decisive measures that have been taken to allocate public funds to recapitalize banks and to facilitate bank resolution processes will ensure that problems can be dealt with promptly. Increased oversight, more targeted on- and off-site inspections, and improved cross-border supervisory cooperation will help to strengthen the financial system. A proactive strategy to resolve corporate and household debt problems will also be essential to reduce banking sector vulnerabilities.

"A prudent fiscal stance is planned, consistent with both the financing constraint and the need for recession-related social spending. The target of a balanced budget in 2009 will be kept under review in light of the macroeconomic, financing, and revenue outlooks. The targets would be achieved in part by expenditure restraint, and by a phased increase in energy tariffs. Ukraine's extensive safety net provides a backstop to protect vulnerable groups, and the program also allows higher funding for unemployment insurance and targeted income support.

"The authorities have developed a strong and comprehensive package of measures to address the challenges Ukraine is facing and the Fund has provided commensurate financial assistance. Decisive measures have already been implemented by the authorities, including the passage of anti-crisis legislation. Moreover, the authorities' policy framework is sufficiently robust to adapt to evolving circumstances. The commitment of leaders of the main political parties to the core elements of the program increases the prospects for successful program implementation. All these elements give confidence that the program will succeed in stabilizing economic and financial conditions," Mr. Portugal said.

ANNEX

Recent Economic Developments

Ukraine's economy has grown very rapidly since 2000, expanding by more than 7 percent on average. Initially, this reflected the utilization of large excess capacity and increased productivity supported by a series of structural reforms. Since 2005, growth has been propelled by real domestic demand, namely a credit boom driven by strong capital inflows as well as incomes policies that redistributed large terms-of-trade gains to the population.

By mid-2008, the economy was overheating. Credit growth exceeded 70 percent, CPI inflation exceeded 30 percent, wage growth settled in the 30-40 percent range, a buoyant property market pushed valuations to high levels, and imports surged at an annual rate of 50-60 percent. The current account deficit reached 7 percent of GDP in the second quarter of 2008.

The Ukrainian economy also became vulnerable along other dimensions, including high short-term external debt relative to reserves, high exposure of banks to foreign funding, balance sheet mismatches, and a weak underlying fiscal position. Problems came to the fore as commodity prices plunged and the global financial turmoil deepened. These developments have had a considerable impact on the real sector as reflected in the sharp 5-percent contraction of the manufacturing sector in September.

At the same time, a sharp slowdown of external capital flows raised concerns about the ability of banks and corporates to roll over existing credit lines. When the sixth largest bank, Prominvest Bank, was put under receivership, a widespread deposit outflow began with at least US$3 billion—4 percent of deposits—withdrawn during the first three weeks of October. Confidence in the country's banking system and currency weakened. Intervention by the National Bank of Ukraine (NBU) mounted in October, reducing reserves from US$38 billion to US$32 billion. In addition to providing liquidity, the authorities also imposed a set of exchange controls to stem outflows.

The combination of weaker demand from Ukraine's trading partners, falling export prices, rising import prices, and reduced access to international financial markets are expected to weaken growth prospects. Taking these developments into account, Ukraine's overall financing needs for the next two years are large.

Program Summary

The authorities' program aims at restoring confidence in Ukraine's macroeconomic and financial stability by addressing the financial sector problems, facilitating adjustment to

potentially large external shocks, and reducing inflation. The program is designed to respond flexibly to economic developments.

The program is based on projections that assume a global recession and continued deleveraging in international credit markets in 2009, implying a recession in Ukraine with deteriorating exports, limited external financing and a credit crunch. The projected impact on output—a 3 percent decline—is consistent with Ukraine's experience under similar circumstances in 2004-05. Under the program, inflation is expected to decrease to 17 percent by end-2009 from the projected 25.5 percent this year. The current account would compress to a deficit level of about 2 percent of GDP from the mid-2008 level of 7 percent.

Assuming a global recovery in the second half of 2009, the Ukrainian economy could be back at its estimated potential growth rate of 5-6 percent by 2011 with inflation at 5-7 percent by late 2011.Current account deficits are projected to remain small in 2010, in light of the weak economy, and to be moderate thereafter, allowing reserves to rise.

The key measures to achieve the objectives of the program focus on the following areas:

Monetary and Exchange Rate Policy

The program supports the implementation of a flexible exchange rate regime to help Ukraine better absorb the external shocks it now faces. Base money will be the near-term anchor for monetary policy until an inflation targeting regime can be implemented. The independence of the NBU will be strengthened, and in the near term, monetary policy will be tightened to help achieve the 2009 inflation objective of 17 percent. The program envisages eliminating exchange rate controls as soon as possible, and measures to improve the operation of the foreign exchange market, including cancellation of the foreign exchange transactions tax and a more transparent intervention policy.

Financial Sector Policy

The authorities intend to prepare a comprehensive bank resolution strategy that will include the resolution of problem banks and the recapitalization of viable banks to cushion the real economy from a potential credit crunch. The authorities have already resolved the sixth largest bank, Prominvest Bank, through a sale to a strategic investor.

The program further proposes to ensure that viable banks have access to liquidity; increase deposit insurance coverage to Hrv150,000 (about €20,000) from the current Hrv50,000, which will cover 99 percent of individual accounts; and strengthen the monitoring of banks, including through enhanced cross-border supervisory cooperation.

Fiscal Policy

The authorities will adopt a prudent fiscal stance while accounting for the need for recession-related social expenditures, including higher funding for unemployment insurance and

targeted income support. Under the program, the deficit would not exceed 1 percent of GDP in 2008, and in 2009, the general government budget would be balanced (excluding bank recapitalization costs). Even with the substantial increase of 0.8 percent of GDP social spending during the recession, these fiscal targets are deemed attainable. However, given the uncertainties on economic prospects and the availability of financing, the authorities are prepared to adjust the targets as needed. To achieve their fiscal targets, the authorities are determined to correct the pricing policies in the energy sector and pursue a more balanced incomes policy by adjusting the minimum wage, pension, and social transfer increases in line with the projected inflation in 2009. These measures will help guard against higher inflation and depreciation. Ukraine has an adequate social safety net in place to protect the vulnerable against adjustment policies, which the authorities are prepared to expand should the need arise.

Ukraine joined the IMF as a member on September 3, 1992. Its quota is SDR 1,372 million (about US$2,049 million).

Ukraine: Selected Economic and Social Indicators, 2005-09 1/ 2/

	2005	2006	2007	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)					
Nominal GDP (billions of hryvnias)	441	544	713	993	1,112
Real GDP	2.7	7.3	7.6	6.0	-3.0
Contributions:					
Domestic demand	13.2	13.1	16.1	14.4	-14.3
Net exports	-10.5	-5.8	-8.5	-8.3	11.3
Unemployment rate (ILO definition; percent)	7.2	6.8	6.4	6.0	9.5
Consumer prices (period average)	13.5	9.1	12.8	25.6	21.0
Consumer prices (end of period)	10.3	11.6	16.6	25.5	17.0
Nominal monthly wages (average)	36.7	29.2	29.7	37.1	10.5
Real monthly wages (average)	20.4	18.4	15.0	9.1	-8.7
Public finance (percent of GDP)					
Cash balance excluding banks. recap	-2.3	-1.4	-2.0	-1.0	0.0
Augmented balance, including effects of banks recap.	-2.3	-1.4	-2.0	-2.0	-4.5
Privatization proceeds	5.0	0.4	0.6	0.2	0.1
Net domestic financing	-3.3	-0.4	0.3	1.8	4.4
Net external financing	0.6	1.3	1.0	0.0	0.0
Public debt	18.7	15.7	13.0	10.6	17.4
Money and credit (end of period, percent change)					
Base money	53.9	17.5	46.0	33.0	10.9
Broad money	54.4	34.5	51.7	37.2	9.4
Credit to nongovernment	61.8	70.6	74.0	40.9	-9.8
Balance of payments (percent of GDP)					
Total external debt 2/	45.1	49.7	57.8	54.3	78.2
Current account balance	2.9	-1.5	-3.7	-6.2	-2.0
Foreign direct investment	8.7	5.3	6.5	6.2	6.8
Gross reserves (end of period, billions of U.S. dollars)	19.4	22.3	32.4	31.4	30.7
In months of next year's imports of goods and services	4.4	3.7	4.0	5.1	4.5
Goods exports (annual volume change in percent)	-8.5	2.7	3.2	0.3	0.8
Goods imports (annual volume change in percent)	13.0	12.5	20.3	16.0	-19.7
Goods and services terms of trade (percent change)	4.9	1.5	7.4	8.9	-10.5

Social indicators

Per capita GDP: US$ 2,282 (2006); Poverty (percent of population): 8.0 (2006; World Bank estimate);

Life expectancy at birth: 68.2 years (2006); Infant mortality (per 1,000): 16.0 (2005); Gross primary enrollment (percent net): 84 (2005)

Sources: Ukrainian authorities; and staff estimates and projections.
1/ Policies assumed include: (i) increased exchange rate flexibility as from 2008; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2010; (iii) pass-through of rising energy import prices in 2009; (iv) public-financed recapitalization of banks for a total amount of Hrv 54 bln (10 bln by end-2008 and 44 bln in the first half of 2009).
2/ The increase in the external debt ratio in 2009 reflects, inter alia, the inclusion of IMF money in public external debt.

Statement by Mr. Yuriy Yakusha, Alternate Executive Director for Ukraine
November 5, 2008

The Ukrainian authorities would like to thank staff and management for the hard work to make this Board Meeting possible under the emergency financing mechanism. I would like to apologize to my Board colleagues for the rather short time between the distribution of the staff report and the Board meeting.

On their part, the authorities have been fully engaged at all levels of the executive and legislative branches of government, as well as at all levels at the monetary and supervisory authorities. Timely Fund advice helped the authorities to keep the situation under control despite a sudden decline in capital flows, combined with an external terms of trade shock and visible slowdown of key sectors of the economy, aggravated by eroding confidence in the banking system. On top of global concerns, common liquidity strains in the banking sector, a rather unexpected, almost sudden, paralysis of the steel industry around the globe affected Ukraine not only in terms of loss of production, exports and jobs, but it also aggravated the assessment of the country's prospects by external financial markets and rating agencies.

The sudden drop in steel prices by 65 percent since July 2008, combined with a substantial drop in global demand has already translated into a sharp deterioration in the real sector. As of last week, 18 out of 43 pig iron production facilities in Ukraine have been put out of operation, 40 out of 63 steel producing units were temporarily stopped, as well as all ferro alloy production and ore production. The country's ports are loaded with 1.5 mln of steel products that cannot be sold because of lack of external demand. Investment projects in the steel industry have also been largely frozen, affecting the construction industry that had been already slowing down for some time.

Facing the combined current and capital account shocks, the economy has already started to adjust itself to a new external environment. According to customs' statistics, imports dropped already by at least 15 percent in the month of October, in response to tighter domestic credit conditions, a weaker exchange rate and overall drop in confidence. The announced changes in macroeconomic policies, although they are rather painful for Ukrainian citizens, will help the economy to adjust more smoothly when combined with appropriate financing. None of the key stakeholders in the country considered the scenario of a hard landing with uncontrolled crisis adjustment a viable option. Furthermore, such a scenario might produce contagion effects throughout the region and beyond, given the common lender issues and the extreme volatility of the emerging debt asset class.

The authorities have taken the Fund's advice from the previous Article IV consultation to heart – the exchange rate was allowed to float early in the year under appreciation pressure, and this has allowed to avoid the problems usually associated with exiting the peg under downward pressure. The monetary and credit policies have been tightened to prepare for a softer landing. Growth in consumer credit has been practically halved during the first three quarters of the year. Since 2007, the monetary and supervisory authorities adopted prudential

measures to eliminate incentives for banks and other financial companies to fund themselves abroad with short-term debt.

The budget has been kept in surplus through most of the year, while the authorities tried to deliver the deficit outcome advocated by staff during Article IV discussions (up to 0.5 percent deficit). However, the most recent slowdown in important industries that provide a substantial revenue stream will probably result in a deficit of under 1 percent for 2008, despite the recent decisions to substantially slow down income growth in the public sector and to reduce energy subsidies. In fact, several previously made income policy decisions were cancelled on a very short notice.

Unfortunately, an engineered soft landing proved to be out of reach with the aggravation of the global crisis in October. Domestic confidence was also badly damaged by a hostile takeover attempt on the sixth largest bank that resulted in a run on the bank and one week of intense deposit withdrawals from many other banks. Some temporary administrative measures helped to ease the erosion of confidence. These controls, similar to those introduced back in 2004 during street protests, were implemented to prevent disorderly exchange market developments. The authorities are cognizant that a comprehensive policy package, including the recapitalization of the banking system, is needed to rebuild confidence. The legislation to this effect, that has been discussed with staff, has been adopted as part of the anti-crisis legislative package.

The authorities also realize that due to external and domestic shocks the economy will likely face a recession next year (much like many other parts of Europe). The strategy is to have an orderly adjustment to shocks. A sharp exchange rate adjustment would obviously affect balance sheets of corporate and individual borrowers who have borrowed in foreign currency. The confidence effect of a comprehensive program, the impact of supporting fiscal policy measures, and the maintenance of reserve buffers to create a credible threat of intervention should help avoid a sharp overshooting of the exchange rate. These policies will likely allow for a decline in the current account deficit to 2 percent of GDP. The program also supports the implementation of a comprehensive bank resolution strategy described in paras 62-63 of staff report (MEFP). Substantial amounts in terms of GDP (at least 8-10 percent) will be required to undertake recapitalization of viable banks. Alongside with the IMF, the World Bank and the EBRD are committed to provide substantial assistance in this area. The program also recognizes the possible need to facilitate a voluntary resolution of corporate and consumer debts, especially those denominated in foreign exchange.

Monetary policy will be anchored by base money targets. As the financial sector stabilizes, monetary policy will need to be shifted to a tighter stance to contain pressures on the exchange rate. In the medium term the authorities remain committed to their strategic goal of adopting an inflation-targeting regime.

Recession-related social and investment expenditures will have to be accommodated under very tight budget financing constraints. Moreover, the authorities realize that the adjustment of fiscal and incomes policies will limit the risks of disorderly exchange rate adjustment.

Additional buffers will be mobilized by energy policy changes – an increased pace of price adjustments to improve the pass-through of imported prices to all domestic consumers.

The program is based on a number of assumptions, including roll-over of 80 percent of private sector external debt. The authorities acknowledge these risks, but they also see upside risks. The government debt and public external debt in particular is very low by any standards. Some important corporate external credits are mainly intracompany loans (and reflect round tripping of previous export earnings). A significant amount of foreign assets of corporates are not captured by statistics. The important unregistered economy may provide a degree of cushion and absorb some of the unemployed. The flexible labor markets will also facilitate the adjustment. Ukraine is one of the few countries where agricultural land was not subject to sale, while the legislative ban is scheduled to expire soon. FDIs is expected to remain robust and the recent (September-October) radical modernization of the joint-stock company legislation is expected to improve the protection of investors' rights and the investment climate in general. Foreign parent banks are committed to Ukraine and continued to support their Ukrainian subsidiaries during the month of October (about USD 1 Billion of fresh funds). The bumper harvest of this year would allow Ukraine to export additionally up to 10 million tons of grains. Many important enterprises can and will be privatized, some of those facilities (energy, communications, etc.) belong to traditionally cash rich industries that are presumably less affected by the global credit crunch. Finally the authorities are approaching other IFIs and bilaterals to secure additional financing as part of their contingency planning.

The strength of numerous prior actions implemented by the authorities and their commitment to the program calls for support of their adjustment efforts by international community and the Fund in particular.