



UKRAINE

2012 ARTICLE IV CONSULTATION

November 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Ukraine, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 28, 2012, 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 June 15, 2012. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its June 29, 2012 discussion of the staff report that concluded the Article IV consultation.

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UKRAINE

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

June 15, 2012

KEY ISSUES

Context: Following the 2008/9 financial crisis and deep recession, a cyclical recovery took hold in Ukraine, supported by a stronger external environment. Efforts to consolidate public finances and repair the banking system began strengthening Ukraine's resilience to external shocks. More recently, policies have not been sufficient to meet key objectives, and the government has hesitated to undertake politically unpopular reforms. The external environment has become less supportive, and the recovery is losing momentum.

Outlook and risks: Vulnerabilities are elevated given significant external and fiscal funding needs and weak buffers. Risks of external shocks which could worsen Ukraine's growth outlook and reduce the availability of financing have risen. The medium-term outlook is clouded by still weak bank balance sheets and credit growth prospects and an uncertain business environment.

Main policy recommendations: Discussions focused on policies to reduce vulnerabilities, safeguard financial stability, and raise sustainable growth. The immediate tasks are to consolidate fiscal adjustment, improve the monetary and exchange rate policy framework, strengthen banks' balance sheets, and step up structural adjustment, especially in the energy sector.

Approved By
**Poul M. Thomsen and
 Elliott Harris**

Discussions were held in Kyiv during February 1–15, October 24–November 3, 2011, and May 21–28, 2012. The mission met with Prime Minister Azarov; First Deputy Prime Minister Khoroshkovskij; Deputy Prime Minister Tihipko; Deputy Prime Minister Poroshenko; Minister of Finance Kolobov; Former Minister of Finance Yaroshenko (resigned January 2012); Governor of the National Bank of Ukraine (NBU) Arbuzov; and other senior officials, ambassadors, and representatives of international financial institutions, research institutes, labor unions, and business communities. The staff team comprised Messrs. Jarvis (head) and Arvanitis (prior head); Messrs. Dohlman, Atoyan, and Roudet, and Ms. Mitra (EUR); Mr. Olafsson (MCM); Messrs. Hasanov and Ljungman (FAD); and Mr. Chensavadijai and Ms. Basu (SPR). Mr. Alier (resident representative) assisted the mission. The mission cooperated closely with World Bank staff. Mr. Yakusha, Alternate Executive Director for Ukraine, attended most meetings.

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CONTEXT

1. In the aftermath of the 2008/9 crisis, Ukraine's economy stabilized, and growth resumed.

Following one of the deepest recessions in Europe (real GDP contraction of 15 percent in 2009), a cyclical recovery took hold supported by a stronger external environment, better policies, and backing from the international community. Inflation fell to single digits. The combined general government and Naftogaz (NG; the state-owned gas company) fiscal deficit was halved to 4.3 percent of GDP by 2011, supported by policy measures, including pension reform, gas price increases (in mid-2010), and a cyclical rebound in revenues. The banking system was stabilized and recapitalized, and several banking and crisis resolution laws and reforms were completed. The sovereign regained access to international markets and foreign exchange reserves were rebuilt. These efforts strengthened Ukraine's resilience to external and macro-financial shocks and its performance relative to peers, and reduced perceptions of risk (Figure 1).

2. Ukraine's prospects are now hampered by uneven policy implementation and external headwinds.

Confidence in economic policies has deteriorated as the government reform agenda has lost some momentum. The fiscal policy stance for 2012 has been loosened and energy pricing reforms are stalled. The authorities continue to maintain a de facto peg as the nominal anchor, which drives monetary policy. The business environment has seen improvement in some areas, but still suffers from uneven administrative decisions and weak governance, which in turn dampen investment and growth prospects. Compounding this are weaker global growth prospects, renewed volatility in the euro area, ongoing deleveraging, and disruptions in global financial markets. Official sector support to Ukraine has been largely suspended (Box 1).

3. More ambitious policies would help contain risks and boost medium-term growth.

Immediate steps in fiscal consolidation and reforms in the energy and banking sectors are needed to reduce vulnerabilities and strengthen confidence and market access. Contingency planning for potential shocks should continue. Deeper structural reforms are needed to rebuild buffers and strengthen institutions. Together, these steps would help realize Ukraine's substantial growth potential—given abundant resources, an educated labor force, and proximity to major economic centers—and help close the income gap. Ukraine's per-capita income is about \$3,600, or 10 percent of the EU27 level.¹

¹ See Box 2 for discussion of follow-up against 2008 Article IV recommendations.

Box 1. Ukraine: Stand-By Arrangement

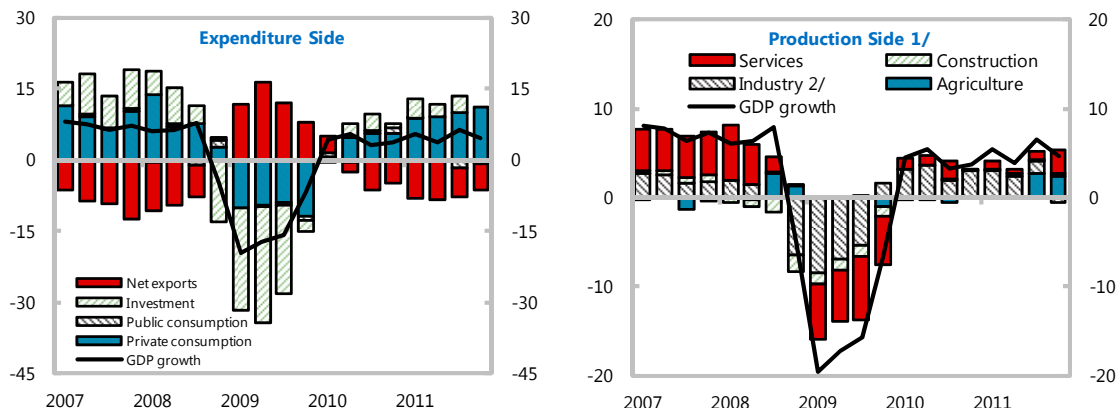
A 29-month, SDR 10.0 billion (US\$15.4 billion, 729 percent of quota) program was approved by the Executive Board on July 28, 2010 (EBS/10/146). The first review was completed in December 2010 (EBS/10/232). Two purchases totaling SDR 2.25 billion have been made, of which US\$2 billion was for budget support. The program expires in December 2012.

The second review under the SBA has been on hold since March 2011 as program performance has fallen short of expectations. On the positive side, a key structural reform, enactment of pension reform legislation, was completed in October 2011 and progress has been made in strengthening the banking sector. However, the authorities' backtracking on their commitment to raise gas and heating tariffs in 2011 has been a key obstacle for the review, and reforms in other areas—including the VAT refund system, social assistance programs, the corporate insolvency law, fx regulations, resolution of intervened banks, and the framework for addressing NPLs—have been delayed or are incomplete. While some fiscal consolidation was achieved in 2011 and the general government deficit target was met, the combined deficit with NG of 4.3 percent of GDP exceeded the 3.5 percent program target due to NG's overruns. The authorities' reluctance to allow greater exchange rate flexibility undermined their ability to boost reserve buffers in line with program objectives. The authorities are considering necessary actions to resume program relations. World Bank and European Commission budget support remain suspended.

RECENT DEVELOPMENTS

4. Ukraine's real GDP growth has moderated, reflecting weakening external demand and tight credit conditions. The economy grew briskly in 2010–2011 by 4.1 and 5.2 percent respectively, led initially by higher industrial and agricultural production and exports and later by domestic demand as recovering incomes and consumer confidence boosted consumption (Figure 2). Labor market conditions have improved, with real wages rising about 8 percent annually and unemployment edging below 8 percent. Growth, however, slowed in 2012:Q1 to 2.0 percent y-o-y (from 4.7 percent in 2011:Q4), notwithstanding still buoyant domestic consumption demand. Industrial production—particularly the metallurgy, chemical, and machine building sectors—decelerated, driven by weakened external demand, except from Russia. Construction stagnated due to lower government investment spending as Euro-2012 preparations tapered off. Credit growth has been constrained by tight monetary policy, government financing requirements, and deleveraging by banks. The total loan portfolio has fallen slightly over the last two quarters, through March.

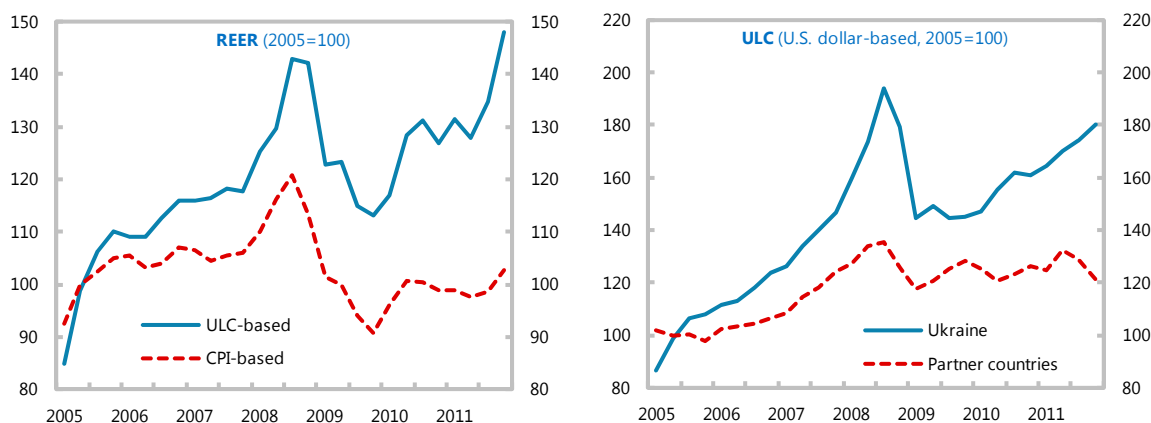
Contribution to Real GDP Growth, 2007–11
(Percent; year-on-year)



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

5. Headline inflation has fallen rapidly, but pressures remain evident. Headline inflation (y-o-y) fell from 12 percent in mid-2011 to -0.5 percent in May, close to historical lows, on account of falling food prices, flat utility prices, tight monetary policy, and decelerating economic activity (Figure 3). However, core inflation is around 4 percent, and wage increases have outpaced productivity growth. Unit labor costs are now approaching pre-crisis levels.

Price Competitiveness Indicators, 2005–11

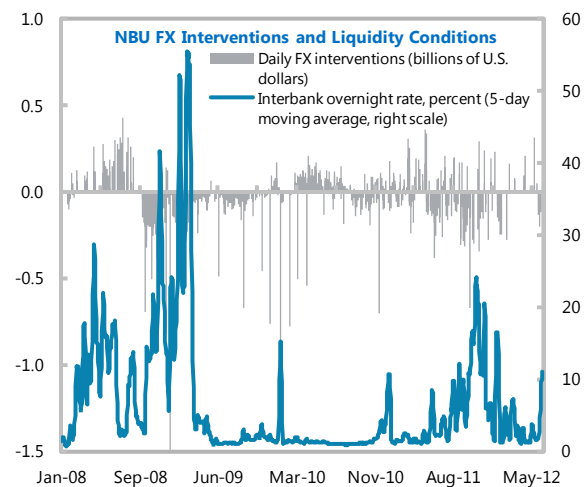


Sources: State Statistics Committee of Ukraine; OECD; Haver; IMF, *International Financial Statistics*; and IMF staff estimates.

6. Ukraine’s external position has been under pressure and buffers have fallen (Table 4; Figure 4). Under the de facto exchange rate peg against the dollar, the real exchange rate depreciation of 2008/9 has been reversed, fueled by high real wage growth and inflation differentials. The exchange rate is now slightly overvalued (Annex I). The current account deficit widened to 5.5 percent of GDP in 2011 from 2.2 percent of GDP in 2010. The government tapped

Eurobond markets for US\$5½ billion from September 2010 through mid-2011, but rising perceptions of risk have effectively blocked sovereign access since then. Spreads have been 800–1,000 bps in recent months, up from 450 bps in early 2011. Overall external rollover rates remain strong but continued bank deleveraging has been accompanied by shortening maturities (Figure 5). The hryvnia came under significant pressure in the second half of 2011, as external conditions worsened and skittish households withdrew fx cash. Gross reserves fell by about 20 percent (about US\$6.5 billion) between May 2011 and January 2012, to around US\$31 billion, or about 55 percent of short-term debt. From January to May 2012, the balance of payments improved—allowing US\$1.2 billion in Fund repurchases without degrading gross reserves.

7. Monetary policy has been geared to support the de facto peg, resulting in large swings in liquidity and interest rates, and fx interventions (Table 6). Through January, the NBU undertook aggressive liquidity tightening (the overnight interbank rate peaked at 33 percent) and stepped-up fx sales, and adjusted prudential and administrative measures to hold the exchange rate at about UAH8/US\$. The latter measures included raising reserve requirements on fx deposits, lowering banks' net open long fx limit, and requiring fx buyers to present identification.² From January to mid-May, falling inflation and stabilization of depreciation expectations allowed the NBU to ease liquidity conditions and withdraw from the fx market. The NBU stepped up liquidity injections and cut its benchmark refinancing rate by 75 bps in three steps (the first movement since August 2010). Interbank interest rates fell to single digits.



Source: Bloomberg.

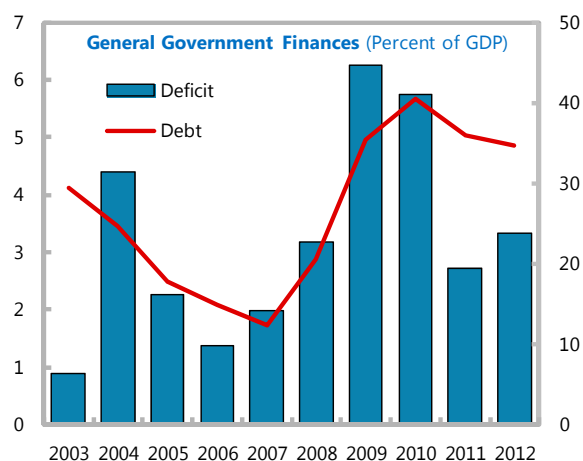
8. After some improvement in 2011, the fiscal stance is loosening. Under current policies, the combined deficit (general government and Naftogaz) is expected to rise to 5.3 percent of GDP in 2012 (from 4.3 percent in 2011).

² In 2011, the NBU issued instructions to ensure that the exchange rate used for transactions between the Government and the NBU will not deviate from the contemporaneous exchange rate in the interbank market by more than 2 percent. Staff continues to discuss with the authorities how the new rule can be implemented to eliminate the multiple currency practice (MCP) earlier identified by the staff. Ukraine also maintains another MCP, as described in the Informational Annex.

- The general government met its deficit target of 2.8 percent of GDP in 2011,³ resulting in a structural fiscal contraction of 0.8 percent of GDP over 2010 (Table 2). But this was achieved through under-implementation of capital expenditures that offset overspending in wages and pensions. Public debt fell from 41 to 36 percent of GDP during 2010–11. The general government deficit target for 2012 is set at 1.8 percent of GDP. However, in April 2012, a supplementary budget was approved that boosts spending by 2.5 percent of GDP. Because much of this increase is for higher wage and pension spending, expenditure in future years is also likely to be higher. The official deficit target remains unchanged because the government has revised revenue projections upward, based on expectations of stronger revenue collection. There is some evidence of revenue increases, but the government’s full year revenue projections appear optimistic, and staff projects a deficit of 3.3 percent of GDP (fiscal performance through May indicates a 1 percent of GDP deficit). With respect to financing, primary issuances dropped significantly in mid-2011 over reluctance to pay high market yields, but have picked up around 2011:Q4 as the government introduced lower yielding foreign currency denominated and indexed bonds and increased reliance on shorter term instruments. The government reported it reached agreement on rolling over 50 percent of a US\$2 billion external bank loan that matures in June.

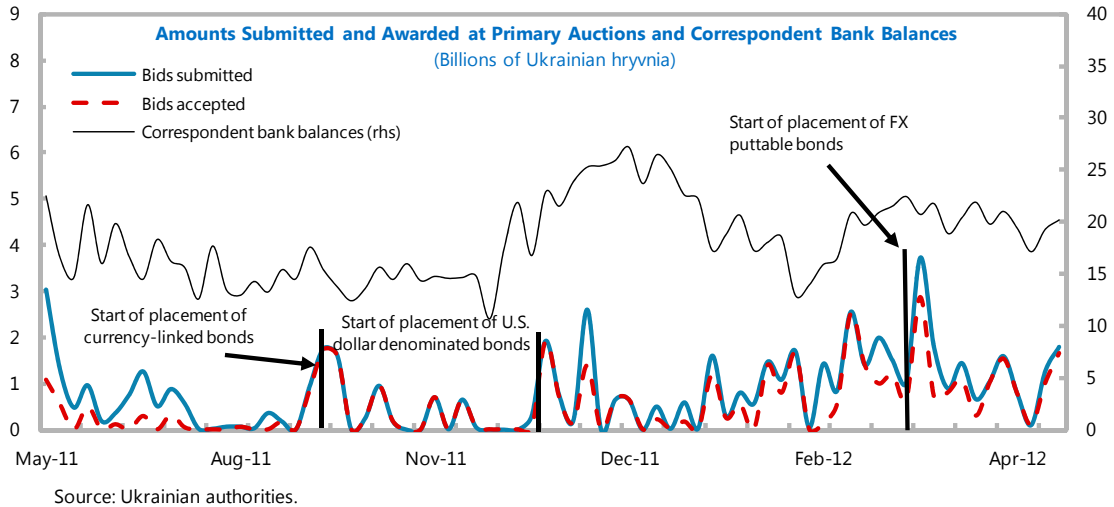
Original deficit target	1.8
Lower revenues (real GDP growth fall from 3.9 to 3.0)	0.8
New revenue measures	-1.7
New expenditures	2.4
Current deficit projection	3.3
Naftogaz deficit projection	2.0
Combined deficit projection	5.3

Source: IMF staff projections.

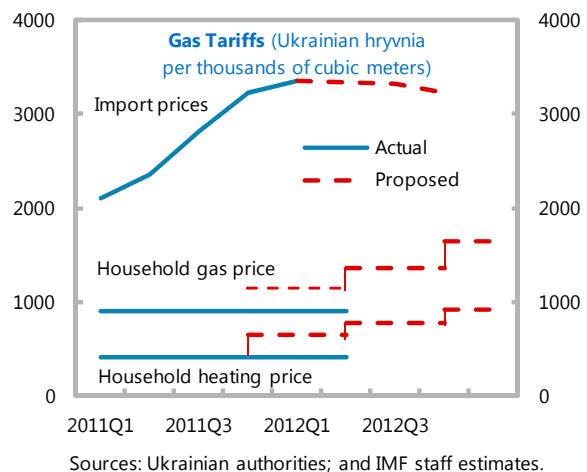


Source: Ministry of Finance.

³ In early 2011, the government adjusted its 2011 deficit target from 3.1 percent of GDP (EBS/10/232) to 2.8 percent to offset an upward adjustment in Naftogaz’s projected 2011 deficit (from 0.4 percent to 0.7 percent of GDP).



- The energy sector remains a fiscal drain.** The deficit of NG was 1.5 percent of GDP in 2011 (against a target of 0.7 percent) and is headed towards 2 percent of GDP this year (against an adjusted target of 0.7 percent). The economic cost is even larger, at about 5 percent of GDP (Annex II). NG finances continue to suffer from failure to raise domestic tariffs, as well as higher import costs and lower than expected payment compliance. The government has set energy independence as a longer term national objective. Key elements of their strategy to achieve this are investment in domestic gas exploration and production, energy efficiency measures, and, if necessary, domestic tariff increases. Ukraine recently signed gas exploration agreements with several major international energy companies, and simultaneously announced its commitment to implement the Extractive Industries Transparency Initiative (EITI). Ukraine is also seeking a reduced gas import price from Russia, so far without results. The authorities agreed with staff to increase gas prices received by NG from household gas distributors and heating utilities by 30 and 58 percent, respectively, in 2011, and to pass these increases through to end-user household tariffs. Instead gas prices received by NG from household gas distributors and heating utilities were reduced by 20 and 6 percent, while leaving end-user household prices unchanged. Domestic tariffs received by NG remain a small fraction of the cost of imported gas.



9. Progress in other fiscal structural reforms has been mixed:

- (i) The authorities recently approved a new customs code which reduces the time for customs clearance from 24 to four hours and sets up a “single window” shop. Discretion in ascertaining customs values is reduced by minimizing the contact between officers and taxpayers.
- (ii) A comprehensive pension law approved in late 2011 is expected to yield medium-term annual savings of 1.8 percent of GDP by aligning the retirement age for women (from 55 to 60) to men (60) and increasing the years of service for pension eligibility. However, some of these gains (about 0.7 percent of GDP) will be eroded by pension increases in the 2012 supplementary budget. Without further reform, the system is projected to carry annual losses of around 5 percent of GDP over the long-term.
- (iii) The authorities have recently started the process of centralizing the Large Taxpayers Office. By end-June, a centralized database will be operational, and reporting could be done online.
- (iv) Significant progress has been made in modernizing state tax services, including implementation of a centralized web-based solution for registering taxpayers, filing and paying taxes, and tax audit execution.
- (v) There has been some progress in automating VAT refunds with latest data through end-May showing about 60 percent of receipts refunded via the automated system, but some companies continue to report overdue refunds.
- (vi) During 2010–11, civil service reforms cut the number of cabinet members from 26 to 17 and the number of ministries from 20 to 16. About 30,000 employees were laid off as part of the public administration rationalization in 2011, though savings were outweighed by overspending on wage and pension increases in 2011.
- (vii) A new tax code was approved in 2010 that gradually lowers corporate tax rates (which dropped 2 percentage points on January 1) and VAT in line with the authorities’ objective of lowering the tax burden. However, the tax system continues to suffer from loopholes, evasion, and uneven administration.

Number of Public Sector Employees
(Millions of persons)

	2008	2009	2010	2011
Public sector employees	4.33	4.34	4.32	4.29
<i>Of which:</i>				
Education	1.68	1.68	1.68	1.67
Health	1.16	1.16	1.15	1.15

Source: Ukrainian authorities.

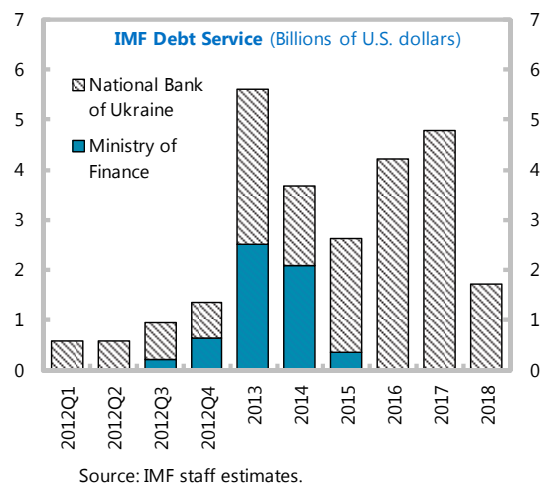
10. Progress has been made on banking sector reforms, but bank balance sheets remain weak, and private credit growth is subdued. (Table 7; Figure 6; Annex III). Capital adequacy ratios are above the statutory minimum, thanks to two rounds of capital injections in 2009–10. But bank profitability is near zero as banks continue provisioning against bad loans. Nonperforming loans are

around 15 percent of total loans (39 percent under broad definition of NPLs). Credit growth to the economy was only 6 percent in March, y-o-y, and credit as a percent of GDP has fallen from 79 percent in 2008 to 59 percent. Notwithstanding some de-dollarization, bank balance sheets remain exposed to currency movements due to regulatory distortions (the banking system has an overall fx short position of about US\$8 billion) and fx (mostly in US\$) loans to unhedged borrowers. External support for the banking system is shrinking. BIS figures show a 26 percent drop in foreign bank exposure to Ukraine during 2011. The loan-to-deposit ratio has fallen to a still high 160 percent, from a 2009 peak of 230 percent. Several important banking laws and reforms were completed during the past 18 months that will strengthen transparency (Ultimate Controllers law), banking supervision (Consolidated Supervision law; new provisioning regulations; migration to IFRS) and the resolution framework (Deposit Guarantee Fund law). Implementing regulations for these laws are being finalized. Nadra Bank (intervened in 2009) was privatized and recapitalized during 2011 with private funds, while resolution of the remaining state-intervened banks continues.

11. Efforts to improve the business environment have had mixed results. Strengthening the business climate is a major focus of the President's Economic Reform Program. Some successes have been achieved. For example, deregulation efforts have reduced the number and time required to receive permits. But after some improvement in 2010, Ukraine has lost ground in international surveys (Figure 7). A recent IFC survey found that the amount of revenues absorbed by unofficial means to resolve business constraints had risen in 2011.

OUTLOOK, RISKS, AND SPILLOVERS

12. Growth will slow and financing needs will widen this year. Headwinds from slowing domestic demand, waning exports (consistent with trading partner growth), and tight credit markets are expected to slow real GDP growth to 3 percent this year (Table 1). While inflation has surprised on the downside, it is expected to rise to 7.4 percent y-o-y given rising food prices (due to unwinding effects of the bumper 2011 harvest) and pressures from rising wages (propelled by social initiatives of the government). The current account deficit is expected to rise to 6.4 percent driven by deterioration in terms of trade (weak commodity prices and high energy prices) and a weak global environment. Gross external financing needs are high (Table 5), including US\$21 billion in maturing bonds and MLT loans, and repayments to the



Fund. Gross reserves are projected to drop to around US\$24 billion (40 percent of short-term debt) by year-end. Public financing needs are significant, and the authorities will likely have to rely heavily on domestic financing (Tables 3 and 8).

13. Absent more comprehensive reforms, medium-term growth prospects are muted, and shadowed by persistent vulnerabilities. Under the baseline scenario, Ukraine's reform program fails to pick up pace, financial support from IMF and most international financial institution (IFI) remains suspended, and global growth gradually improves in line with the latest WEO forecast. Ukraine's real GDP growth would recover to a modest level of around 3.5 percent next year—reflecting in part some recovery in partner country growth—, well below levels that could be expected under a reform scenario that would help unlock Ukraine's considerable growth potential. Gradual increases in nominal exchange rate flexibility (moving in line with trading partner inflation differentials) are anticipated, and the current account deficit would moderate slightly to around 5.5 percent of GDP, weighed down by large energy imports. Inflation would gradually fall to about 5 percent though greater volatility could be expected if the NBU retains its de facto pegged exchange rate regime. Gross reserves would drop to very low levels in 2013–14 (27 percent of short-term debt), leaving Ukraine vulnerable to swings in investor confidence. External and public debt would settle at around 65 and 35 percent of GDP, respectively, but financing requirements would remain elevated. Some standard debt shocks suggest potentially unsustainable trajectories, particularly with respect to growth shocks (Figures 8 and 9).

14. Risks to the outlook are tilted to the downside. A worsening of euro area turbulence or global growth could have significant negative implications for Ukraine. Although Ukraine's direct real and financial sector spillover channels from the euro area are smaller than some peers, Ukraine's underlying vulnerabilities—including low reserve cover, large external and fiscal financing needs, heavy dependence on commodity export prices, and a crisis-weary public—make it vulnerable to external shocks and shifts in investor and depositor sentiment (Annex IV). If Ukraine's market access is lost for a protracted period and global growth slows significantly, Ukraine may come under severe financial and economic strains, with currency overshooting, high interest rates, financial sector disruptions, recession, and higher unemployment.

15. Ukraine's financing prospects will also be influenced by the quality and pace of domestic policies (the prospects for which are rendered more uncertain by approaching parliamentary elections). There are upside as well as downside scenarios. If the authorities succeed in improving revenue collection, the budget deficit and financing needs will be smaller. Greater exchange rate flexibility in 2012 would help the current account. On the downside, an attempt to

hold a fixed exchange rate over the medium-term despite higher inflation than trading partners, coupled with wage increases which exceed productivity gains, would lead to higher current account deficits, more reserve depletion, and severe financial and economic disruptions. The perceived deterioration in the business climate, if left unaddressed, could also result in lower investment and growth.

REPORT ON DISCUSSIONS

A. The Policy Mix and Overall Risks

16. Against this backdrop, discussions centered on policies to: (i) secure sound public finances; (ii) strengthen the energy sector; (iii) reduce financial vulnerabilities and revive lending; (iv) enhance the effectiveness of monetary policy; and (v) facilitate higher, sustainable medium-term growth. Discussions also covered spillovers, crisis preparedness, and contingency plans. The authorities broadly agreed with staff's assessment of spillover channels but believe that the staff's baseline scenario and assessment of risks is overly pessimistic. They expect a post-election environment that will allow them to implement key reforms, thus facilitating IFI financial support, which would increase reserves and reduce risks.

B. Securing Sound Public Finances and a Strong Energy Sector

17. Strengthening public finances in a durable manner remains an overarching policy objective. The authorities agreed that the rapid increase in public debt in recent years is a key vulnerability. They viewed strict control over budget deficits and other debt-creating activities as critical to reduce financing needs and debt, rebuild confidence, and lower borrowing costs. In this context, they reiterated a commitment to limit the general government deficit to 1.8 percent of GDP in 2012 and the NG deficit to 0.7 percent of GDP. They intend to further reduce government deficits over the medium-term and to take further steps to bolster NG's finances.

18. Staff urged measures to reverse projected fiscal slippages this year. While some improved collection can be expected in corporate tax and VAT revenues, staff argued that this would only be sufficient to offset lower revenues from reduced corporate tax rates. It would not fully offset higher expenditures under the supplementary budget and, therefore, the deficit is likely to approach 3.3 percent of GDP. To meet the 1.8 percent of GDP deficit target, staff urged immediate adoption of fiscal measures—including increasing the tax rate for higher income earners (from 17 to 20 percent for the second tax bracket), eliminating tax exemptions (mainly VAT exemptions), removing special tax treatment with offshore tax havens, and cuts in current spending. If the authorities prefer contingency measures, they should be prepared to adopt them quickly, given that

half the year has already passed (and therefore revenue gains will be more limited). Staff cautioned against the use of restrictive trade policy measures (tariffs) to generate revenue, as they can damage the business climate and competitiveness, and result in longer-term economic costs.

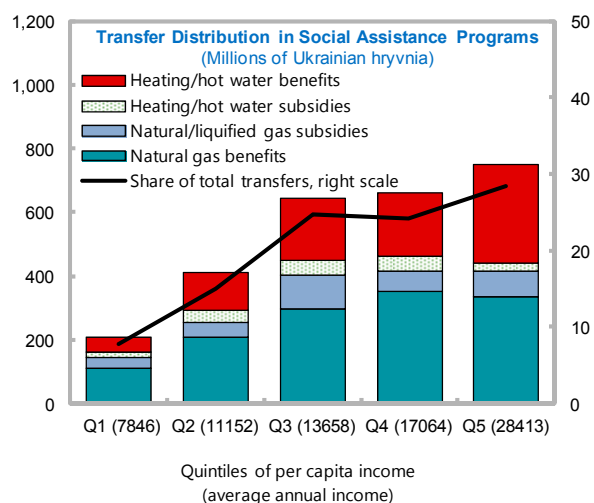
19. Authorities' views: The authorities argued that stronger revenue collection efforts will be sufficient to offset increased expenditures. They pointed to stronger enforcement mechanisms under the new customs code, efforts to increase formalization of economic activity, and better management of the tax authority. They agreed, however, to quickly identify contingency revenue and expenditure measures that could be implemented if needed.

20. Staff pressed for measures to strengthen NG's finances, and to articulate a broader energy sector reform strategy. The most effective initial step towards achieving energy

independence would be to raise household gas and heating tariffs, permitting an increase in the gas price received by NG. These prices are currently, on average, less than one-quarter of the cost to import the gas. Gradually raising prices will lower NG's deficit, reduce imports, and free up resources for investment in domestic production and energy efficiency.⁴ This would initially bring modest revenue gains (0.2 percent of GDP this year), but over time would generate significant revenue. Staff urged the authorities to consider such tariff hikes as a critical part of any

broader energy sector strategy that should also include energy efficiency improvements and implementation of better-targeted social assistance to support the poorest (Annex V). The mission welcomed recent efforts to boost investment in gas exploration through new tenders and off-shore drilling. Staff supported the authorities' metering and energy savings efforts (see below), and urged the authorities to work closely with the World Bank on these efforts.

21. Authorities' views: The authorities reiterated their medium term goals of weaning NG off budget support, enhancing efficiency, and (in the long-term) achieving energy independence. But they continue to reject near-term household tariff increases, arguing that they would hurt the poor,



Source: 2010 Household Survey, State Statistics Service of Ukraine.

⁴ Staff has argued for significant and upfront increases of 30 percent and 58 percent in the price received by NG for household gas and from heating utilities (with full pass-through to end-user tariffs), in the context of SBA negotiations, followed by semi-annual increases (20 percent) for each.

have little impact on efficiency and consumption without proper metering and housing upgrades, and further weaken payment discipline. Instead, they intend to focus on payment discipline, improving heating meter coverage and household energy saving infrastructure supported by subsidized loans to households. Once this process has advanced, they will gradually increase end-user energy prices. They will also continue efforts to attract investment in domestic gas exploration to boost domestic production.

22. Staff highlighted the risks from higher fiscal deficits. Absent measures, staff projects that the combined general government and NG deficit will rise to 5.3 percent of GDP (against a 2.5 percent target) in 2012, putting pressure on financing needs in an already challenging environment. This would push yields higher, crowd out private sector credit, or push up inflation. Staff also expressed concern over increasing amounts of shorter term and fx-linked government debt. Over the medium-term, staff projects that without new measures, the combined general government and NG deficit would remain at around 5 percent of GDP, which would continue to pose financing risks. Staff suggested that cutting tax rates may need to be postponed until better revenue collection is achieved, exemptions are eliminated, or expenditures are cut (so as to bring public debt down). It would also be important to contain the government wage bill and to bring the pension system into balance through further reforms. Staff also noted risks that unanticipated shocks could push debt to unsustainable levels (Figure 8).

23. Authorities' views: The authorities argued that better revenue collection and energy efficiency and increased domestic production would help bring down combined general government and NG deficits to 2½ percent of GDP in 2012 and to around 1 percent of GDP in the medium-term, resulting in a medium-term reduction of public sector debt. Over the medium-term, the authorities want to reduce the high tax burden over time and create space for higher infrastructure spending (EBS/10/232).

24. To strengthen public finances over the medium-term, staff urged reforms to strengthen institutions and increase investment. Steps to achieve this could include:

- *Well-targeted social spending* to help cushion the impact of fiscal consolidation on the most vulnerable. *The authorities* expressed their intention to reform social spending in consultation with the World Bank.
- *Public administration reform* in the critical health and education sectors where the bulk of public employment rest and the quality of services is low. *The authorities* noted they plan to continue reforms and reductions in 2013–2014.

- *Fiscal framework* improvements to strengthen procedures for monitoring, disclosing and controlling fiscal risks and develop a medium-term fiscal framework. *The authorities* agreed with these goals, and would gradually implement them.
- *Improved revenue administration* to increase taxpayers' trust in the tax system and reduce widespread tax avoidance. *The authorities* indicated this was a priority area, particularly reducing the shadow economy.
- *Public investment increases* to rehabilitate and develop infrastructure. Staff stressed that investment projects need to be prioritized and included in the budget (with off-budget guarantees strictly limited). *The authorities* agreed on the need for further investment.

C. Strengthening the Monetary and Exchange Rate Policy Framework

25. Monetary policy should focus on achieving price stability, rather than on the exchange rate. There was agreement on the importance of maintaining domestic price stability, consistent with the NBU's mandate, and that present monetary conditions were striking an appropriate balance between heightened external risks and the still closing output gap. However, a tighter policy stance would be needed if balance of payments or inflationary pressures intensify. The mission noted that gradually increasing exchange rate flexibility would better serve Ukraine in adapting to changing economic fundamentals (and help preserve competitiveness; Annex I), provide a buffer to external shocks, push the private sector to more properly assess fx risk, and help raise reserves, which are very low compared to debt service. It would also free up monetary policy to focus more squarely on inflation (Annex VI) and would represent an important step towards the medium-term objective of transitioning to full-fledged inflation targeting. Increased exchange rate flexibility should be supported by fiscal, monetary, and wage policies consistent with maintenance of price stability. Staff also advised the authorities to continue with the agreed foreign exchange market liberalization plan, including establishing a framework to develop the forward exchange market.

26. Authorities' views. The authorities stressed they have no predetermined path for the exchange rate (the de jure policy remained a "transition to a free floating exchange rate") and accepted the case for more day-to-day flexibility. However, they were concerned that significant exchange rate volatility would be detrimental to efforts to rehabilitate the financial sector given balance sheet mismatches, and would undermine public confidence in the hryvnia. They agreed that interest rates need to take a leading role in the conduct of monetary policy in the period ahead but wished to proceed carefully and gradually. The authorities shared staff's concerns regarding low reserve cover, but noted that import coverage remained above 3 months, and as the external environment and confidence improved, fx inflows would increase. They also expressed hope that the wider range of instruments (including fx-denominated instruments) would help repatriate resident fx

holdings. With respect to fx market liberalization, the authorities are continuing work to strengthen the framework for forward markets.

27. Unwinding crisis-era policies pose significant challenges to monetary policy. There was agreement that the unwinding of two major crisis era policies, Resolution 109 and stabilization loans (Annex III), combined with external deleveraging of banks, could put significant pressure on liquidity and the exchange rate, and must be carefully managed to avoid unnecessary disruption in financial, credit, and exchange rate markets.⁵ With respect to Resolution 109, staff urged the NBU to gradually unwind the measure through staged liberalization of LLPs on fx loans (gradually returning them into banks' statutory calculation of net open position) in a manner that treats all banks equally. Staff agreed that the next stage in unwinding the resolution (following an NBU pilot involving a few banks) would need to be carefully sequenced, and that modest issuance of fx-linked bonds by the government would be useful. This should begin soon, given the vulnerability of the banks to exchange rate depreciation. The other major challenge is bank repayment of remaining UAH60 billion in NBU stabilization loans. Together with hryvnia liquidity needs to unwind Resolution 109, and the loss of term financing through deleveraging, banks face a potential systemic liquidity gap that could be addressed by the NBU through refinancing, repo, and other liquidity management tools. The NBU should reaffirm bank solvency before extending or providing new liquidity (and should be careful not to undermine development of private longer term capital funding).

28. Authorities' views. The NBU noted it is preparing modifications of liquidity support mechanisms to address the withdrawal of term financing, and to address any systemic liquidity gaps. There was agreement that policies to unwind these crisis era legacies should be consistent with broader monetary policy objectives (with any support provided only to solvent banks), and that issuance of fx-linked bonds should be limited.

⁵ Resolution 109 has pushed banks' economic net open position about US\$8 billion short. Banks have outstanding stabilization loans totaling about UAH60bn (granted by the NBU in 2008-9 in response to deposit runs and an external funding freeze).

D. Reducing Financial Sector Vulnerabilities and Reviving Lending

29. **Global and domestic risks call for contingency planning and close supervision to ensure an effective response in the event of any renewed pressure on the banking system.**

Staff urged a review of contingency plans, strengthened monitoring, and creation of a dedicated financial stability unit. The mission also urged close supervision of banks to ensure compliance with prudential norms (including through more reliance on 'early warning system' tracking of financial soundness). Banks with weaker indicators should be subject to enhanced monitoring with a well-developed action plan including, if necessary, additional capital injection (and reductions of related party lending), as needed. Efforts are also needed to encourage consolidation of the sector. The large number of smaller banks (with reportedly significant connected lending in many cases) could pose supervision and governance problems. Staff urged quick resolution of remaining state-intervened banks. This should include completion of the transformation of one of these banks into a bad bank to absorb NPLs from state-owned banks and state-intervened banks. Staff also urged further steps to strengthen state-owned banks consistent with the findings of due diligence studies.

30. Authorities' views. The authorities agreed on the importance of contingency plans, and noted ongoing upgrades of their supervisory framework, bank resolution and emergency liquidity assistance frameworks, as well as strengthened communication channels. They indicated they are maintaining appropriate monitoring and supervision of all banks, and are proceeding with plans for enhanced financial stability functions inside the NBU. They are proceeding with plans to resolve the three remaining state-intervened banks, which include completing the creation of a bad bank to manage their NPLs.

31. **Further steps are needed to help remove bad assets from private bank balance sheets.**

Staff stressed the importance of removing regulatory and tax obstacles to recognizing, restructuring, writing off, and selling (to third parties) bad loans. Corporate insolvency legislation, which was approved by Rada in January 2012, needs to be amended to facilitate out-of-court restructuring. A strategy to develop the personal insolvency framework is also needed. These efforts would also need to be complemented by steps to strengthen judicial decisions and collateral enforcement. These steps would help free up resources to facilitate new lending to the economy.

32. Authorities' views. The authorities agreed that further steps to facilitate NPL reduction are important, and noted they are in discussions with banks and the government over possible additional tax and legal amendments to achieve this. They intend to incorporate changes to the insolvency law later this year. They have no plans at this time to reform the personal insolvency framework.

33. Progress has been made in strengthening some aspects of the NBU's safeguards framework. The external audit of the NBU's 2011 financial statements was conducted by Ernst & Young (EY) and completed in a timely manner. EY issued an unqualified audit opinion, which is progress from the previous qualified opinions from PWC. The NBU Council has met and approved the audited financial statements as required under the law. Staff is awaiting EY's 2011 report concerning internal controls and other issues identified by the audit. This report is currently being finalized and should be available for review in mid-2012.

E. Creating a More Dynamic Economy

34. Generating sustained improvements in living standards will require further structural reforms to boost competitiveness and growth, while limiting external imbalances. Achieving higher long-term growth depends on addressing underlying structural weaknesses, including the business climate, high entry barriers, weak competition, poor infrastructure, and low export diversification.

35. The authorities should press forward with reforms envisaged in the President's Economic Reform Plan to promote growth, improve the business climate, and attract investment. Goals include deeper global integration, more deregulation, stronger governance, and further privatization. Key reform areas include:

- *Agriculture.* This sector has significant potential to promote higher growth, exports, and investment. The authorities indicated they are now exploring measures, including land reform, and a unified registry of land and real estate, that could enhance efficiency and production.
- *Investment and integration.* The authorities are pursuing measures to ease the barriers to business entry, operation, and exit. Faster integration with the EU would support these efforts.
- *Transparency and governance.* Reports from private businesses, and Ukraine's standing in international surveys, suggest that Ukraine's business reputation continues to slip, hurt by perceptions of partial and discriminatory enforcement of laws and an uneven playing field fostered by weak governance and institutions (a 2011 EBRD survey cited corruption as the top business obstacle in Ukraine). The authorities recognize the need to strengthen the investment climate. They are undertaking measures to reduce the scope for discretionary administrative decisions and plan to set up a one-stop investment bureau.

F. Capacity to Repay the Fund

36. Authorities have made commitments at the highest level to repay the Fund. Ukraine has repurchases of SDR 1.9 million and SDR3.7 million over the remainder of 2012 and 2013, respectively. All Fund repayments are fully reflected under the current baseline (which also shows a drop in gross reserves through 2014).

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37. Ukraine has made progress in several areas since the 2008–09 crisis. The government has targeted, and in 2011 achieved, a lower general government deficit. The NBU has succeeded in bringing down inflation. Pension reform passed in 2011 will support medium-term fiscal adjustment. Simplification of the tax and customs codes enacted during the last six months has the potential to improve the business environment.

38. However, there have also been policy slippages. The new spending in the supplementary budget is certain, the projected higher revenue much less so. The authorities have failed to increase gas tariffs paid by households, leading to a continued large NG deficit. The NBU's reluctance to let the exchange rate move deprives them of a useful tool in responding to shocks.

39. These policy settings expose Ukraine to serious risks. The current account deficit is high, and is projected to increase this year. There are financing risks for both the budget and the balance of payments. Debt has fallen from its post-crisis peak, but remains high. Reserve cover remains very low in relation to debt service. Spreads have risen. In part this is due to external developments beyond Ukraine's control. But the deterioration in Ukraine's perceived creditworthiness also reflects doubts about the credibility of domestic policies.

40. In the short term, the authorities' priority should be to make sure that policies, particularly fiscal policy, provide strong support for domestic and external stability. The authorities are determined to meet the general government deficit target of 1.8 percent of GDP. But they are depending heavily on better revenue collection to achieve this target. The authorities stress their willingness to adopt new measures if it seems that the target will not be met. However, they have not specified contingency measures. High financing needs, the difficulty of putting in place new measures quickly, and the approaching parliamentary elections all argue for clear and credible advance planning.

41. Monetary and exchange rate policies also need to be more supportive. Monetary policy has been relatively strong, but has been subordinated to a policy of keeping the exchange rate

stable. Staff continues to believe that gradual increases in exchange rate flexibility would make Ukraine more resilient in the face of fragile domestic confidence and possible external shocks, whether from reduced demand for Ukraine's exports or shortfalls in financing. Increased exchange rate flexibility should be supported by fiscal, monetary, and wage policies consistent with maintenance of price stability. The authorities will face a difficult few months, with financing needs high and confidence fragile. They should set policies to reduce risks, and prepare contingency plans in case they materialize. Ukraine maintains two multiple currency practices as described in the Informational Annex. Staff does not recommend approval of those MCPs and encourage the authorities to eliminate them as soon as feasible.

42. It will also be important to resolve problems in the banking sector. High levels of NPLs are present in the banking system, many banks still rely heavily on liquidity support from the NBU (and face external deleveraging pressures), balance sheets remain exposed to currency movements, and a plethora of banks, some of which reportedly have significant connected lending, pose governance problems. If not addressed, the banking system will be hindered from providing a supporting role for economic growth—capital could be eroded and risks to stability could re-emerge. The crisis-era resolution setting rules on the calculation of foreign exchange positions leaves banks exposed to currency fluctuations should be unwound as soon as possible, as it leaves the banks exposed and inhibits exchange rate flexibility. Some use of fx-linked bonds could help in this process, but the authorities should avoid exposing the government balance sheet to greatly increased foreign exchange risks. The authorities also need to unwind another crisis era resolution supplying emergency liquidity. In doing so, they should avoid excessive liquidity creation and provide any new liquidity support only to solvent banks.

43. Comprehensive reform of the energy sector is needed. Low prices paid by households for gas and heating result in high consumption and heavy losses for NG, and ultimately for Ukrainian taxpayers. The authorities' goal is energy independence, but they shrink from significant increases in the prices paid by domestic consumers. Such increases are an essential component of any strategy to bring supply and demand into balance at a lower level, alongside increased investment in domestic energy production, improved energy efficiency, and targeted subsidies to help the poorest households.

44. Over the medium term, Ukraine is at risk of getting stuck in a low growth equilibrium. An aging population and financing constraints mean that neither growth in the labor force nor greatly increased investment is likely to be a source of strong growth. This puts a premium on improvements in productivity. The President's Economic Reform Program contains many initiatives which are designed to support this, but much will depend on their implementation. There is also a

disjunction between the authorities' plans to improve the business environment and the business community's view that they are more exposed to fiscal pressure and selective decisions by officials.

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

Box 2. Ukraine: 2008 Article IV Consultation: Key Recommendations and Actions Taken

Soon after the conclusion of the 2008 Article IV consultation Ukraine was engulfed by the global financial crisis and entered into a program relationship with the Fund. As circumstances drastically changed, several recommendations became less or no longer relevant, in particular those related to short-term macroeconomic management. Staff policy advice was adjusted accordingly as reflected in program documents. Structural reforms remained largely valid and progress has been mixed.

- *Fiscal recommendations.* Fiscal restraint (deficit at or below 2 percent of GDP); strengthen fiscal framework (broaden fiscal coverage; adopt medium-term fiscal framework).
- *Progress:* In 2009 (when GDP fell 15 percent), the Fund adjusted its fiscal stance advice and encouraged greater protection of the poorest. The general government deficit widened to 6¼ percent of GDP, and narrowed to 2¾ percent of GDP by 2011. Some progress has been achieved in strengthening the fiscal framework. A medium-term budget was adopted this year as required by a new budget code. However, off-budget expenditures have continued (including significant guarantees).
- *Monetary/exchange rate recommendations.* Shift to a flexible exchange rate regime, and ultimately to inflation targeting anchor.
- *Progress:* During the global financial crisis the authorities devalued the hryvnia. An opportunity was missed to adopt a more flexible exchange rate regime and the hryvnia was eventually re-pegged. The NBU has continued technical preparations for adopting inflation targeting, including by strengthening its forecasting and modeling capabilities.
- *Financial sector recommendations.* Strengthen banking sector risk management and oversight, including consolidated supervision, transparency of ownership, and intensified supervision.
- *Progress:* The banking system nearly collapsed in 2009. Since then, banks have been recapitalized twice (and others liquidated or nationalized). As confidence returned the banking system regained deposits. The legal framework has been strengthened. However, implementation of some of these measures is still pending.
- *Structural reform recommendations.* Energy sector reform; tax system reform (VAT administration, broader base; rate reductions); financial sector development.
- *Progress:* Domestic gas prices for the industry and budgetary institutions are in line with import prices and adjusted regularly. Domestic prices for households and heating companies have been increased on two occasions but the increases have not offset the depreciation of the hryvnia and higher import prices. VAT administration has remained problematic with refund arrears recurrently accumulating.

Table 1. Ukraine: Selected Economic and Social Indicators, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Proj.		
Real economy (percent change, unless otherwise indicated)									
Nominal GDP (billions of Ukrainian hryvnias)	913	1,083	1,317	1,473	1,649	1,816	1,996	2,194	2,406
Real GDP	-14.8	4.1	5.2	3.0	3.5	3.5	3.5	3.5	3.5
Contributions:									
Domestic demand	-26.4	7.3	11.5	4.1	5.6	4.5	4.4	4.4	4.3
Consumption	-10.2	5.6	9.2	4.9	4.4	3.4	3.3	3.2	3.2
Investment	-16.2	1.7	2.3	-0.8	1.2	1.1	1.1	1.1	1.1
Net exports	11.6	-3.1	-6.4	-1.1	-2.1	-1.0	-0.8	-0.8	-0.8
Unemployment rate (ILO definition; percent)	8.8	8.1	7.9	7.8	7.7	7.6	7.4	7.2	7.1
Consumer prices (period average)	15.9	9.4	8.0	3.8	6.9	5.3	5.0	5.0	5.0
Consumer prices (end of period)	12.3	9.1	4.6	7.4	5.9	5.0	5.0	5.0	5.0
Core inflation (period average) 1/	19.4	8.6	7.7	5.2	6.1	5.0	5.0	5.0	5.0
Core inflation (end of period) 1/	14.9	7.9	6.9	5.3	5.1	5.1	5.0	5.0	5.0
Nominal monthly wages (average)	5.5	17.7	17.5	13.8	10.9	8.3	8.0	8.0	8.0
Real monthly wages (average)	-8.9	7.6	8.8	9.6	3.7	2.8	2.9	2.9	2.9
Public finance (percent of GDP)									
General government balance 2/	-6.3	-5.8	-2.7	-3.3	-3.5	-3.5	-3.3	-3.2	-3.1
Overall balance (including Naftogaz operational deficit)	-8.7	-7.4	-4.2	-5.3	-5.5	-5.5	-5.3	-5.2	-5.1
Cyclically-adjusted general government balance 3/	-2.6	-3.1	-2.3	-3.3	-3.5	-3.5	-3.3	-3.2	-3.1
Structural general government balance	-2.6	-3.1	-2.3	-3.8	-3.5	-3.5	-3.3	-3.2	-3.1
Public debt (end of period) 4/ 5/	35.4	40.5	36.0	34.7	35.1	35.2	35.5	35.5	35.6
Money and credit (end of period, percent change)									
Base money	4.4	15.8	6.3	4.0	7.2	9.4	9.4	9.4	9.3
Broad money	-5.5	22.7	14.7	5.8	14.3	10.6	9.9	9.9	9.7
Credit to nongovernment	-2.2	1.1	9.5	1.9	5.8	5.6	5.6	8.4	8.8
Velocity	1.9	1.8	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Interbank overnight rate (annual average, percent) 6/	12.6	3.4	7.1	2.3	...	...	...	...	...
Balance of payments (percent of GDP)									
Current account balance	-1.5	-2.2	-5.5	-6.4	-7.6	-7.3	-6.8	-6.2	-5.5
Foreign direct investment	4.0	4.2	4.2	4.6	4.5	4.4	4.4	4.4	4.4
Gross reserves (end of period, billions of U.S. dollars) 7/	26.5	34.6	31.8	24.4	19.9	18.1	20.0	21.3	24.2
Months of next year's imports of goods and services	4.3	4.2	3.6	2.6	2.0	1.7	1.7	1.7	1.8
Percent of short-term debt (remaining maturity)	67.4	71.5	55.2	39.6	31.4	27.3	28.5	28.7	31.5
Net reserves (end of period, billions of U.S. dollars)	15.5	20.3	17.6	13.6	14.7	16.6	20.0	21.3	24.2
External debt (percent of GDP)	88.2	86.0	76.4	69.8	67.2	65.9	65.6	65.3	65.1
Goods exports (annual volume change in percent)	-24.2	9.3	7.1	4.4	6.1	7.7	8.1	8.1	8.1
Goods imports (annual volume change in percent)	-41.6	18.1	20.3	7.3	7.9	7.5	7.5	7.5	7.5
Goods terms of trade (percent change)	-13.8	0.3	7.6	-1.3	0.8	1.4	1.5	1.4	1.3
Exchange rate									
Hryvnia per U.S. dollar, end-of-period 6/	8.0	8.0	8.0	8.0	...	...	...	...	...
Hryvnia per U.S. dollar, period average 6/	7.8	7.9	8.0	8.0	...	...	...	...	...
Real effective rate (CPI, percent change) 8/	-17.6	6.0	0.1	2.6	...	...	...	...	...
Memorandum items:									
Nominal GDP (billions of U.S. dollars)	117.2	136.4	165.2	...	...	...	...	...	...
Per capita GDP (2011): \$3,624 (WEO)									
									Percent of population below poverty line (2006): 8.0
Quota (2011): SDR 1,372 million (2,166 million U.S. dollars)									

Sources: State Statistics Committee of Ukraine; Ministry of Finance; National Bank of Ukraine; World Bank, *World Development Indicators*; and IMF staff estimates and projections.

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

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

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

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

5/ Other debt creating flows include bonds issued to (i) recapitalize banks in 2009–11, and (ii) settle arrears on VAT refunds in 2010.

6/ Latest data as of end-May, 2012.

7/ Assumes no further Fund disbursements under the SBA program.

8/ Latest data as of end-April 2012.

Table 2. Ukraine: General Government Finances, 2009–12

(Billions of Ukrainian hryvnia)

	2009	2010		2011		2012	
		EBS/10/232	EBS/10/232	EBS/10/232	EBS/10/232	Suppl. Budget	Proj.
Revenue	386.3	468.8	468.3	520.9	558.2	645.9	624.6
Tax revenue	337.4	407.4	406.4	464.6	499.8	583.7	565.1
Tax on income, profits, and capital gains	77.5	94.9	91.4	103.2	115.3	126.8	129.4
Personal income tax	44.5	50.5	51.0	58.2	60.2	68.9	68.9
Corporate profit tax	33.0	44.4	40.4	45.0	55.1	57.9	60.5
Payroll tax	110.8	122.5	126.1	141.1	161.2	188.6	186.7
Property tax	8.4	9.6	9.5	11.0	10.7	12.1	11.9
Tax on goods and services	125.8	144.7	143.5	159.7	175.7	218.5	198.8
VAT	84.6	102.0	102.8	108.3	130.1	163.0	145.9
Excise	21.6	30.4	28.3	41.5	33.9	42.5	39.6
Other	19.5	12.3	12.4	9.9	11.7	13.0	13.3
Tax on international trade	6.9	8.8	9.1	9.8	11.8	12.4	13.1
Other tax	8.0	26.9	26.8	39.8	25.1	25.4	25.2
Nontax revenue	48.9	61.4	61.9	56.3	58.4	62.2	59.5
Expenditure	443.5	524.3	530.6	560.2	594.1	673.6	673.6
Current	420.5	494.5	498.2	520.9	550.1	625.7	625.7
Compensation of employees 1/ Goods and services	106.0	131.1	123.6	134.8	135.1	157.2	157.2
Interest	67.6	78.0	79.2	84.2	88.6	100.3	100.3
Subsidies to corporations and enterprises	10.6	15.7	17.6	24.3	25.6	31.6	31.6
Social benefits	27.2	21.3	26.5	17.6	24.6	28.4	28.4
Social programs (on budget)	209.1	248.2	251.1	259.7	275.9	307.6	307.6
Pensions	26.3	37.1	36.4	39.7	42.3	53.8	53.8
Unemployment, disability, and accident insurance	165.8	192.3	193.9	199.1	210.8	228.8	228.8
Other transfers	16.9	18.8	20.8	20.9	22.8	25.0	25.0
Capital	0.1	0.2	0.2	0.3	0.3	0.6	0.6
Net lending	20.0	27.1	30.7	37.1	39.2	46.5	46.5
Discrepancy / reserve fund	2.8	1.2	1.4	0.7	4.8	-0.1	-0.1
Overall balance	0.1	1.5	0.3	1.5	0.0	1.5	1.5
Overall balance	-57.1	-55.5	-62.3	-39.3	-35.9	-27.7	-49.0
Primary balance	-46.5	-39.9	-44.7	-15.0	-10.3	3.6	-17.4
General government financing	57.1	55.5	62.3	39.3	35.9	...	49.0
External	42.7	44.0	50.0	9.5	16.7	...	-10.0
Disbursements	58.4	50.5	57.7	34.2	32.6	...	20.0
Of which: IMF (includes SDR allocations)	37.0	16.0	16.1	0.0	0.0	...	0.0
Amortizations	-15.7	-6.5	-7.7	-24.7	-16.0	...	-30.0
Domestic (net)	14.4	11.6	12.3	29.8	19.2	...	59.0
Bond financing	9.1	25.2	20.2	9.8	0.8	...	41.7
Direct bank borrowing	-2.4	0.0	2.7	0.0	-0.5	...	0.0
Deposit finance	5.7	-15.3	-12.9	10.0	7.0	...	7.3
Privatization	2.1	1.7	2.3	10.0	12.0	...	10.0
Naftogaz financing	22.7	15.0	18.2	5.1	20.4	...	29.4
General government and Naftogaz financing	79.8	70.5	80.5	44.4	56.3	...	78.4
Other financing	23.3	36.4	22.8	0.0	13.6	...	0.0
Bank recapitalization	23.3	20.0	6.4	0.0	13.6	...	0.0
VAT bonds	0.0	16.4	16.4	0.0	0.0	...	0.0
Total financing	103.2	106.9	103.3	44.4	69.9	...	78.4

Table 2. Ukraine: General Government Finances, 2009–12 (concluded)
(Percent of GDP, unless otherwise indicated)

	2009	2010		2011		2012	
		EBS/10/232	EBS/10/232	EBS/10/232	EBS/10/232	Suppl. Budget	Proj.
Revenue	42.3	43.3	43.3	41.6	42.4	43.1	42.4
Tax revenue	36.9	37.6	37.5	37.1	38.0	38.9	38.4
Tax on income, profits, and capital gains	8.5	8.8	8.4	8.2	8.8	8.5	8.8
Personal income tax	4.9	4.7	4.7	4.6	4.6	4.6	4.7
Corporate profit tax	3.6	4.1	3.7	3.6	4.2	3.9	4.1
Payroll tax	12.1	11.3	11.6	11.3	12.2	12.6	12.7
Property tax	0.9	0.9	0.9	0.9	0.8	0.8	0.8
Tax on goods and services	13.8	13.4	13.3	12.7	13.3	14.6	13.5
VAT	9.3	9.4	9.5	8.6	9.9	10.9	9.9
Excise	2.4	2.8	2.6	3.3	2.6	2.8	2.7
Other	2.1	1.1	1.1	0.8	0.9	0.9	0.9
Tax on international trade	0.8	0.8	0.8	0.8	0.9	0.8	0.9
Other tax	0.9	2.5	2.5	3.2	1.9	1.7	1.7
Nontax revenue	5.4	5.7	5.7	4.5	4.4	4.1	4.0
Expenditure	48.6	48.4	49.0	44.7	45.1	44.9	45.7
Current	46.0	45.7	46.0	41.6	41.8	41.7	42.5
Compensation of employees 1/ Goods and services	11.6	12.1	11.4	10.8	10.3	10.5	10.7
Interest	7.4	7.2	7.3	6.7	6.7	6.7	6.8
Subsidies to corporations and enterprises	1.2	1.4	1.6	1.9	1.9	2.1	2.1
Social benefits	3.0	2.0	2.4	1.4	1.9	1.9	1.9
Social programs (on budget)	22.9	22.9	23.2	20.7	21.0	20.5	20.9
Pensions	2.9	3.4	3.4	3.2	3.2	3.6	3.7
Unemployment, disability, and accident insurance	18.2	17.8	17.9	15.9	16.0	15.3	15.5
Other transfers	1.9	1.7	1.9	1.7	1.7	1.7	1.7
Capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	2.2	2.5	2.8	3.0	3.0	3.1	3.2
Discrepancy / reserve fund	0.3	0.1	0.1	0.1	0.4	0.0	0.0
Discrepancy / reserve fund	0.0	0.1	0.0	0.1	0.0	0.1	0.1
Overall balance	-6.3	-5.1	-5.8	-3.1	-2.7	-1.8	-3.3
Primary balance	-5.1	-3.7	-4.1	-1.2	-0.8	0.2	-1.2
General government financing	6.3	5.1	5.8	3.1	2.7	...	3.3
External	4.7	4.1	4.6	0.8	1.3	...	-0.7
Disbursements	6.4	4.7	5.3	2.7	2.5	...	1.4
Of which: IMF (includes SDR allocations)	4.0	1.5	1.5	0.0	0.0	...	0.0
Amortizations	-1.7	-0.6	-0.7	-2.0	-1.2	...	-2.0
Domestic (net)	1.6	1.1	1.1	2.4	1.5	...	4.0
Bond financing	1.0	2.3	1.9	0.8	0.1	...	2.8
Direct bank borrowing	-0.3	0.0	0.3	0.0	0.0	...	0.0
Deposit finance	0.6	-1.4	-1.2	0.8	0.5	...	0.5
Privatization	0.2	0.2	0.2	0.8	0.9	...	0.7
Naftogaz financing	2.5	1.4	1.7	0.4	1.5	...	2.0
General government and Naftogaz financing	8.7	6.5	7.4	3.5	4.3	...	5.3
Other financing	2.6	3.4	2.1	0.0	1.0	...	0.0
Bank recapitalization	2.6	1.8	0.6	0.0	1.0	...	0.0
VAT bonds	0.0	1.5	1.5	0.0	0.0	...	0.0
Total financing	11.3	9.9	9.5	3.5	5.3	...	5.3
Memorandum items:							
Cyclically-adjusted general government balance 2/	-2.6	-2.1	-3.1	-1.1	-2.3	...	-3.3
Government deposits at NBU	1.1	...	2.3	...	0.9	...	0.8
Public sector debt 3/	35.4	41.7	40.5	42.4	36.0	...	34.7
Nominal GDP (billions of Ukrainian hryvnia)	913	1,083	1,083	1,253	1,317	1,500	1,473

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

1/ Numbers are based on actual local governments' budgets. Numbers in EBS/10/232 column are based on estimates and projections.

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

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

Table 3. Ukraine: Gross Financing Requirements for General Government, 2011–13

(Billions of Ukrainian hryvnia)

	2011	2012					2013
		Q1	Q2	Q3	Q4	Annual	
Uses	84.4	17.5	41.3	21.5	33.9	114.1	113.9
General government deficit	35.9	6.7	10.8	12.2	19.2	49.0	58.2
Amortizations	48.5	10.7	30.4	9.3	14.6	65.1	55.7
Domestic MLT 1/	32.5	9.2	9.3	7.2	8.9	34.7	24.0
External	16.0	1.5	21.1	2.0	5.7	30.4	31.7
Sources	84.4	17.5	41.3	21.5	33.9	114.1	113.9
Domestic financing	51.7	17.1	32.6	12.1	32.7	94.4	93.1
Government bond issuance	32.7	7.2	30.0	9.6	30.3	77.1	83.1
MLT 1/	32.7	7.1	16.7	8.3	17.4	49.6	51.3
ST, net change 1/	...	0.1	13.3	1.3	12.8	27.5	31.9
Draw-down of government deposits	7.0	7.3	0.0	0.0	0.0	7.3	0.0
Privatization	12.0	2.6	2.6	2.5	2.4	10.0	10.0
External financing	32.6	0.4	8.7	9.4	1.2	19.6	20.8
Eurobond	25.1	0.0	0.0	8.0	0.0	8.0	16.6
External bank lending (incl. VTB financing)	3.0	0.0	8.0	0.0	0.0	8.0	0.0
IFI budget support and project financing	4.6	0.4	0.7	1.4	1.2	3.7	4.1
ST debt (coming due next 12 months)	23.0	23.1	36.4	37.7	50.5	50.5	82.4

Sources: Ministry of Finance; and IMF staff estimates.

1/ Short-term data only shown from 2012Q1. Prior to that, it is included in medium and long-term data.

Table 4. Ukraine: Balance of Payments, 2009–17

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

	2009	2010	2011	2012		2013	2014	2015	2016	2017
				EBS/10/232	Proj.						Proj.
Current account balance	-1.7	-3.0	-9.0	-4.5	-11.8	-15.0	-15.4	-15.3	-14.8	-14.1
Merchandise trade balance	-4.3	-8.4	-13.8	-10.1	-18.1	-20.2	-20.4	-20.1	-19.8	-19.5
Exports, f.o.b.	40.4	52.2	69.4	64.4	73.5	78.2	84.7	92.4	101.0	110.6
Imports, f.o.b. 1/	-44.7	-60.6	-83.2	-74.4	-91.6	-98.5	-105.1	-112.5	-120.8	-130.0
Of which: energy	-14.5	-19.4	-25.8	-19.7	-26.2	-25.7	-24.9	-24.5	-24.4	-24.7
Services (net)	2.4	4.4	4.9	4.9	6.0	4.9	4.8	4.7	4.6	4.7
Receipts	13.9	17.1	19.4	19.3	21.3	21.0	21.3	21.8	22.3	22.9
Payments	-11.5	-12.7	-14.5	-14.4	-15.3	-16.1	-16.6	-17.1	-17.6	-18.2
Income (net)	-2.4	-2.0	-3.8	-2.6	-3.6	-3.8	-4.1	-4.4	-4.2	-4.0
Current transfers (net)	2.7	3.0	3.7	3.3	4.0	4.1	4.3	4.4	4.6	4.7
Capital and financial account balance	-12.3	6.3	5.8	7.3	6.9	16.1	17.3	18.7	16.2	17.0
Capital account	0.6	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-12.9	6.1	5.7	7.3	6.8	16.1	17.3	18.7	16.2	17.0
Direct investment (net)	4.7	5.8	7.0	6.3	8.5	9.0	9.3	9.9	10.5	11.2
Portfolio investment (net)	-1.6	4.3	1.6	2.2	1.6	2.7	4.3	2.9	2.1	3.5
Other investment (net)	-16.0	-3.9	-2.8	-1.2	-3.3	4.4	3.7	5.9	3.6	2.3
Medium and long-term loans	-3.3	1.7	-0.8	2.1	-1.1	2.9	2.2	3.9	3.8	3.9
Official	0.2	1.5	-0.2	0.6	-1.5	-0.1	-1.1	-0.1	-0.2	-0.1
Disbursements 2/	0.7	1.9	0.3	1.0	0.9	0.4	0.4	0.4	0.4	0.4
Repayments	-0.5	-0.5	-0.5	-0.4	-2.4	-0.5	-1.5	-0.6	-0.6	-0.6
Banks	-1.9	-1.8	-3.4	0.8	-1.7	0.3	0.5	1.0	1.5	1.5
Other sectors	-1.6	2.1	2.8	0.7	2.1	2.7	2.8	3.0	2.5	2.5
Short-term loans	-1.5	3.3	10.7	1.0	5.5	5.0	4.9	5.5	3.2	1.9
Banks	-4.7	0.4	1.8	0.3	0.6	0.5	0.4	0.4	0.4	0.5
Other sectors 3/	3.2	2.9	8.9	0.7	5.0	4.5	4.5	5.1	2.8	1.5
Currency and deposits	-11.3	-9.0	-12.7	-4.2	-7.6	-3.5	-3.5	-3.5	-3.5	-3.5
Banks	-1.6	-2.8	-0.4	0.3	0.5	0.5	0.5	0.5	0.5	0.5
Other sectors 4/	-9.7	-6.1	-12.4	-4.5	-8.2	-4.0	-4.0	-4.0	-4.0	-4.0
Errors and omissions	0.2	1.4	0.4	0.0	0.5	0.0	0.0	0.0	0.0	0.0
Overall balance	-13.9	4.7	-2.7	2.8	-4.4	1.1	1.9	3.4	1.3	2.9
Official financing	...	0.4	0.3	1.2	0.5	...	...	...	...	...
World Bank	...	0.2	0.2	0.7	0.2	...	...	...	...	...
EU	...	0.1	0.1	0.5	0.1	...	...	...	...	...
EBRD/EIB/Others	...	0.1	0.0	0.1	0.2	...	...	...	...	...
Financing	13.9	-5.0	2.5	-4.0	3.9	-1.1	-1.9	-3.4	-1.3	-2.9
Gross official reserves (increase: -)	5.7	-8.5	2.5	-6.4	7.3	4.6	1.8	-1.9	-1.3	-2.9
Net use of IMF resources 5/	8.2	3.4	0.0	2.3	-3.4	-5.6	-3.7	-1.5	0.0	0.0
Memorandum items:										
Total external debt	103.4	117.3	126.2	130.3	128.7	133.3	139.3	147.7	157.0	166.8
Total external debt (percent of GDP)	88.2	86.0	76.4	76.5	69.8	67.2	65.9	65.6	65.3	65.1
Current account balance (percent of GDP)	-1.5	-2.2	-5.5	-2.6	-6.4	-7.6	-7.3	-6.8	-6.2	-5.5
Excluding transfers	-3.7	-4.4	-7.7	-4.6	-8.1	-7.5	-7.2	-7.0	-7.0	-7.3
Gross international reserves	26.5	34.6	31.8	45.4	24.4	19.9	18.1	20.0	21.3	24.2
Months of next year's imports of goods and services	4.3	4.2	3.6	5.6	2.6	2.0	1.7	1.7	1.7	1.8
Percent of short-term debt (remaining maturity)	67.4	71.5	55.2	91.7	39.6	31.4	27.3	28.5	28.7	31.5
Merchandise export value (percent change)	-40.3	29.2	33.0	11.0	5.8	6.5	8.3	9.1	9.3	9.4
Merchandise import value (percent change)	-46.7	35.5	37.4	11.2	10.0	7.5	6.7	7.1	7.4	7.6
Merchandise export volume (percent change)	-24.2	9.3	7.1	6.8	4.4	6.1	7.7	8.1	8.1	8.1
Merchandise import volume (percent change)	-41.6	18.1	20.3	8.0	7.3	7.9	7.5	7.5	7.5	7.5
Goods terms of trade (percent change)	-13.8	0.3	7.6	0.9	-1.3	0.8	1.4	1.5	1.4	1.3

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

1/ Assumes gas import price of US\$417 per tcm in 2012 and in line with global oil price developments beyond.

2/ For program period (2010–12), financing from official sources is recorded below the line.

3/ Includes trade credit and arrears, including those related to RUE settlement (2010 and 2011).

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

5/ Assumes no further Fund disbursements under the SBA program.

Table 5. Ukraine: Gross External Financing Requirements, 2009–13

(Billions of U.S. dollars)

	2009	2010	2011	2012	2013
				Proj.	
Total financing requirements	57.4	48.9	69.9	72.0	71.3
Current account deficit	1.7	3.0	9.0	11.8	15.0
Portfolio investment	4.7	4.3	6.7	2.1	2.2
Private	3.1	1.5	2.1	1.1	1.2
Public	1.6	2.8	4.6	1.0	1.0
Medium and long-term debt	16.9	14.7	16.4	19.3	14.5
Private	16.4	14.2	15.9	16.9	14.0
Banks	6.5	4.7	5.9	4.9	5.0
Corporates	9.9	9.6	10.1	12.0	9.0
Public	0.5	0.5	0.5	2.4	0.5
Short-term debt (including deposits)	13.4	9.7	12.2	13.2	16.6
Other net capital outflows 1/	11.4	6.2	12.0	8.2	4.0
Trade credit 2/	9.4	11.0	13.6	17.5	19.0
Total financing sources	43.3	52.2	66.7	67.1	72.3
Capital transfers	0.6	0.2	0.1	0.0	0.0
Direct investment, net	4.7	5.8	7.0	8.5	9.0
Portfolio investment	3.1	8.7	8.2	3.6	4.9
Private	2.8	2.6	2.6	2.1	2.6
Public	0.3	6.1	5.6	1.6	2.4
Medium and long-term debt	14.0	16.3	15.9	18.2	17.4
Private	13.3	14.4	15.7	17.3	17.0
Banks	4.6	2.8	2.4	3.2	5.3
Corporates	8.7	11.6	13.2	14.1	11.7
Public 3/	0.7	1.9	0.3	0.9	0.4
Short-term debt (including deposits)	9.7	12.1	16.5	17.7	19.2
Trade credit 2/	11.3	9.1	18.9	19.0	21.9
Increase in gross reserves	-5.7	8.5	-2.5	-7.3	-4.6
Errors and omissions	0.2	1.4	0.4	0.5	0.0
Financing gap	8.2	3.8	0.3	-2.9	-5.6
Official financing	8.2	3.8	0.3	-2.9	-5.6
IMF 4/	8.2	3.4	0.0	-3.4	-5.6
Official creditors	...	0.4	0.3	0.5	...
World Bank	...	0.2	0.2	0.2	...
EU	...	0.1	0.1	0.1	...
EBRD/EIB/Others	...	0.1	0.0	0.2	...
Memorandum items:					
Gross international reserves	26.5	34.6	31.8	24.4	19.9
Percent of short-term debt (remaining maturity)	67.4	71.5	55.2	39.6	31.4
Months of next year's imports of goods and services	4.3	4.2	3.6	2.6	2.0
Loan rollover rate (percent)					
Banks	56.6	78.7	72.2	86.4	109.1
Corporates	105.0	137.2	138.0	129.2	121.9
Total	76.8	110.2	113.4	116.3	118.2

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

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

2/ Trade credits in EBS/10/232 were recorded in net terms under sources.

3/ For program period (2010–12), financing from official sources is recorded below the line.

4/ Assumes no further Fund disbursements under the SBA program. The SDR-USD exchange rates assumed are 1.54 for 2012.

Table 6. Ukraine: Monetary Accounts, 2010–13

	2010		2011				2012				2013
	Dec.	Mar.	Jun.	Sep.	Dec.		Mar.	Jun.	Sep.	Dec.	Dec.
					EBS/10/232		Proj.				Proj.
(Millions of Ukrainian hryvnias)											
Monetary survey											
Net foreign assets	62,043	73,231	95,971	75,070	36,641	60,968	64,960	66,447	67,424	36,625	37,237
Net domestic assets	535,828	548,150	556,429	587,206	624,413	624,547	626,342	646,508	663,366	688,686	791,549
Domestic credit	858,853	867,021	906,899	932,655	969,579	964,728	959,702	978,972	995,287	1,022,288	1,126,867
Net claims on government	114,980	102,336	115,617	115,112	151,757	146,773	140,873	162,911	164,869	188,751	244,896
Credit to the economy	728,384	748,639	770,635	798,020	803,499	797,543	796,099	794,767	810,588	812,737	859,962
Other claims on the economy	15,488	16,046	20,647	19,523	14,324	20,412	22,729	21,294	19,830	20,801	22,009
Other items, net	-323,025	-318,871	-350,470	-345,448	-345,166	-340,181	-333,359	-332,464	-331,920	-333,602	-335,319
Broad money	597,872	621,380	652,400	662,276	661,054	685,515	691,302	712,955	730,790	725,311	828,786
Currency in circulation	182,990	179,528	187,702	189,909	204,091	192,665	187,913	197,390	202,337	205,427	212,868
Total deposits	413,851	439,202	461,288	468,934	453,536	489,136	500,234	511,839	524,665	515,955	611,428
Domestic currency deposits	239,918	257,024	270,032	268,204	261,482	281,105	289,319	297,952	305,428	294,735	364,450
Foreign currency deposits	173,933	182,179	191,256	200,730	192,054	208,031	210,915	213,887	219,237	221,220	246,978
Money market instruments	1,031	2,650	3,410	3,433	3,427	3,714	3,156	3,726	3,788	3,929	4,490
Accounts of the NBU											
Net foreign assets	167,723	178,351	186,518	168,105	160,725	145,495	142,534	144,022	143,762	113,597	130,839
Net domestic assets	57,969	45,166	41,626	66,246	92,281	94,390	90,595	99,633	105,475	135,887	136,685
Net domestic credit	111,578	88,696	90,893	113,631	153,693	143,523	133,951	143,181	149,119	179,626	181,207
Net claims on government	49,956	34,111	35,647	50,438	85,291	77,428	68,445	78,445	87,545	120,845	136,345
Claims on government	71,526	57,297	67,612	77,337	95,683	89,650	83,298	93,298	102,398	135,698	151,198
Liabilities government	21,570	23,186	31,965	26,900	10,392	12,222	14,853	14,853	14,853	14,853	14,853
Net claims on the economy	206	202	152	172	243	179	201	201	201	201	201
Net claims on banks	61,416	54,384	55,094	63,022	68,159	65,917	65,306	64,535	61,374	58,580	44,662
Other items, net	-53,609	-43,531	-49,267	-47,385	-61,412	-49,133	-43,356	-43,548	-43,645	-43,739	-44,522
Base money	225,692	223,517	228,144	234,351	253,006	239,885	233,128	243,655	249,236	249,484	267,524
Currency in circulation	182,990	179,528	187,702	189,909	204,091	192,665	187,913	197,390	202,337	205,427	212,868
Banks' reserves	42,702	43,989	40,442	44,442	48,915	47,220	45,216	46,265	46,900	44,057	54,655
Cash in vault	17,103	15,768	16,762	17,593	16,614	16,900	17,006	17,400	17,836	17,540	20,786
Required reserves	12,359	12,522	13,197	13,919	13,470	14,953	15,180	15,532	15,921	15,657	18,554
Excess reserves	13,241	15,699	10,483	12,930	18,831	15,367	13,031	13,333	13,142	10,860	15,316
Deposit money banks											
Net foreign assets	-105,680	-105,121	-90,547	-93,035	-124,084	-84,528	-77,574	-77,575	-76,338	-76,972	-93,601
Net domestic assets	518,198	542,755	550,246	560,667	577,620	572,390	576,428	589,414	601,003	592,927	705,029
Domestic credit	788,517	820,741	854,830	862,638	864,694	867,048	869,482	883,468	896,057	888,854	1,001,472
Net claims on government	65,024	68,225	79,970	64,675	66,465	69,345	72,429	84,466	77,324	67,906	108,551
Credit to the economy	728,040	748,292	770,332	797,704	803,138	797,225	795,762	794,430	810,250	812,399	859,625
Other claims on the economy	15,488	16,046	20,647	19,523	14,334	20,412	22,729	22,843	22,957	23,072	23,302
Of which:											
NBU refinancing loans	72,756	69,067	67,193	66,413	...	73,675	66,732	...	...	...	...
Banks' reserves	42,702	43,989	40,442	44,442	48,915	47,220	45,216	46,265	46,900	44,057	54,655
Other items, net	-270,319	-277,986	-304,584	-301,971	-287,074	-294,658	-293,054	-294,054	-295,054	-295,927	-296,443
Banks' liabilities	412,518	437,634	459,698	467,631	453,536	487,862	498,854	511,839	524,665	515,955	611,428
Demand deposits	147,136	162,180	168,638	168,339	...	169,019	...	...	...	...	...
Time deposits	265,382	275,454	291,061	299,292	...	318,843	...	...	...	...	...
Memorandum items:											
	(Year-on-year percent change)										
Base money	15.8	13.7	3.9	8.1	13.5	6.3	4.3	6.8	6.4	4.0	7.2
Broad money	22.7	25.7	22.3	16.4	15.1	14.7	11.3	9.3	10.3	5.8	14.3
Credit to the economy	1.1	6.9	9.9	10.2	7.5	9.5	6.3	3.1	1.6	1.9	5.8
	(Ratio)										
Velocity of broad money	1.8	1.8	1.8	1.9	1.9	1.9	1.9	...	...	2.0	2.0
Money multiplier	2.6	2.8	2.9	2.8	2.6	2.9	3.0	2.9	2.9	2.9	3.1

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

Table 7. Ukraine: Financial Soundness Indicators for the Banking Sector, 2007–12

(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011				2012
					Mar.	Jun.	Sep.	Dec.		Mar.
Ownership									
Number of banks	175.0	184.0	182.0	176.0	176.0	178.0	177.0	176.0	176.0
Private	173.0	182.0	180.0	174.0	174.0	176.0	175.0	174.0	174.0
Domestic	126.0	132.0	129.0	119.0	120.0	120.0	120.0	121.0	121.0
Foreign	47.0	50.0	51.0	55.0	54.0	56.0	55.0	53.0	53.0
<i>Of which: 100% foreign-owned</i>	17.0	18.0	18.0	20.0	20.0	21.0	22.0	22.0	22.0
State-owned	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Foreign-owned banks' share in statutory capital	35.0	36.7	35.8	40.6	41.6	38.9	41.6	41.9	41.8
Concentration									
Share of assets of largest 10 banks	49.7	52.0	52.8	53.9	54.1	54.2	53.7	52.8	51.8
Share of assets of largest 25 banks	75.2	76.4	76.5	75.9	75.4	75.6	75.3	74.6	74.4
Number of bank with assets less than \$150 million	85.0	81.0	107.0	92.0	88.0	87.0	85.0	81.0	77.0
Capital Adequacy									
Regulatory capital to risk-weighted assets	13.9	14.0	18.1	20.8	20.0	19.2	18.9	18.9	17.9
Capital to total assets	11.6	12.9	13.1	14.6	13.9	14.5	14.8	14.8	14.6
Asset Quality									
Credit growth (year-over-year percent change) 1/	74.1	72.1	-2.3	1.1	6.9	9.9	10.2	9.5	6.3
Credit to GDP ratio 1/ 2/	59.4	77.7	78.9	67.3	66.4	65.0	63.3	60.6	59.5
NPLs to total loans (NBU definition) 2/	3.0	3.9	13.7	15.3	15.5	15.4	15.3	14.7	14.9
NPLs to total loans (broad definition) 3/	13.2	16.4	37.6	40.3	39.8	40.3	38.2	37.7	39.1
NPLs net of provisions to capital	72.9	9.1	32.0	29.2	28.5	25.8	26.5	25.8	26.9
Specific provisions (percent of NPLs, NBU definition)	7.0	132.4	65.1	66.6	68.3	70.1	69.3	68.3	66.8
Specific provisions (percent of total loans)	3.3	5.1	8.9	10.2	10.6	10.8	10.6	10.1	9.9
Foreign Exchange Rate Risk									
Loans in foreign currency to total loans 1/	49.8	58.9	51.2	46.5	46.1	44.8	42.4	40.6	40.3
Deposits in foreign currency to total deposits	32.1	44.0	47.2	42.1	41.6	41.6	42.9	42.6	42.3
Foreign currency loans to foreign currency deposits 1/	237.2	275.5	239.2	194.8	189.3	180.7	168.6	155.7	152.1
Total net open position in foreign currency to regulatory capital	7.0	33.1	28.5	21.6	23.5	20.0	13.8	8.4	9.1
Liquidity Risk									
Liquid assets to total assets	10.3	8.2	9.6	10.1	10.4	10.0	9.6	10.5	...
Customer deposits to total loans to the economy 1/	65.3	48.5	45.3	56.7	58.5	59.7	58.6	61.2	62.7
Earnings and Profitability									
Return on assets (after tax; end-of-period)	1.5	1.0	-4.4	-1.5	-0.1	-0.2	-0.8	-0.8	0.7
Return on equity (after tax; end-of-period)	12.7	8.5	-32.5	-10.2	-0.6	-1.5	-5.3	-5.3	4.4
Net interest margin to total assets	5.0	5.3	6.2	5.8	5.8	5.4	5.4	5.3	4.7
Interest rate spreads (percentage points; end-of-period)									
Between loans and deposits in domestic currency	5.8	8.6	5.6	7.6	8.0	9.1	8.7	6.6	6.1
Between loans and deposits in foreign currency	4.9	4.4	0.7	4.7	4.7	4.6	3.2	2.8	2.7
Between loans in domestic and foreign currency	3.2	9.0	9.4	5.3	4.6	5.9	7.7	9.4	8.3
Between deposits in domestic and foreign currency	2.3	4.9	4.5	2.4	1.2	1.4	2.2	5.6	4.8
Number of banks not complying with banking regulations									
Not meeting capital adequacy requirements for Tier I capital	0.0	4.0	12.0	3.0	5.0	5.0	3.0	2.0	...
Not meeting prudential regulations	1.0	12.5	22.0	8.0	10.0	10.0	10.0	11.0	9.0
Not meeting reserve requirements	1.0	5.0	15.0	5.0	5.0	5.0	4.0	5.0	4.0

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

1/ Monetary statistics data.

2/ Includes NPLs that are classified as doubtful and loss.

3/ Includes NPLs that are classified as substandard, doubtful, and loss. However, this broad definition may not be comparable to other countries as, in addition to servicing status, loan classification also depends on borrower's financial conditions and collateralization level.

Table 8. Ukraine: Public Sector Debt Sustainability Framework, 2007–17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: public sector debt 1/	12.3	20.5	35.4	40.5	36.0	34.7	35.1	35.2	35.5	35.5	35.6	0.4
<i>Of which</i> : foreign-currency denominated	9.7	15.5	23.8	26.1	22.7	18.0	14.7	11.2	10.1	8.8	8.1	
Change in public sector debt	-2.5	8.2	14.8	5.1	-4.5	-1.3	0.4	0.1	0.3	0.0	0.1	
Identified debt-creating flows (4+7+12)	-2.2	4.5	15.3	3.5	-2.6	-0.9	-1.2	0.3	-0.3	0.0	-0.1	
Primary deficit	1.5	2.6	5.1	4.1	1.0	1.3	1.0	0.8	0.4	0.4	0.1	
Revenue and grants	41.8	44.3	42.3	43.3	42.4	42.4	40.7	40.1	39.5	39.0	38.5	
Primary (noninterest) expenditure	43.3	46.9	47.4	47.4	43.4	43.7	41.6	40.9	39.9	39.4	38.6	
Automatic debt dynamics 2/	-3.1	1.6	2.6	-4.0	-4.9	-1.4	-0.7	-0.2	0.0	-0.1	0.2	
Contribution from interest rate/growth differential 3/	-3.1	-2.4	1.9	-3.9	-5.0	-1.4	-0.7	-0.2	0.0	-0.1	0.2	
Of which: contribution from real interest rate	-2.3	-2.1	-1.1	-2.7	-3.3	-0.4	0.4	1.0	1.1	1.0	1.3	
Of which: contribution from real GDP growth	-0.8	-0.3	3.1	-1.2	-1.7	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1	
Contribution from exchange rate depreciation 4/	0.0	4.1	0.6	-0.1	0.1	0.0	1.5	0.1	0.8	0.1	0.4	
Other identified debt-creating flows	-0.6	0.3	7.7	3.3	1.4	-0.8	-1.4	-0.4	-0.7	-0.3	-0.4	
Privatization receipts (negative)	-0.6	-0.3	-0.2	-0.2	-0.9	-0.7	-0.6	-0.2	-0.2	-0.2	-0.2	
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	
Other (specify, e.g. bank recapitalization)	0.0	0.5	7.9	3.5	2.3	-0.1	-0.8	-0.1	-0.5	-0.1	-0.2	
Residual, including asset changes (2-3) 5/	-0.3	3.7	-0.5	1.6	-1.9	-0.5	0.1	-0.3	-0.2	-0.1	-0.3	
Public sector debt-to-revenue ratio 1/	29.4	46.4	83.6	93.7	84.9	81.8	86.3	87.8	89.8	90.9	92.3	
Gross financing need 6/	2.8	3.8	11.5	10.0	7.5	9.7	12.2	14.7	20.8	14.4	15.6	
Billions of U.S. dollars	4.0	6.8	13.4	13.6	12.4	17.9	24.3	31.2	46.9	34.6	39.8	
Scenario with key variables at their historical averages 7/						34.7	31.5	28.5	26.0	24.0	22.2	-3.2
Scenario with no policy change (constant primary balance) in 2011–16						34.7	31.7	32.2	32.1	32.6	33.1	-0.1
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (percent)	7.3	3.4	-14.4	4.1	5.2	3.0	3.5	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (percent) 8/	4.6	5.5	5.5	5.4	6.5	7.6	9.7	9.6	9.8	9.5	10.2	
Average real interest rate (nominal rate minus change in GDP deflator, percent)	-18.9	-21.7	-7.1	-8.4	-9.1	-1.0	1.6	3.2	3.7	3.3	4.3	
Nominal appreciation (increase in U.S. dollar value of local currency, percent)	0.0	-34.4	-3.6	0.3	-0.4	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	23.5	27.2	12.5	13.8	15.7	8.6	8.2	6.4	6.2	6.2	5.9	
Growth of real primary spending (deflated by GDP deflator, percent)	13.2	15.4	-23.5	5.3	-2.2	-2.5	-1.8	0.1	0.8	2.2	1.3	
Primary deficit	1.5	2.6	5.1	4.1	1.0	1.3	1.0	0.8	0.4	0.4	0.1	

1/ Gross debt of general government (including guarantees) and of monetary authorities.

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

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 9. Ukraine: External Debt Sustainability Framework, 2007–17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 7/
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: external debt	56.0	56.4	88.2	86.0	76.4	69.8	67.1	65.9	65.5	65.3	65.0	-5.5
Change in external debt	5.4	0.4	31.8	-2.2	-9.6	-6.6	-2.7	-1.3	-0.4	-0.2	-0.2	
Identified external debt-creating flows (4+8+9)	-19.2	-9.3	29.1	-17.6	-3.4	-1.2	-0.5	-1.4	-1.1	-1.2	-2.4	
Current account deficit, excluding interest payments	0.7	3.2	-4.5	-2.7	-0.2	1.7	3.7	2.9	2.5	1.9	1.3	
Deficit in balance of goods and services	5.7	8.0	1.7	2.9	5.4	6.6	7.7	7.4	6.8	6.3	5.8	
Exports	44.8	47.5	46.3	50.8	53.8	51.4	50.0	50.2	50.6	51.2	52.0	
Imports	50.6	55.5	47.9	53.7	59.2	57.9	57.7	57.5	57.5	57.5	57.8	
Net non-debt creating capital inflows (negative) 1/	-10.5	-4.8	-2.6	-7.4	-5.2	-5.5	-5.8	-6.4	-5.7	-5.2	-5.7	
Automatic debt dynamics 2/	-9.4	-7.8	36.3	-7.5	2.0	2.6	1.5	2.1	2.1	2.1	2.1	
Contribution from nominal interest rate	3.0	3.9	6.0	4.9	5.6	4.7	3.8	4.3	4.3	4.2	4.2	
Contribution from real GDP growth	-3.0	-1.0	12.8	-3.1	-3.7	-2.1	-2.3	-2.2	-2.2	-2.2	-2.1	
Contribution from price and exchange rate changes 3/	-9.4	-10.6	17.4	-9.3	...	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 4/	24.6	9.8	2.6	15.4	-6.2	-5.4	-2.2	0.1	0.7	1.0	2.2	
External debt-to-exports ratio (percent)	124.9	118.7	190.6	169.4	142.1	135.9	134.3	131.3	129.3	127.4	125.0	
Gross external financing need (billions of U.S. dollars) 5/	53.2	67.1	57.4	48.9	69.9	72.0	71.3	74.3	78.4	83.1	85.6	
Percent of GDP	37.2	37.2	49.0	35.8	42.3	39.1	35.9	35.1	34.8	34.5	33.4	
Scenario with key variables at their historical averages 6/					76.4	60.3	45.8	33.7	23.1	13.5	5.2	-6.0
Key macroeconomic assumptions underlying baseline												
Real GDP growth (percent)	7.9	2.3	-14.8	4.1	5.2	3.0	3.5	3.5	3.5	3.5	3.5	
GDP deflator in U.S. dollars (change in percent)	22.8	23.4	-23.6	11.8	15.2	8.3	4.0	2.9	3.0	3.1	2.9	
Nominal external interest rate (percent)	7.9	8.7	6.9	6.5	7.9	6.9	5.9	6.9	6.9	6.9	6.9	
Growth of exports (U.S. dollar terms, percent)	27.4	33.8	-36.6	27.7	28.3	6.6	4.8	6.9	7.7	8.0	8.2	
Growth of imports (U.S. dollar terms, percent)	35.4	38.5	-43.8	30.3	33.5	9.3	7.2	6.2	6.5	6.9	7.1	
Current account balance, excluding interest payments	-0.7	-3.2	4.5	2.7	0.2	-1.7	-3.7	-2.9	-2.5	-1.9	-1.3	
Net non-debt creating capital inflows	10.5	4.8	2.6	7.4	5.2	5.5	5.8	6.4	5.7	5.2	5.7	

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

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

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

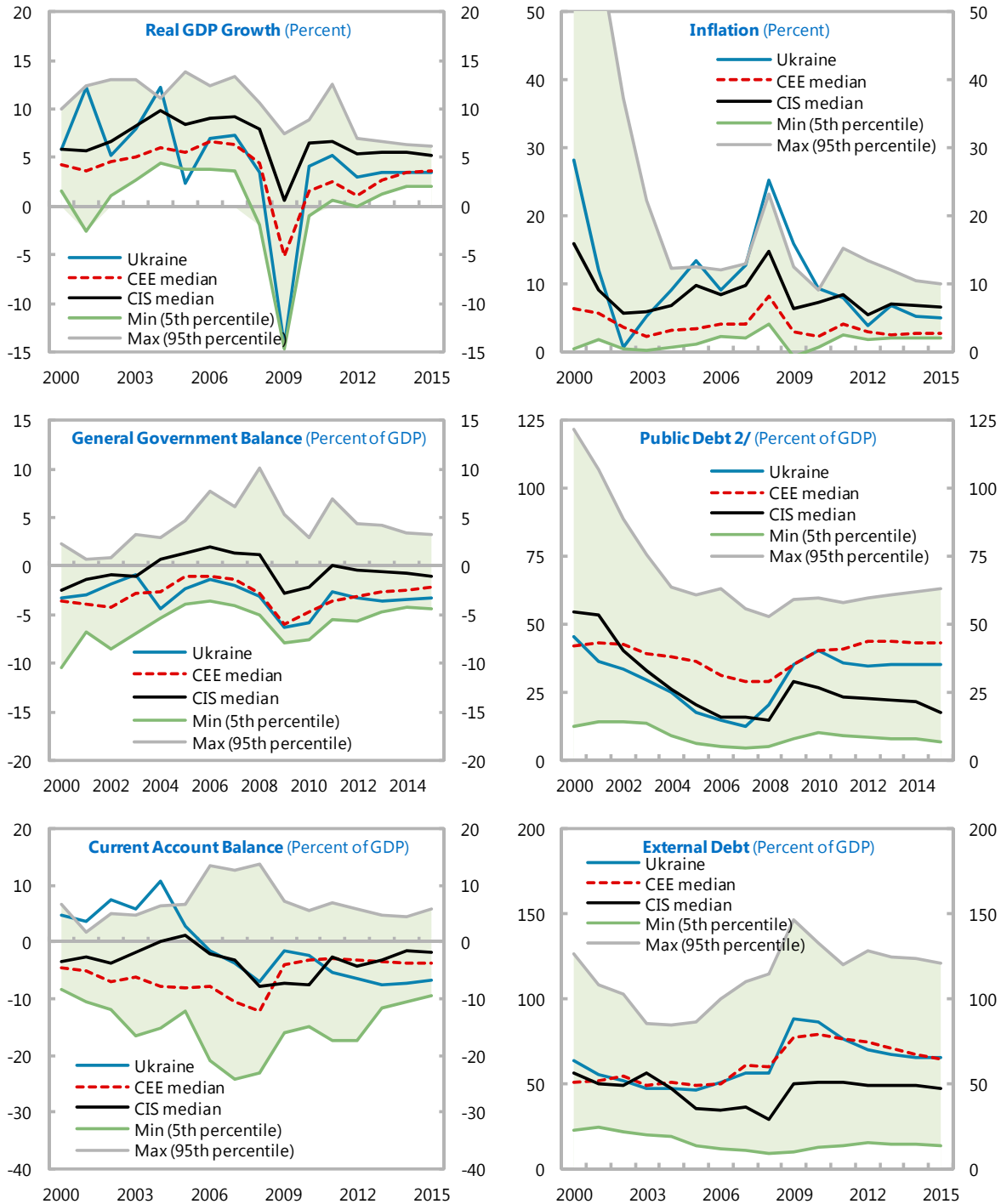
4/ For projection, line includes the impact of price and exchange rate changes.

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

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

7/ 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.

Figure 1. Ukraine: Performance Among Peers, 2000–15 1/

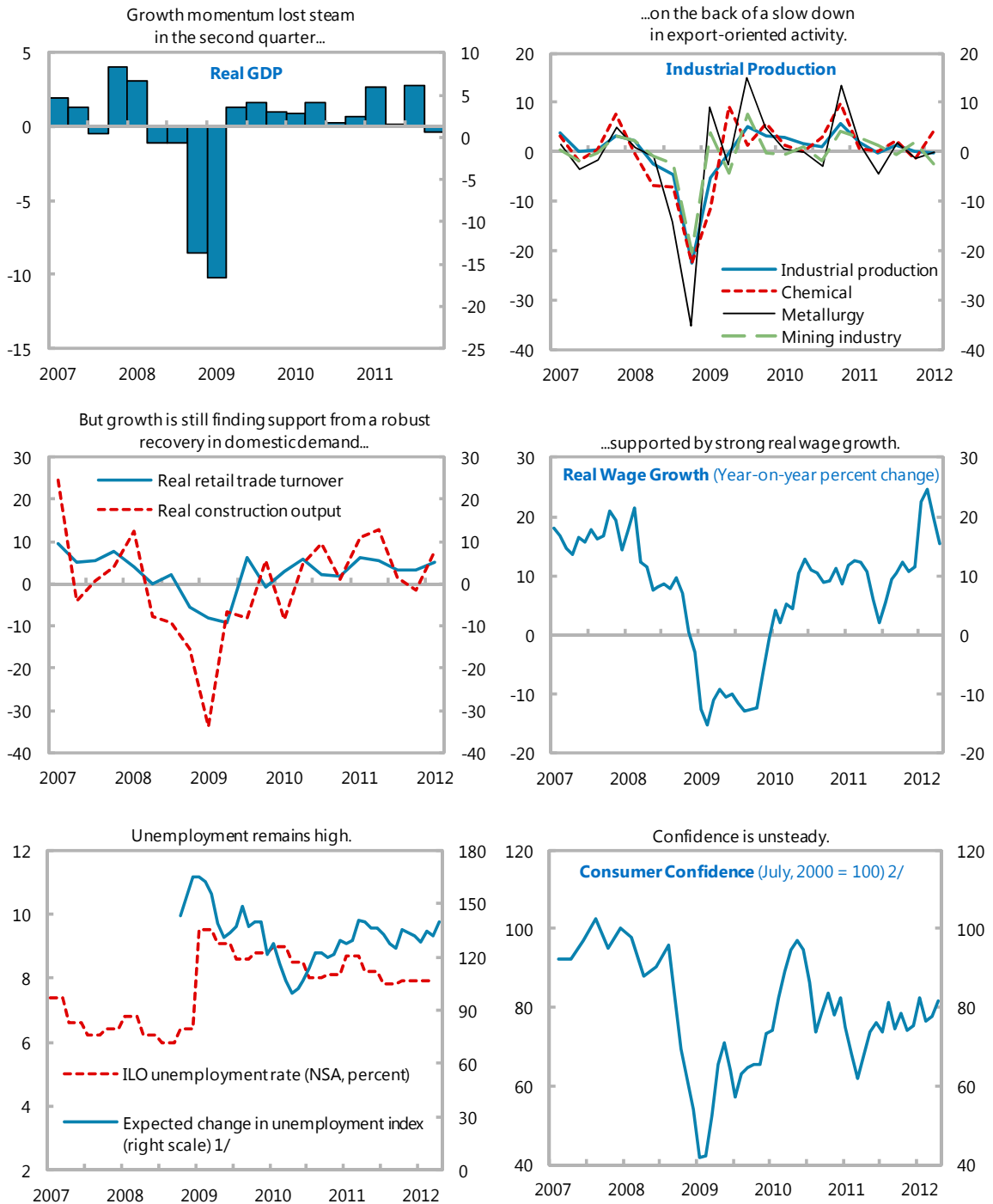


Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

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

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

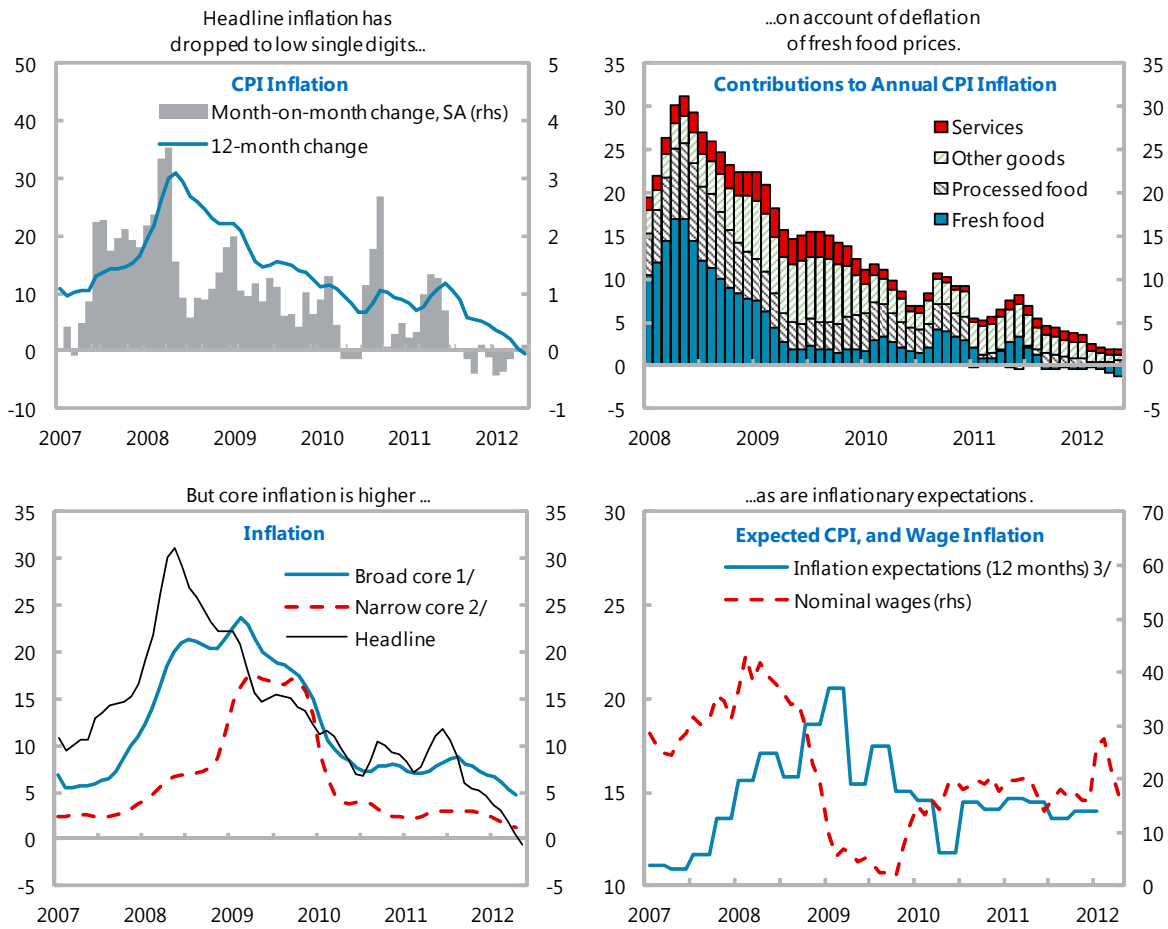
Figure 2. Ukraine: Real Sector Indicators, 2007–12
 (Seasonally adjusted, quarter-on-quarter percent change, unless otherwise indicated)



Sources: State Statistics Committee of Ukraine; Haver; International Centre for Policy Studies; and IMF staff calculations.
 1/ Values above 100 indicate that more respondents expect unemployment to rise than fall over the next one to two months. Values can vary from 0 to 200.

2/ Consumer confidence index is based on survey respondents' answers to questions that relate to personal financial standing, changes in personal financial standing, economic conditions over the next year, economic conditions over the next five years, and propensity to consume.

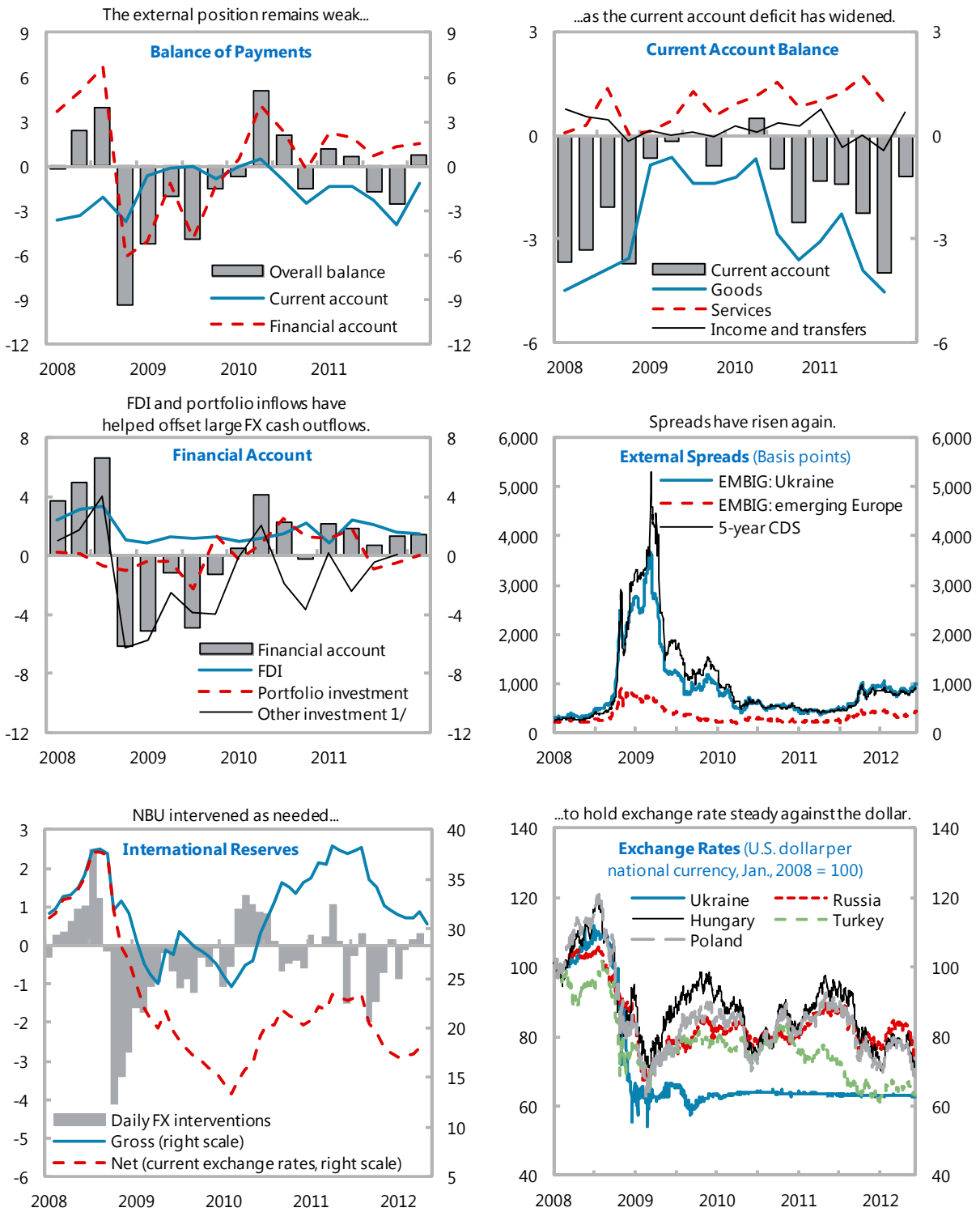
Figure 3. Ukraine: Inflation, Monetary, and Exchange Rate Developments, 2007–12
(Year-on-year percent change, unless otherwise indicated)



Sources: State Statistics Committee of Ukraine; International Centre for Policy Studies; National Bank of Ukraine; Bloomberg; and IMF staff calculations.
 1/ Broad core excludes unprocessed food, fuel, and administrative services.
 2/ Narrow core excludes food, fuel, and all services.
 3/ Inflation expectations are surveyed and compiled by Economic Analysis and Forecasting Department of the NBU.

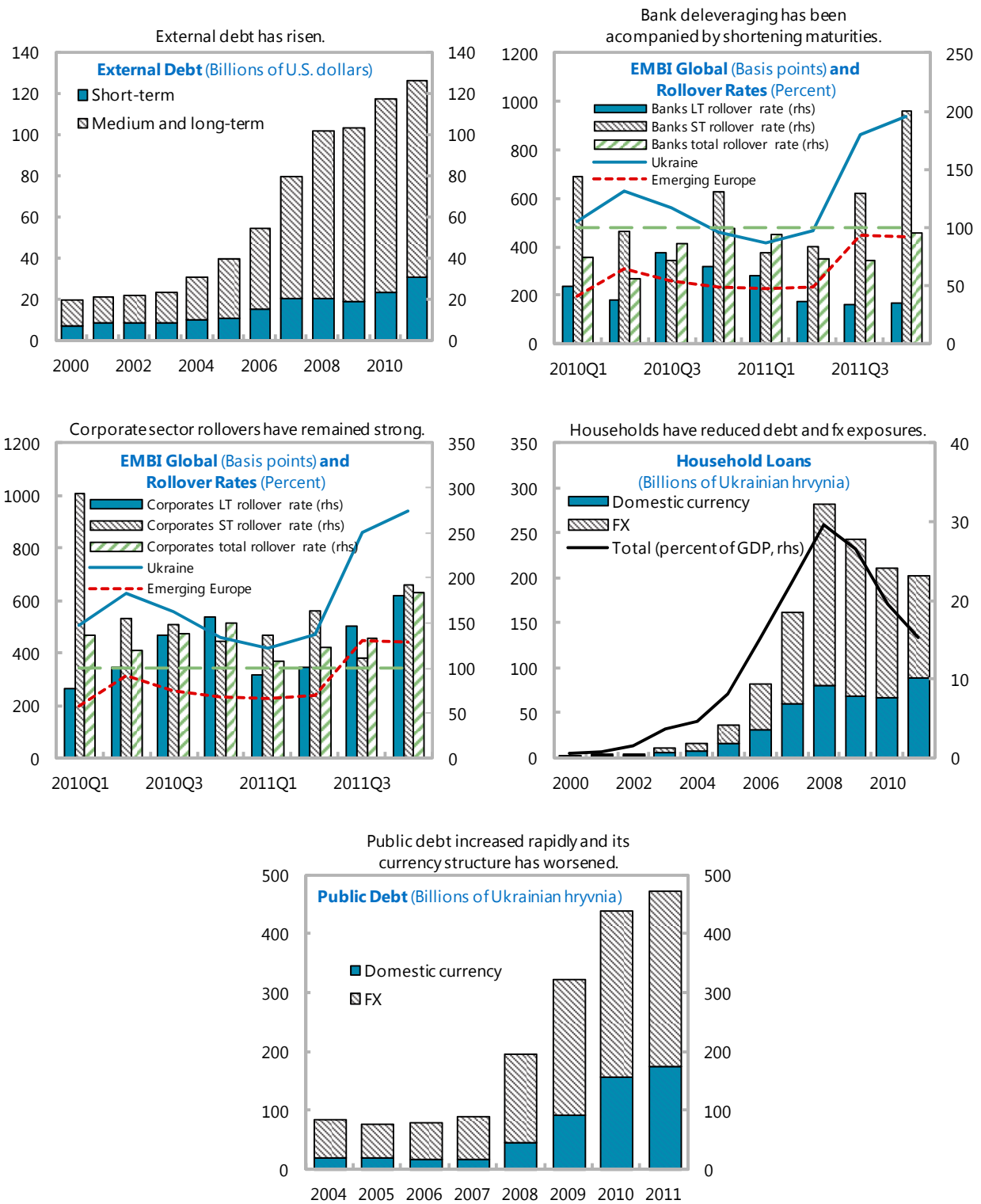
Figure 4. Ukraine: External Sector Developments, 2008–12

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



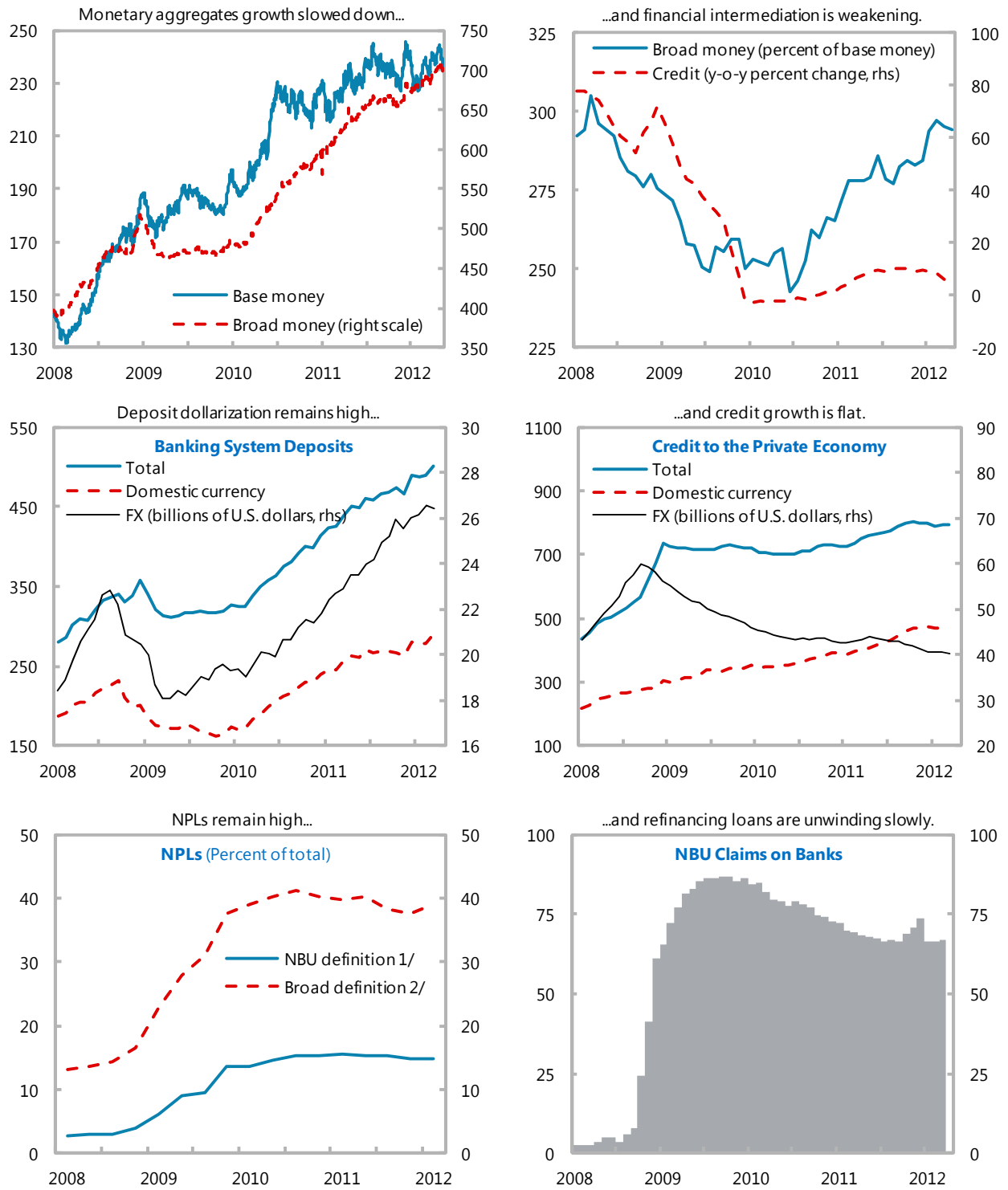
Sources: National Bank of Ukraine; State Committee of Statistics; Bloomberg; and IMF staff estimates and calculations.
 1/ Includes residents' conversion of hryvnia cash to foreign currency held outside the banking system.

Figure 5. Ukraine: Debt and Rollover of Debt, 2000–11



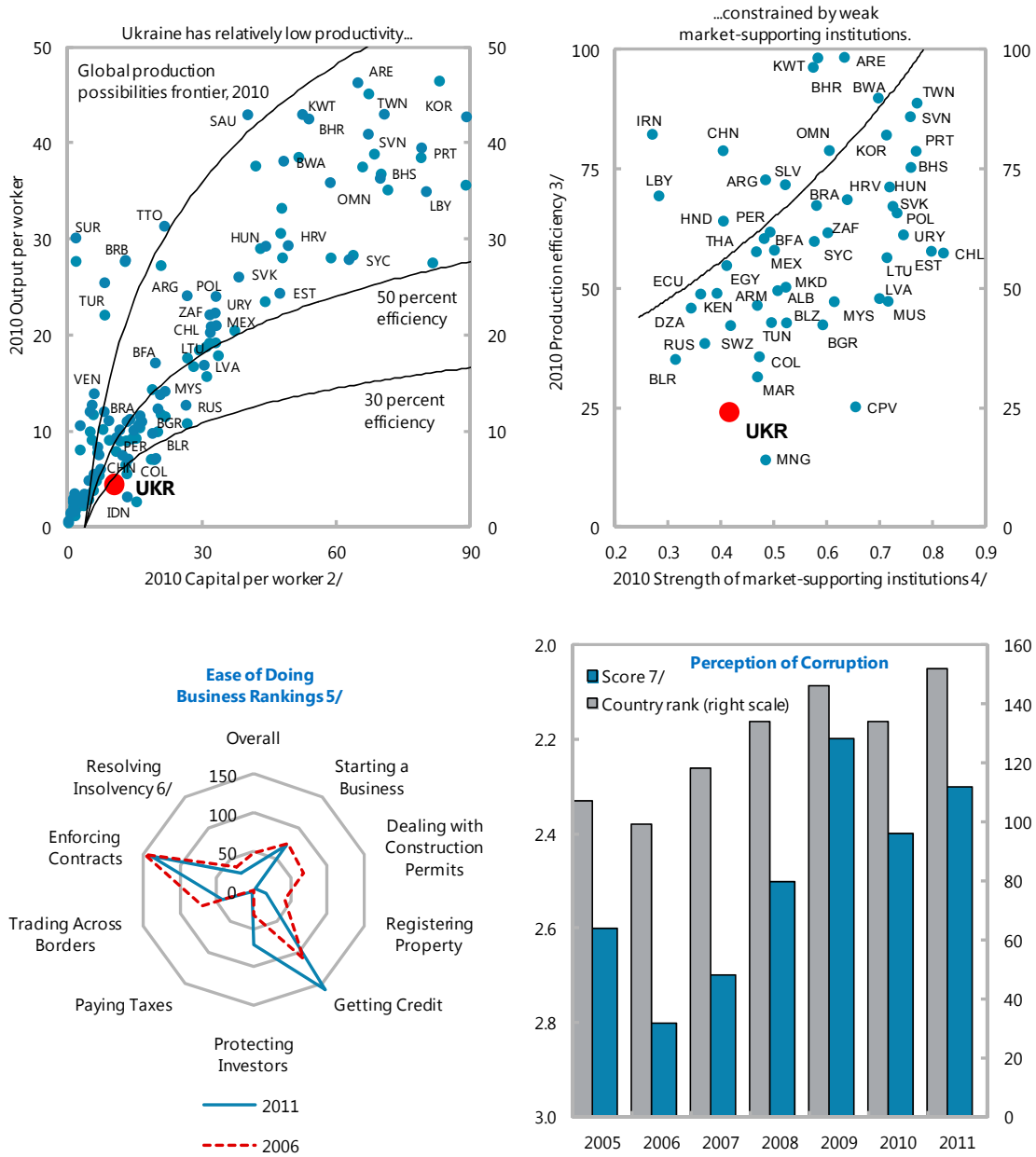
Sources: National Bank of Ukraine; Bloomberg; Ministry of Finance; and IMF staff estimates.

Figure 6. Ukraine: Financial Sector Indicators, 2008–12
(Billions of Ukrainian hryvnias, unless otherwise indicated)



Sources: National Bank of Ukraine; and IMF staff calculations.
1/ Includes NPLs that are classified as doubtful and loss.
2/ Includes NPLs that are classified as substandard, doubtful, and loss.

Figure 7. Ukraine: Potential Output and Structural Reforms



Sources: IMF, *World Economic Outlook*; World Bank, *World Governance Indicators*; World Bank, *Doing Business Indicators*; Transparency International, *Corruption Perceptions Index*; and IMF staff calculations and estimates.

1/ The frontier represents the implicit output level that could be obtained if a country were to employ all its resources efficiently (IMF Working Paper 06/167).

2/ Initial capital stock in 1994 calculated as twice nominal output in 1994. Evolves with U.S. dollar-based real gross fixed capital formation with 2005 base year and assumes a depreciation rate of 9 percent.

3/ Measures how closely (in percent) a country operates to the global production possibilities frontier.

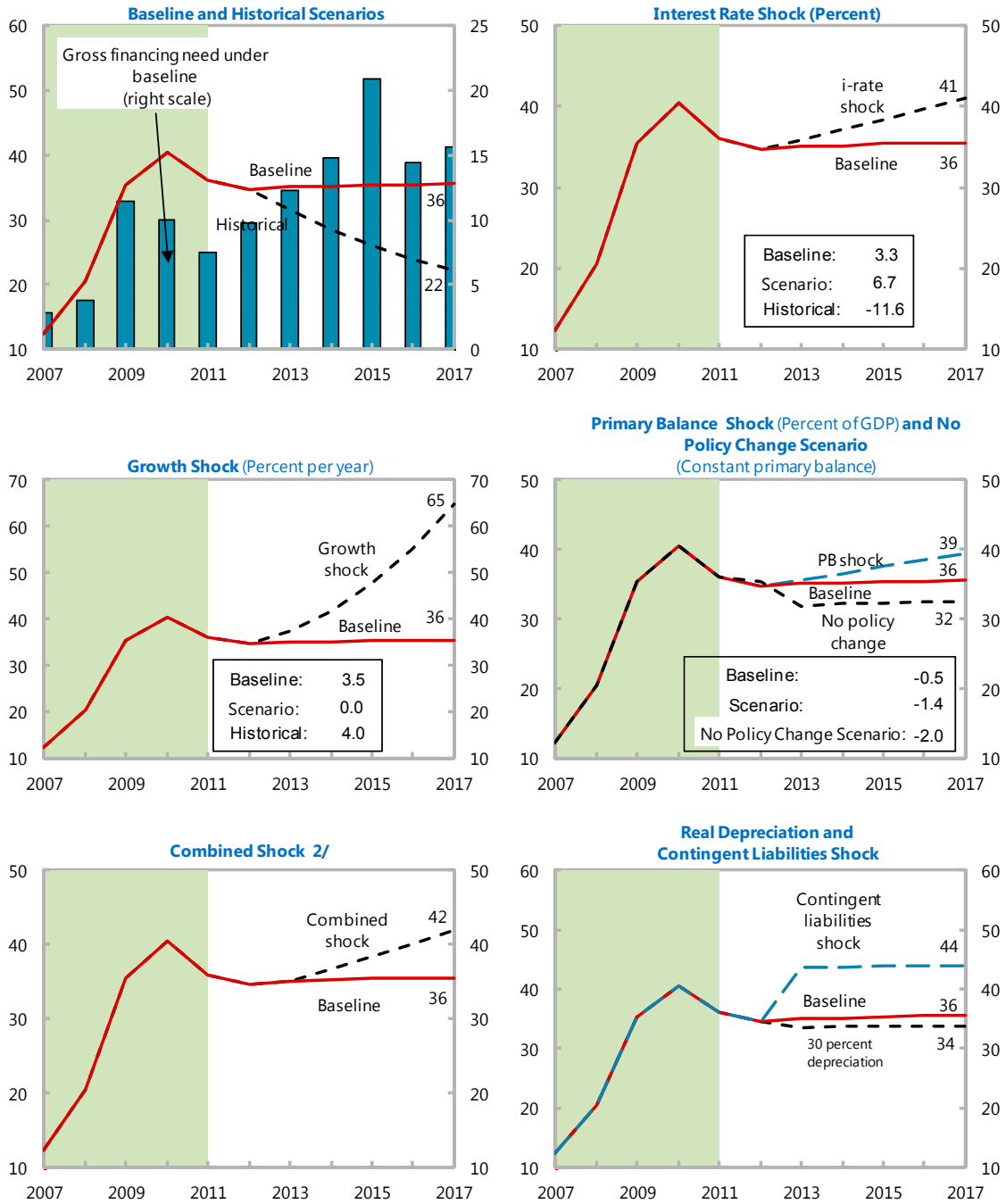
4/ Calculated as the normalized average of five indices from the World Bank Governance Database: rule of law, political stability and absence of violence, control of corruption, government effectiveness, regulatory quality, and voice and accountability.

5/ Ranked from worst to best with the worst receiving a ranking of "1." Data corresponds to 2007 and 2012 publications.

6/ Formerly, "Closing a Business."

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

Figure 8. Ukraine: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



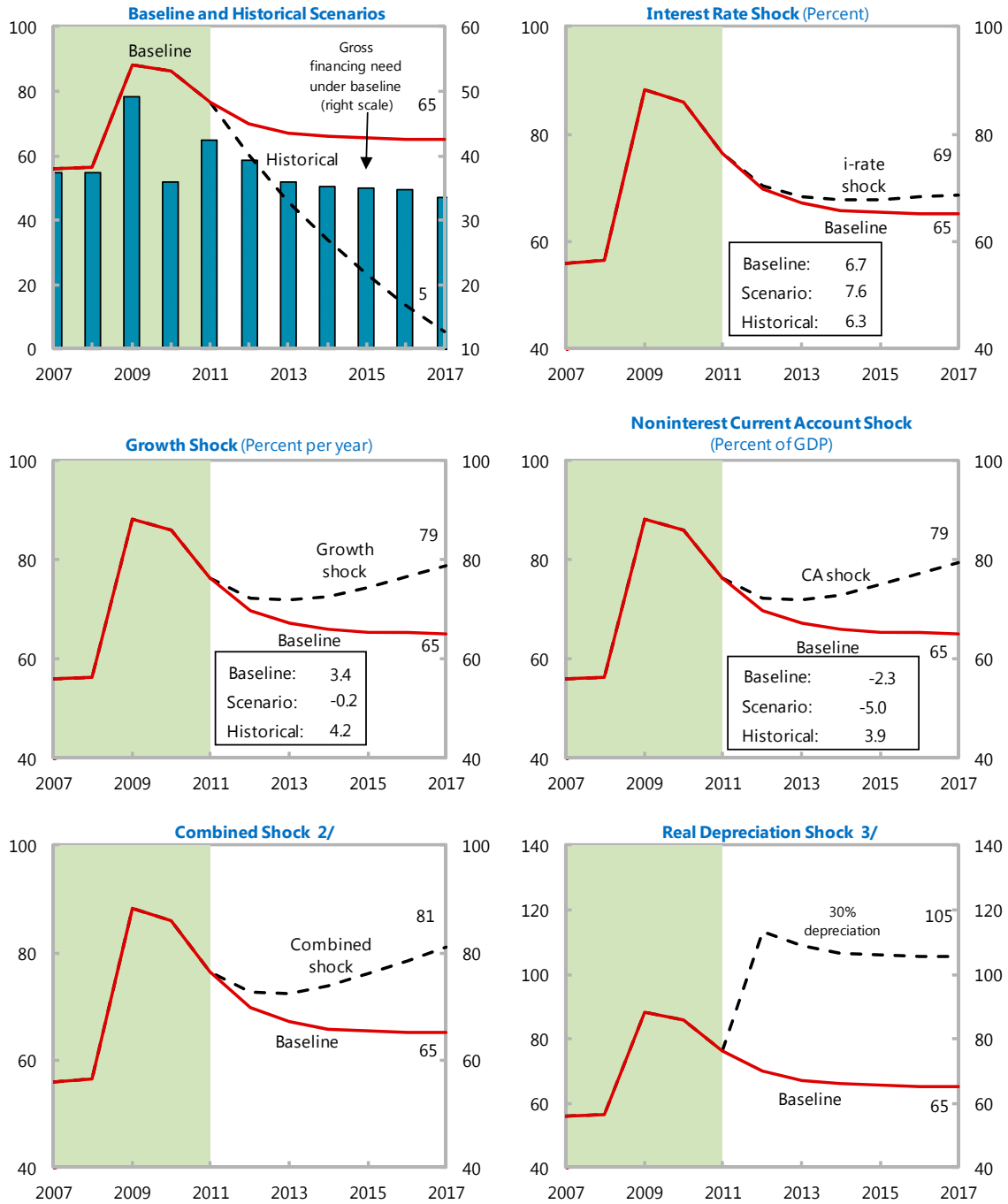
Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, 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 9. Ukraine: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ In line with standard IMF stress tests, the shock simulates the impact of a one-time real depreciation of 30 percent in 2010.

Annex I. Ukraine: Exchange Rate, External Sustainability, and Competitiveness

Over the years, the Fund has recommended shifting from a peg to the U.S. dollar to a more flexible exchange rate with a view to gaining better control over inflation, facilitating adjustment to external shocks, and discouraging dollarization and excessive risk taking by unhedged borrowers.

In the past, large inflation differentials vis-à-vis main trading partners led to overvaluation of the real effective exchange rate (REER), eroding competitiveness. Between 2004 and 2008, Ukraine's real effective exchange rate appreciated by over 40 percent—with inflation at times exceeding that of the main trading partners by 20–30 percent—increasingly pushing the trade balance into the red, notwithstanding high international demand for traditional exports. In 2009, a nominal exchange rate devaluation, forced by external shock, compressed imports and boosted competitiveness. Since then, there has been some appreciation of the REER.

Staff assessment of the exchange rate suggests the hryvnia is now slightly overvalued. An assessment of the real effective exchange rate based on standard CGER-type methodologies suggest that the exchange rate is slightly more overvalued relative to September 2011.¹ Of the three approaches, two yield estimates of overvaluation in the range of 8 and 13 percent. The macroeconomic balance method suggests a moderate overvaluation, implying that the REER needs to depreciate by 13 percent to close the gap between the underlying current account balance (CAB) and an estimated equilibrium CAB. The external sustainability method also points to an overvaluation, implying that an REER adjustment of 8.3 percent would be needed to close the gap between the underlying CAB and the balance that would stabilize Ukraine's NFA position at around -28 percent of GDP. The equilibrium real exchange rate method estimates on the other hand indicate that the current level of the REER is undervalued by 9.2 percent relative to its medium-term equilibrium value, driven mainly by non-structural and more volatile variables such as terms of trade, relative productivity, relative government consumption, and initial net foreign assets (NFA).

Exchange Rate Assessment 1/
(Percent deviation from equilibrium REER)

	Sep-11	Apr-12
Macroeconomic balance 2/	8.5	13.0
External sustainability 3/	5.5	8.2
Equilibrium real exchange rate	-9.3	-9.2

Source: IMF Exchange Rate Assessment Toolkit.

1/ Based on September, 2011 and March, 2012 WEO.

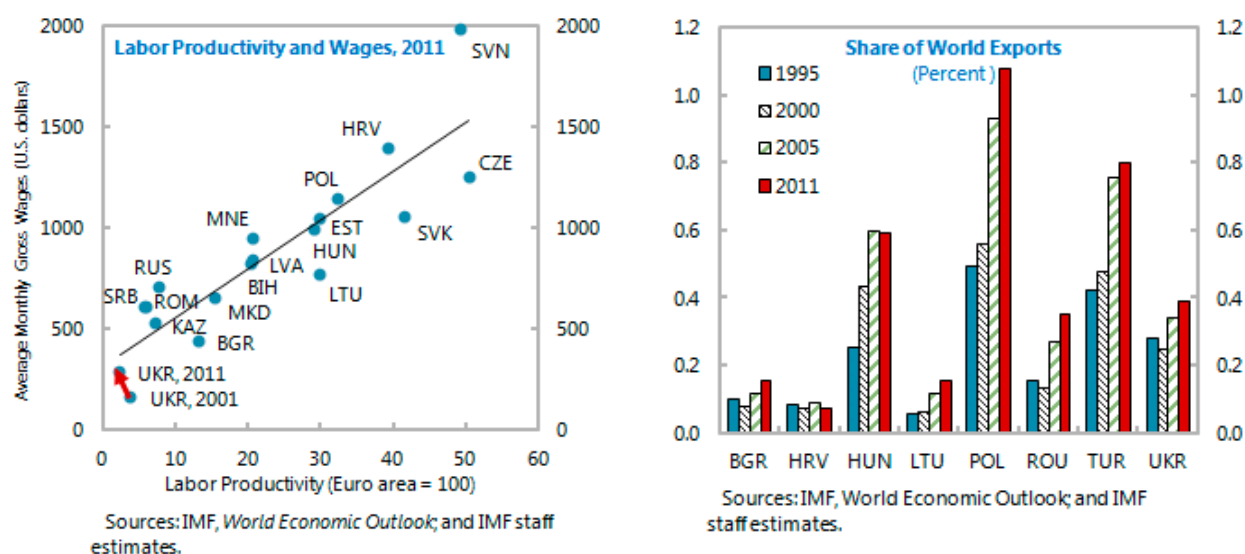
2/ REER adjustment needed to bring underlying current account to the level of the norm.

3/ REER adjustment needed to stabilize NFA position.

¹ These results are based on Vitek (2012), which uses a panel data set of annual macroeconomic variables for 184 countries over the period 1973–2010, together with medium-term projections of these variables.

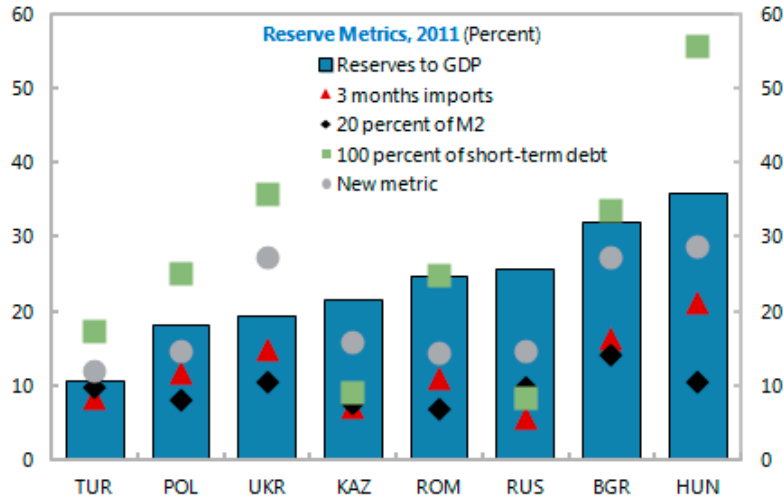
Ukraine's wage competitiveness is eroding and risks are aggravated by the unattractive

business environment. Ukraine's low nominal wages still appear to be consistent with its low total labor productivity, but competitiveness will be eroded if wage pressures are not abated. Productivity growth has been somewhat slower than in other European countries, in part due to the poor quality of capital stock and limited technological advancement. This, coupled with Ukraine's poor performance in cross-country rankings of business environment indicators, undermines overall competitiveness and attractiveness of the economy for inward foreign direct investment and further technological progress. As a result, Ukraine's penetration in global export markets has been well below that of other countries in the region.

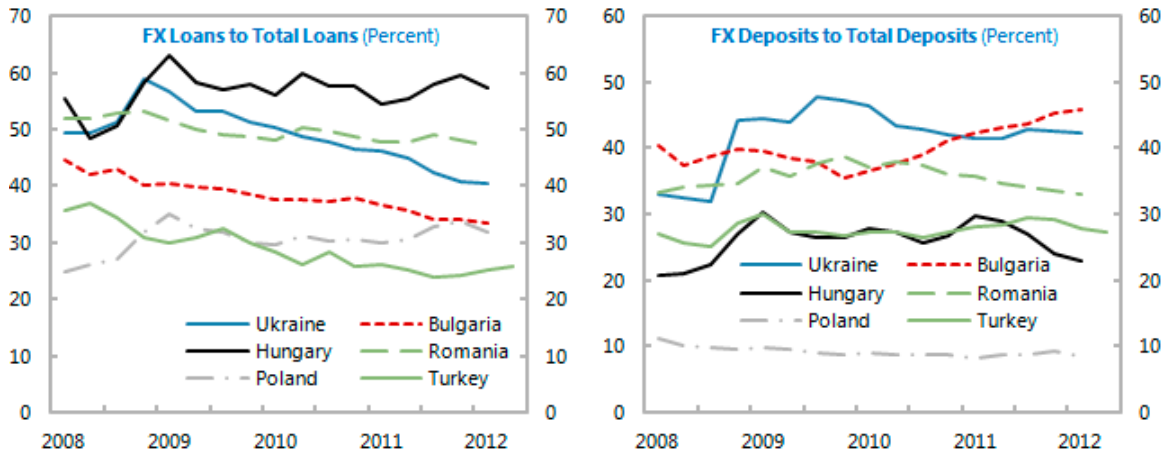


Ukraine's vulnerability remains elevated with limited policy buffers. Gross reserves fell to around \$31 billion in January 2012—from a peak of \$38 billion in May 2011—and are expected to fall to \$24 billion (40 percent of short-term debt) by end-2012, driven by Fund repurchases, low bank rollovers, additional household fx withdrawals, and constrained sovereign market access. Ukraine scores poorly in cross-country comparisons of reserve adequacy per the new metric—assessing liquid reserve needs based on a combined measure of a country's exposure to external liabilities, current account variables (export earnings) and risks of potential capital flight (broad money) based on experience of past crisis—and has particularly poor coverage of short-term debt.²

² An event study shows that, during periods of exchange market pressure, EM countries with higher reserve holdings were more able to maintain more stable consumption growth (relative to the pre-event trend) than those with lower reserve levels. They were also more able to expand fiscal policy to help offset the effects of the crisis, whereas low levels of reserves were associated with procyclical fiscal contraction. In both cases the effects were more apparent in moving from low to moderate levels of reserves than in moving from moderate to high levels.



Source: IMF staff calculations.



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

Annex II. Energy Sector: Economic Costs and Policy Reform

I. Background

Naftogaz (NG) dominates Ukraine's gas sector. This State-owned holding company is composed of several subsidiaries specializing in oil and gas exploration, production, import, storage, transit, and distribution:

- *Exploration and production.* Chronic underinvestment has hampered NG's natural gas production in recent years—currently down to 16 from 20 bcm per annum in past years. Appropriate investment levels would permit Ukraine to tap into about 1.1 trillion cubic meters of proven gas reserves, eliminating the need to import gas.
- *Importing gas from Russia.* Being one of the most energy-intensive countries in Europe, Ukraine imports about two thirds of its annually consumed gas from Russia. A contract signed in early 2010 with Gazprom links the price of gas to a nine-month backward looking moving average of oil prices, and offers a 30-percent discount over the price implied by the contract's formula.
- *Transiting gas to Europe.* NG manages the system of pipelines and storage that transits about 100–110 bcm of Russian gas to western and central Europe—making Ukraine the most important transit country for Russian gas. As compensation, NG receives a transit fee based on volume of gas transported, gas import prices, and distance.
- *Domestic gas distribution.* NG supplies gas to: (i) industries—one third of the domestic market; (ii) households—another third of the market; (iii) budgetary institutions; and (iv) utility companies—including district heating companies which use gas as one of their main inputs in producing heat for households. Some gas is also consumed in the production process and some is lost (technical losses).

Gas prices paid by households and district heating companies are far below rising import prices, weighing on NG's finances. Years of gas import subsidies from Russia were terminated in 2006 when Ukraine's import prices were raised close to European levels. Domestic prices for industrial users have been adjusted to import parity while those for households and utilities remain regulated. Despite several rounds of increases, prices for households and heating companies remain among the lowest in Europe and create losses for NG, together on average about one quarter of import prices.

End-user household heating tariffs also fall short of production costs. District heating companies receive subsidies from the government in addition to already paying below import prices for gas from NG.

II. Economic Costs

NG carries out large quasi-fiscal activities. Defined as operations carried out by NG that have a direct impact on the company's financial position and would not prevail without government intervention, these activities result from:

- *Below cost-recovery of domestic gas and heating prices.*¹ Implicit subsidies are provided to: (i) households and district heating companies by selling natural gas to them at prices below import prices; and (ii) households by setting heating tariffs below the cost of producing heat.
- *Under-priced domestically produced gas.* NG subsidiaries and some private gas production companies sell domestically produced gas at about one-seventh of import prices (or potential re-export prices), representing significant foregone revenues.
- *Poor payment enforcement.* Gas payment compliance is less than 90 percent.
- *Output losses.* Underinvestment and weak oversight produce significant output losses.

Naftogaz: Balances and Quasi-Fiscal Activities
(Billions of Ukrainian hryvnia, unless otherwise indicated)

	2009	2010	2011
Revenue	78.4	121.8	114.4
Gas sales	60.7	73.6	86.9
Gas transit fees	13.1	29.0	25.5
Other	4.6	19.1	2.1
Expenditure	101.1	140.0	134.8
Gas imports	41.8	98.0	73.8
Domestic gas	4.3	4.8	6.1
Other	55.0	37.2	54.9
Cash balance	-22.6	-18.2	-20.4
Underlying balance 1/ Percent of GDP	-20.0 -2.2	-22.0 -2.0	-21.4 -1.6
Quasi-fiscal activities 2/ Total (percent of GDP)	4.7	5.2	5.0
Per unit of gas sold (UAH/tcm)	1035	1201	1480

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

1/ Excludes operations related to the RosUkrEnergocase (MEFP in EBS/10/232); excludes direct cash transfers from the government; assumes import levels consistent with no change in stocks.

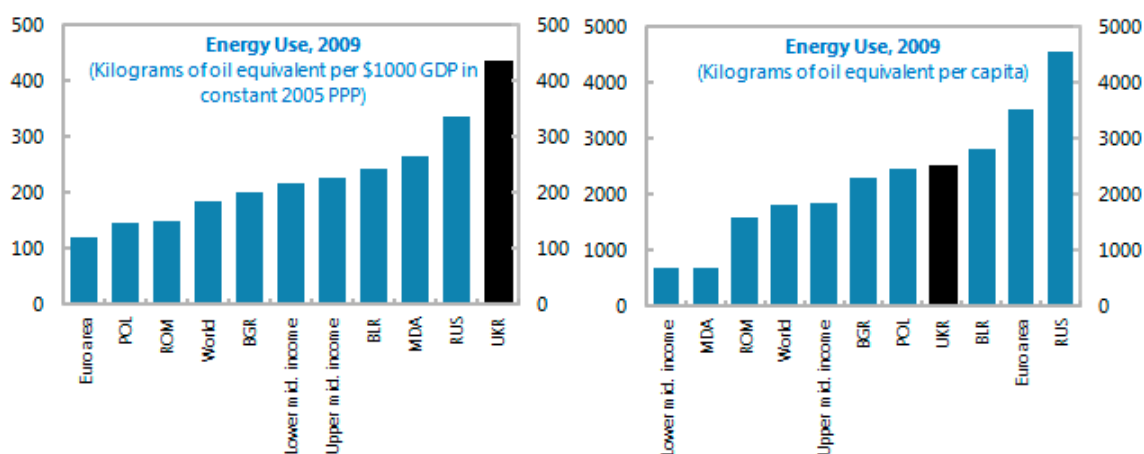
2/ Difference between theoretical sales at market prices (import prices plus margin to cover the gas used in the production process and technical losses) with 100-percent compliance and actual sales.

In 2011, NG's economic cost was almost 5 percent of GDP. In recent years, gas transit revenues have not fully offset these costs from quasi-fiscal activities. As a result, NG suffered deficits of 1.7 and 1.5 percent of GDP in 2010 and 2011, undermining its financial viability.

The below cost pricing policy has had several adverse implications:

¹ For the purpose of this analysis, quasi-fiscal activities are calculated as the difference between theoretical sales at market prices (import price plus margin to cover gas used in the production process and technical losses) with 100-percent compliance and actual sales.

- *Reliance on government support.* An unsustainable pricing structure coupled with poor global market conditions has left NG without market access. Instead NG relies on government support, including direct cash transfers, recapitalization bonds, tax offsets, and a government guarantee that enabled restructuring of NG's external liabilities in 2009.²
- *Underinvestment.* Running large deficits, NG has had to cut back on investments, which are critically important given the capital intensive nature of NG's activities in exploration, production, transport and distribution of gas.
- *High energy consumption.*



Source: World Bank, *World Development Indicators*.

- *Arbitrage across industries (paying import prices) and households (paying below-import prices).*

III. Policy Reforms

Reducing economic costs will require large domestic gas and heating tariff adjustments. At the outset of a Fund-supported program, prices received by NG from households and utilities were increased by 50 percent in July 2010, with pass-through to end-user heating prices in January 2011. However, NG's finances have since deteriorated substantially reflecting rising gas import prices and postponement of further domestic gas price hikes. The President's Economic Reform Committee reform program recognizes the challenges posed by the current gas and heating pricing policies. However, the authorities advocate a very gradual pace of adjustment.

² A combined deficit target for the general government and Naftogaz was introduced under the program supported by an SBA to capture all the financial support provided by the government.

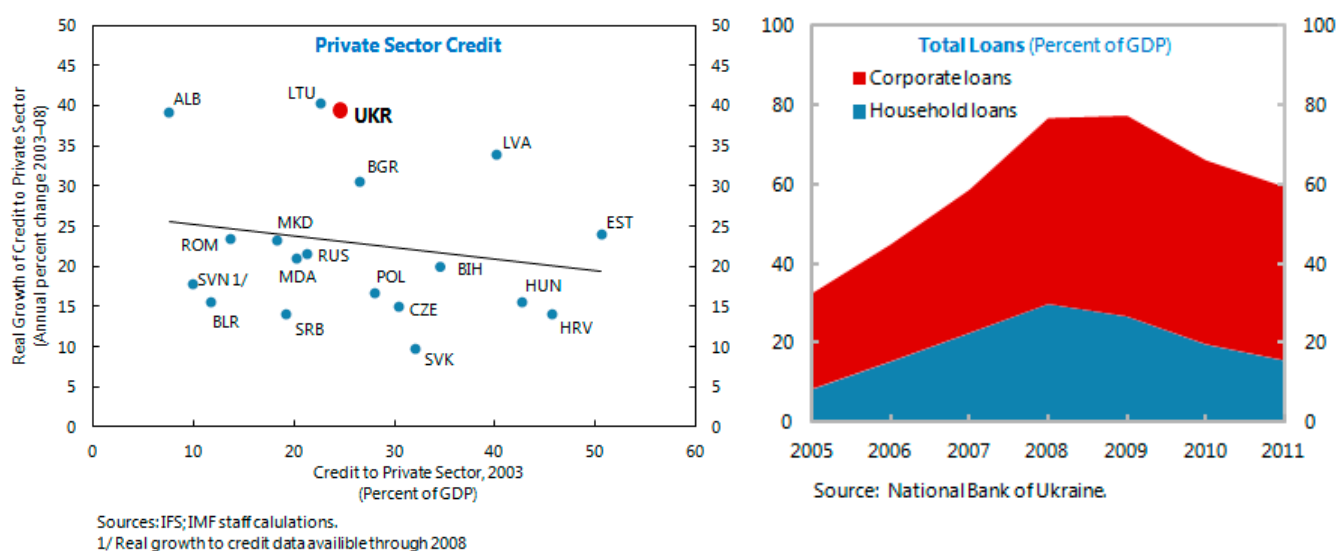
A new centralized and independent regulator is gradually assuming the responsibility of overseeing the tariff-setting mechanism. During the transition, the National Energy Regulatory Commission is setting the gas tariffs and the National Commission for Utility Regulation is setting the household heating tariffs.

Broader reforms to modernize the gas sector are also advancing. These are important for enhancing energy efficiency and ensuring efficient and reliable gas delivery to Ukraine and Europe. The protocol for Ukraine's accession to the Energy Community Treaty (ECT) was signed in the fall of 2011, following the adoption of the gas sector law during the summer (which included provisions for restructuring NG). In 2012 a law permitting the unbundling of Naftogaz entities was another key step in fulfilling ECT requirements, although privatization is still prohibited. Further efforts are being made to speed up progress on pilot projects for modernization of the gas transit and distribution system with the assistance of the EBRD and EIB, and also to join the EITI.

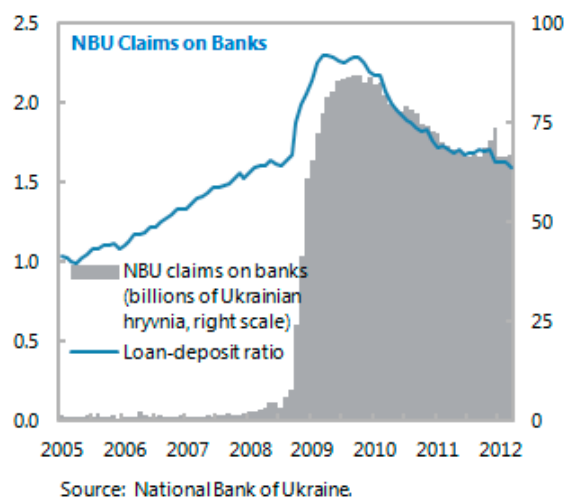
Annex III. Financial Sector Developments and Challenges

This annex looks at the emergence of Ukraine's banking crisis and the policy response and highlights some key near-term challenges facing the sector and policymakers, including: deleveraging, high nonperforming loans, currency mismatches, and withdrawal of longer term liquidity support granted during the crisis. It concludes with an assessment of banks' relative financial soundness.

In the years leading up to the 2008/9 financial crisis, bank lending in Ukraine grew at a very rapid pace. Credit growth peaked in 2005–07 at an average of 70 percent per annum and the loan-to-GDP ratio surged to nearly 80 percent of GDP by end-2008.



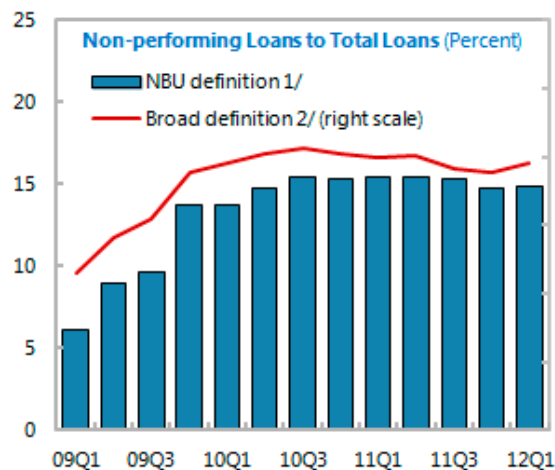
The credit boom exacerbated vulnerabilities, many of which were discussed in the context of the 2008 FSAP (Box A1). Household and corporate sector debt grew rapidly, but banks' risk management and lending standards, and supervisory oversight did not keep pace. Credit risks rose from real estate prices that surged well past levels in countries with comparable income levels and from currency mismatches on borrowers' balance sheets from pervasive foreign-currency lending. Banks' liquidity risk deepened as loan-to-deposit ratios approached 230 percent.



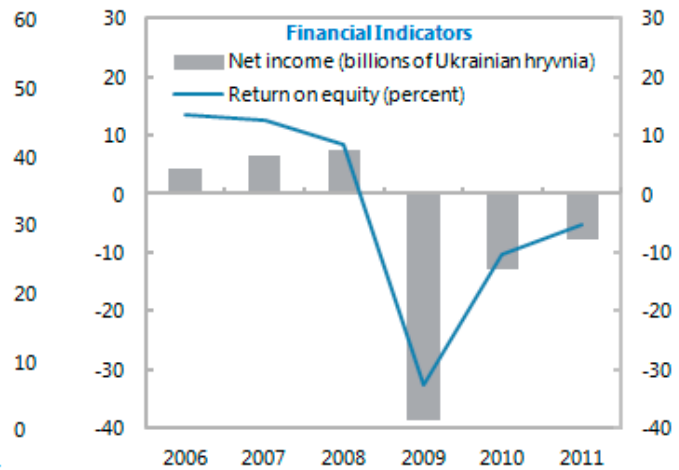
Box A1: Key recommendations of the 2008 FSAP

The 2008 FSAP focused on financial system stability, contingency planning, and capital market development. The authorities were encouraged to address risks related to balance sheet currency mismatches and growing credit risk, closely monitor liquidity risk management, deepen consolidated supervision and cooperation, and increase disclosure standards and transparency practices. This was to be undertaken in the context of a transition to a more flexible exchange rate regime and supportive monetary policy framework. The authorities were also encouraged to enhance contingency planning, strengthen the bank resolution framework, and facilitate mergers and acquisitions. Other recommendations were made regarding capital market development and the securities market.

In late 2008, Ukraine was hit by a banking crisis. Weakened confidence in Ukraine's policies and concerns about banks' ability to roll over existing credit lines set off a deposit run that quickly developed into a full-blown banking crisis. As depositors fled (resulting in a 20 percent drop in the depositor base) they also abandoned the hryvnia, triggering a currency crisis. Bank lending froze (-2 percent nominal credit growth in 2009), NPLs rose rapidly, and bank profitability plummeted as banks increased their capital buffers and provisioned against loan losses.



Source: National Bank of Ukraine.
 1/ Includes loans classified as doubtful and loss.
 2/ Includes loans classified as doubtful, loss, and all substandard.



Source: National Bank of Ukraine.

The initial focus was on containing the crisis. The Fund (backed by a CIDA technical assistance grant) worked closely with the authorities and the World Bank, initially to stabilize the system through anti-crisis measures, and then on rehabilitation and strengthening banks and the institutional framework, and reducing vulnerabilities (Box A2). Two rounds of recapitalization have raised capital adequacy ratios to their current level of about 18 percent—well above the statutory minimum of 10 percent (Table 7)—thus providing some buffer against any further losses.

Box A2: 2008/9 Crisis Response

Emergency liquidity support (“stabilization loans”) was granted by the NBU to banks, peaking at about UAH 85 billion (about 8 percent of GDP).

Deposit guarantees were expanded to cover nearly all household deposits. The Deposit Insurance Fund provided about UAH 4 billion (0.3 percent of GDP) in reimbursements. Limits were imposed on early withdrawal of time deposits.

Crisis management and bank resolution procedures were strengthened. A Crisis Management Unit was created within the NBU to deal with bank resolution issues. A Recapitalization Board composed of senior government officials was established to decide on government participation in the capitalization of individual systemic banks.

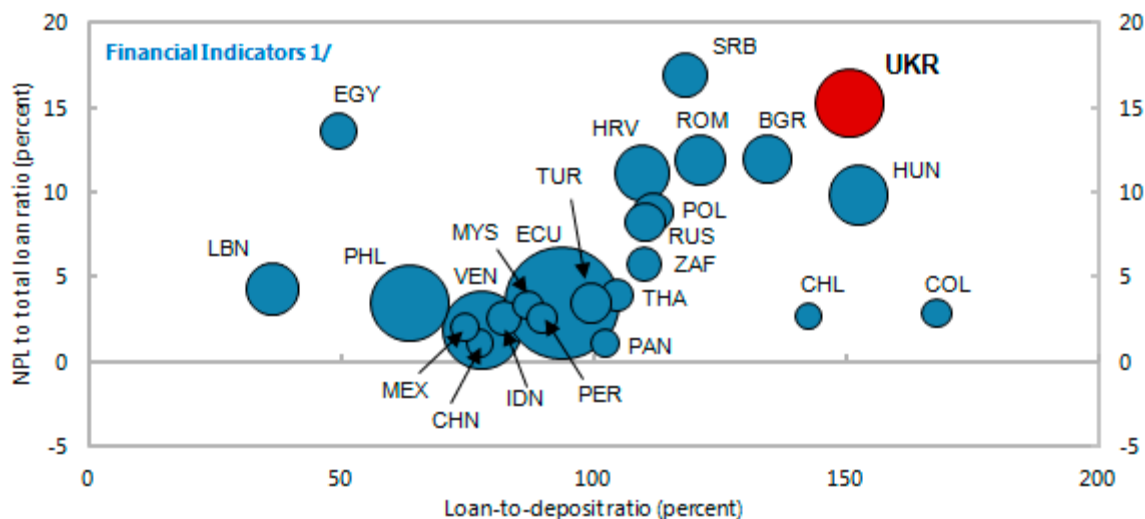
Removal of weak banks. The legal framework to resolve banks was amended to facilitate more prompt and cost-effective bank resolution. Several systemic and many smaller banks were intervened. Of the 184 banks operating before the crisis, 28 banks had temporary administrators appointed and 20 went into liquidation.

Recapitalization. Diagnostic tests in 2009 and 2010 identified 61 private banks with capital shortfalls totaling about UAH 30 billion (2.8 percent of GDP). This was covered by raising additional capital and reducing credit exposures. The government provided about UAH 40 billion (4.0 percent of GDP) in additional recapitalization funds.

Regulatory measures. (1) In early 2009, the NBU revised (via “Resolution 109”) banks’ fx net open position calculation by removing loan loss provisions against fx loans from the statutory calculation. This forced banks to sell fx to comply with the new resolution, which in turn eased pressure on the exchange rate, but also pushed most banks short in economic terms (the banking system is currently about US\$8 billion short). (2) A ban on fx lending to unhedged borrowers was put in place.

The focus has gradually shifted towards strengthening the legal and regulatory framework, and the contingency framework. Several important laws have been passed to strengthen supervision (consolidated supervision law), transparency (ultimate controllers law), and the resolution framework—implementing regulations for all three will be finalized during 2012. Under the revised resolution framework, responsibility for administering intervened banks has been shifted to the Deposit Guarantee Fund, which will allow the NBU to focus more squarely on its core mandate. The NBU is reviewing their emergency liquidity assistance and refinancing operation frameworks to allow longer maturities in some circumstances (while retaining strong collateral, solvency, and monitoring conditions, as needed). Given their experience in during the 2008/9 banking crisis, Ukraine could quickly re-activate other crisis response functions, if needed.

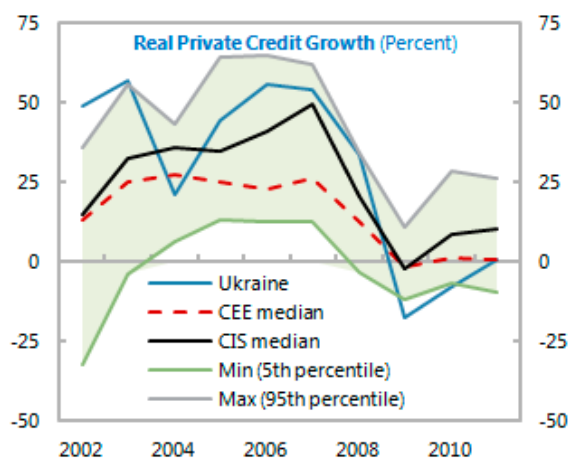
Despite progress made, Ukraine’s financial soundness indicators, and credit growth, remain comparatively weak. Ukraine is one of the more vulnerable countries with respect to NPL and loan-to-deposit positions (and spreads), and real credit growth has been negative.



Sources: Bloomberg; IMF, *Global Financial Stability Report*; and IMF staff estimates.
 1/ Size of bubble refers to 5-year sovereign CDS spread.

Key challenges. There are a range of challenges inhibiting banks from reviving lending and providing a more supportive role for growth, including: risks of macroeconomic instability, a weak legal framework, lack of stable long-term funding, and still-weakened bank balance sheets. The focus here is on four specific near-term challenges: deleveraging, high NPLs, currency mismatches, and unwinding long-term liquidity support (stabilization loans).¹

Deleveraging. The foreign banking presence in Ukraine is smaller than in many peer countries (about 40 percent of Ukraine’s banking system is foreign owned; about 22 percent by euro area banks). Nonetheless, the drop in external funding has been significant, and has dampened banks’ capacity to lend (despite some increase in deposits). External debt of banks fell 35 percent between end-2008 to end-2011 to US\$25 billion) and BIS figures indicate significant reductions in foreign claims on Ukraine. Bank balance sheets continue to grow (with loans to corporates increasing), but at a slower



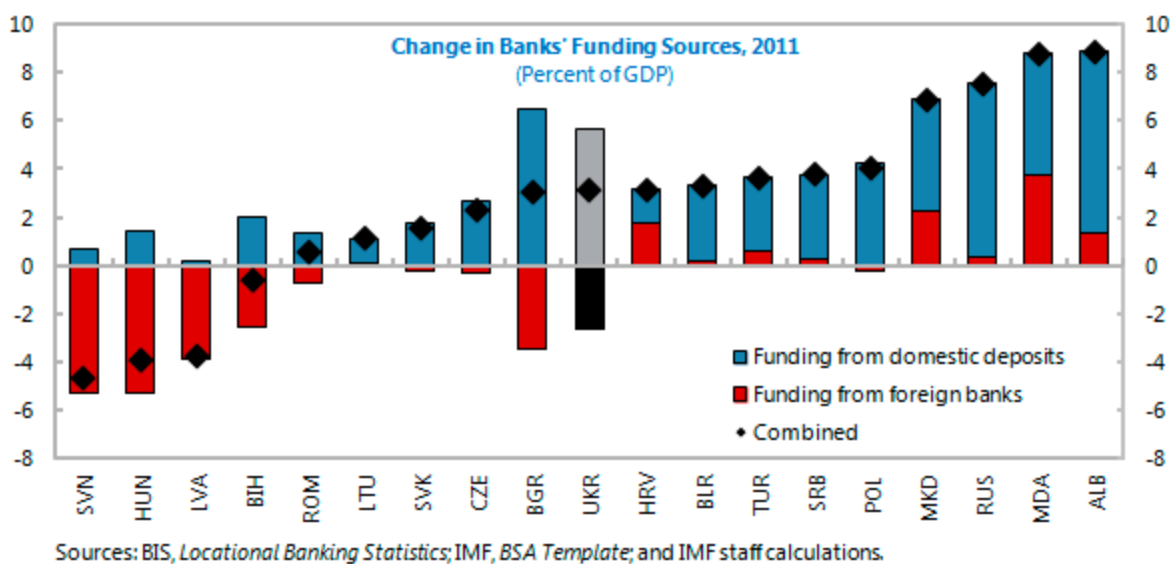
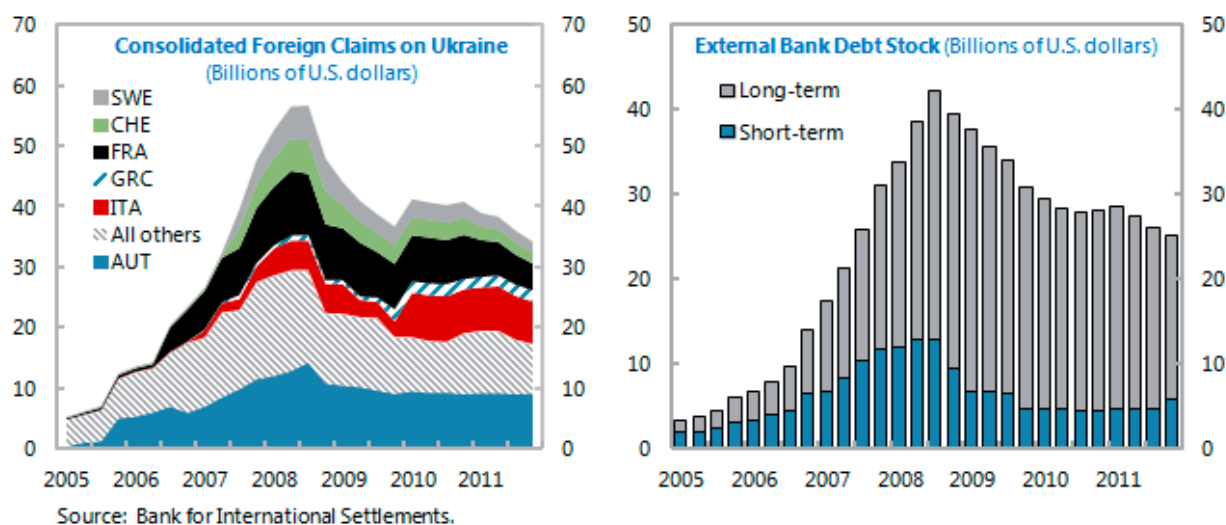
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

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

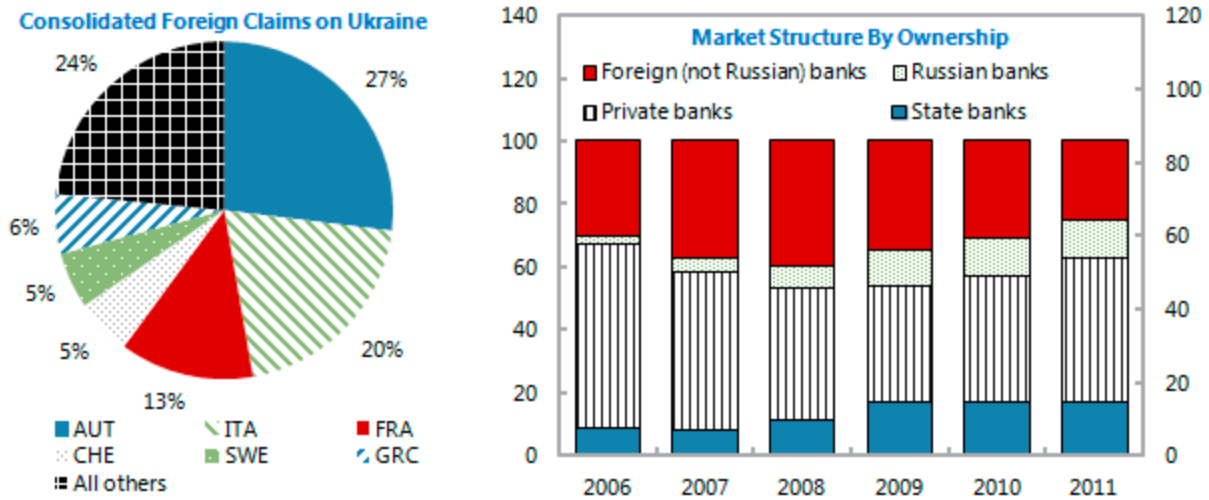
¹ There are a range of other important reform issues not discussed here, including a need to facilitate mergers and acquisitions and strengthening the derivatives framework.

pace than nominal GDP (banks are relying relatively more on local deposits to reduce still-high loan-to-deposit ratios). Overall nominal credit growth is in single digits (fx-denominated loans continue to fall, driven by the ban on fx loans to unhedged borrowers, which has contributed to an overall drop in retail loans). Deleveraging is expected to continue to weigh on bank balance sheets, with foreign financing to Ukraine’s banking system is expected to continue to fall. The NBU has expressed interest in participating in Vienna 2.0, which could provide a platform for mitigating deleveraging pressures, and better cross-border coordination.

Ukrainian Banking System: BIS Exposure and External Debt Stock

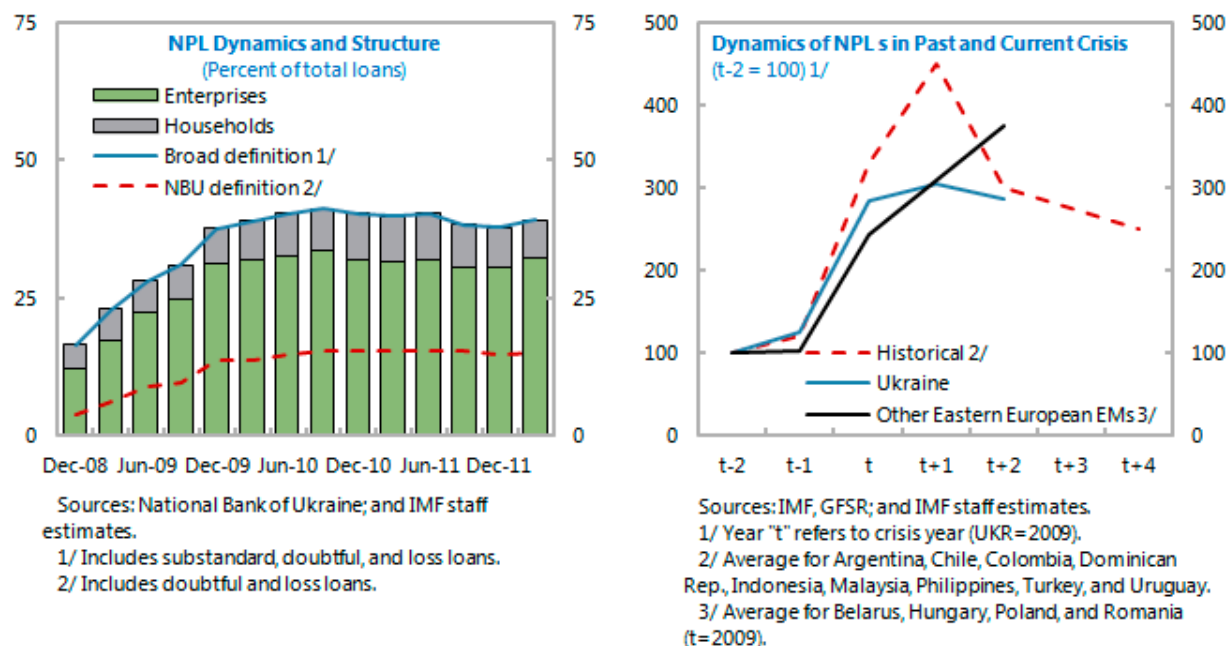


BIS Exposure to Ukraine By Country: Bank Ownership (Percent of Total)



Source: Bank for International Settlements.

Reducing NPLs. The crisis pushed NPLs and loan loss provisions (LLPs) into a steep upward trend. By end-April 2012, NPLs (doubtful and loss items) appeared to have stabilized at around 15 percent of total loans (or around 40 percent if including “substandard” loans). A comparison against past crisis cases suggests Ukraine is lagging in terms of bringing down NPL levels at this stage of the post-crisis cycle (though contemporaneously better than some peers). NPLs are concentrated among enterprises, though household mortgages have also contributed. These high levels of NPLs are weighing heavily on bank balance sheets and profitability, and the lack of incentives to write-off loans could be dampening full realization of the extent of bad loans (some analysts have noted that current levels of LLPs may be insufficient). The NBU and the Government have taken some measures to help cleanse NPLs from the banks’ balance sheets by providing tax relief for loss provisions and write-offs, the latter of which totaled to UAH 33 billion (about 4 percent of loans) during the past 16 months. A new regulation bringing asset classification and loan loss provisioning rules closer to international best practices was approved, but further tax, legal, and regulatory measures are needed. Where banks report high ratios of restructured loans (or other risk factors), independent assessments may be useful. Other steps should include further strengthening of creditors’ rights, and tax measures to facilitate write-offs (e.g., clarify tax consequences of writing off fully provisioned loans, establishing fair value of NPL sales for tax purposes, tax treatment of accrued but unpaid (suspended) interest on overdue loans, and VAT on resale of repossessed collateral).



Reducing currency mismatches. In early 2009, the NBU redefined (via 'Resolution 109') the coverage of banks' net open fx positions by instructing banks to exclude fx LLPs against fx loans from the calculation. This created a sudden increase of long (or a decrease of short) fx positions that compelled the banks to sell fx in the market against UAH. The overall short position of the banking system (from an economic perspective) is currently estimated at about US\$8 billion, or about 6 percent of system assets. This leaves banks exposed to movements in the exchange rate, with implications for capital adequacy through devaluation losses and possible increases in NPLs and provisioning (banks remain exposed to exchange rate movements from fx lending to unhedged borrowers). The NBU is moving forward with a pilot program for unwinding this policy that has included the parallel sale of government fx-indexed bonds. The impact on the exchange rate or fx reserves (and bank liquidity) from unwinding this resolution is an important consideration, though the magnitude is contingent on the mix of adjustment chosen by banks. Overall, stress tests suggest that existing banking system capital buffers could absorb a modest exchange rate depreciation, though some individual banks could require additional capital.

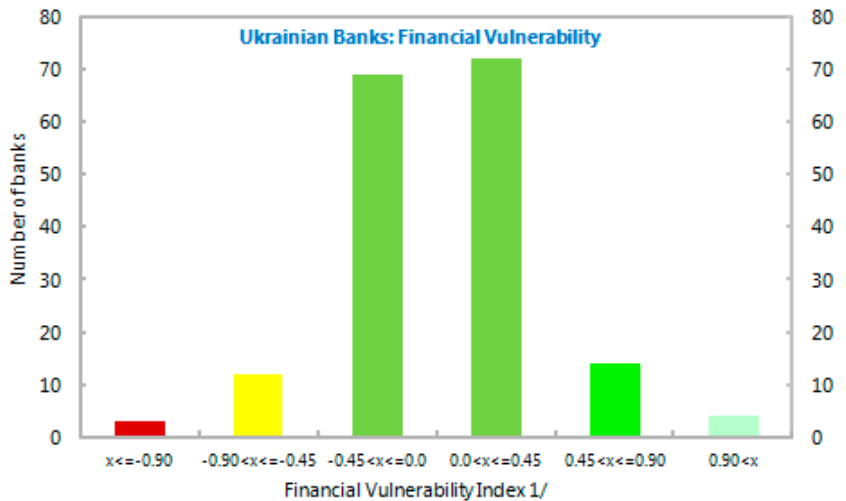
Unwinding Longer Term Liquidity Support (Stabilization Loans). The stock of stabilization loans has fallen from a peak of about UAH85 billion shortly after the onset of the crisis, to around UAH60 billion. These loans are scheduled to be paid down in roughly equally distributed amounts over the next four years, though some of these loans may be only partially recoverable (e.g., those to state-intervened banks). These repayments, combined with liquidity needs from unwinding Resolution 109 (and deleveraging), present liquidity management challenges for banks and the NBU. It is likely that

the NBU will need to provide liquidity support, to banks determined to be solvent, in the context of unwinding these crisis era policies and as term external funding is withdrawn. In this context, the authorities are reviewing their refinancing window, with an eye towards extending maturities out towards 365 days, and are considering some smoothing payments of stabilization loans under strengthened collateral conditions.

Assessment of Ukrainian Banks’ Financial Soundness. To assess the health of the banking system, staff compiled a financial soundness indicators (FSI) index using bank-by-bank data. The results suggest that while the large majority of banks currently have adequate indicators, there is a need for close monitoring and assessment of some banks. Such indicators (with established thresholds that could trigger supervisory actions) provide useful ‘early warning indicators’ for bank monitoring purposes.

Technical note on FSI Index. Six vulnerability indicators were normalized and then compiled into an

index, drawing from NBU data for 2011. In addition to standard CAMEL indicators, we add an additional indicator for stabilization loans. Liquidity support (LS) = Refinancing loan as percent of deposits. Capital adequacy ratio (CAR) = Capital/risk weighted assets. NPLs net of provisions/total loans (NPL) = (Broad NPLs-provisions)/(total loans). Liquidity (LIQ) = (Liquid assets)/deposits. Return on assets (ROA) = Net profit (loss)/(total assets). Fx Risk (FX) = Net fx exposure/capital where net fx exposure = gross fx assets – gross fx liabilities. The index was constructed using differential weights, based on literature and judgment and statistical normalization. The FSI Index = 0.15*LS + 0.20*CAR + 0.20*NPL + 0.10*LIQ + 0.28*ROA + 0.07*FX. Before aggregation into the index, the individual FSIs are normalized (*statistical normalization* was used, consisting of expressing all values in standard deviation, where FSIs’ averages are equal to

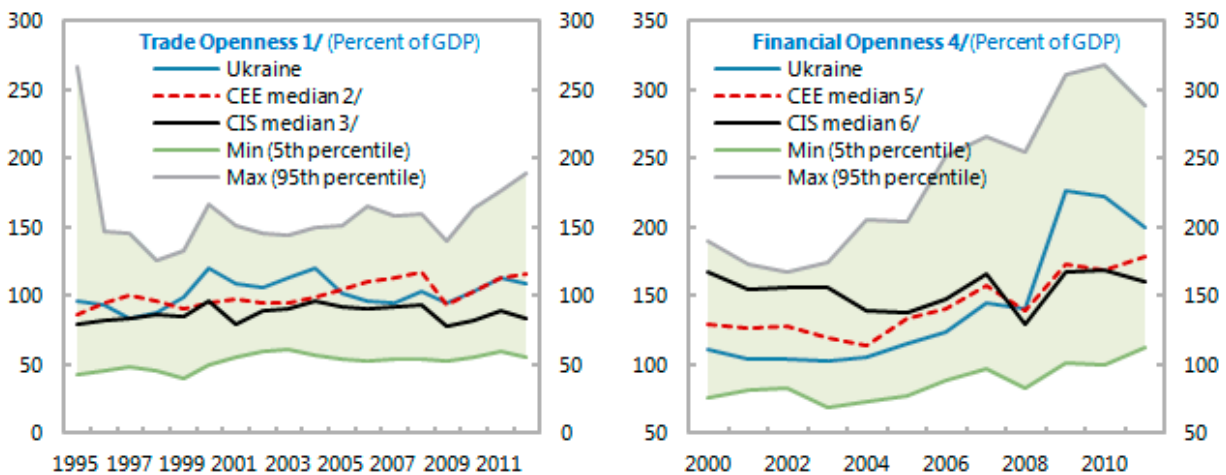


Source: IMF staff calculations.
 1/Financial vulnerability index is weighted average of six financial vulnerability indicators: Risk (net fx position to capital), weight of 0.07; CAR, 0.20; Asset quality (NPL ratio-Broad definition, net of provisions), 0.20; Profitability (ROA), 0.28; Liquidity Ratio (liquidity/deposits), 0.10; Liquidity problems (NBU Refinancing/deposits), 0.15. Indicators are normalized using statistical method.

zero), to avoid one indicator from skewing the aggregated index, or having overly important impact on variation, as they do not have the same unit or variation). The use of equal weights and different normalization techniques did not alter the results significantly.

Annex IV. Spillovers and Risks

In the event of a major external shock, Ukraine—a relatively open country—would be hit through trade and financial spillover channels. Analysis of a potential intensification of the crisis in the euro area (EA) suggests that Ukraine could be significantly affected. Russia would play a significant role in transmitting such a shock to Ukraine given close linkages—and could act as an accelerator or brake (e.g., if higher oil prices are sustained). In response to a major shock, some conventional policy responses may have limited effectiveness, and additional measures (e.g., capital controls and bank holidays) may need to be considered to achieve initial stability.



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

1/ Exports plus imports. The 5th and 95th percentiles include the entire CEE and CIS samples excluding Ukraine.

2/ CEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Rep, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovak Rep., and Turkey.

3/ CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Rep, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, and Uzbekistan.

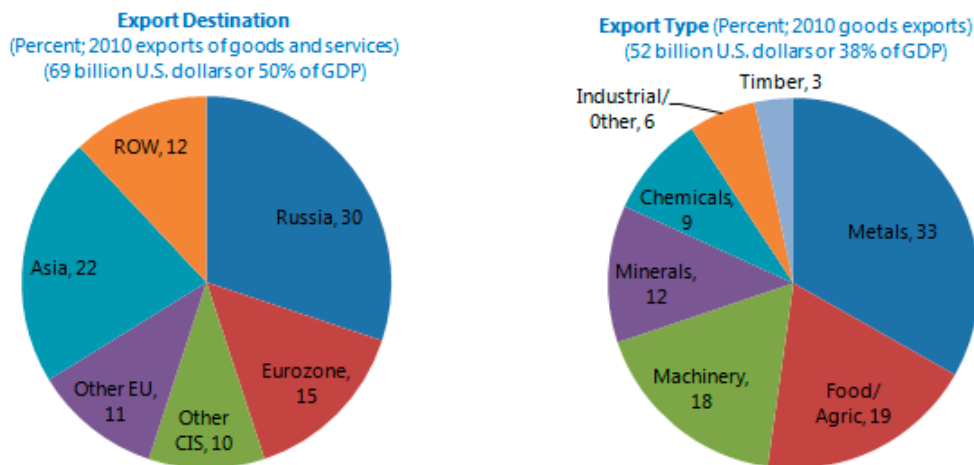
4/ IIP assets plus liabilities. The 5th and 95th percentiles include the entire CEE and CIS samples excluding Ukraine.

5/ CEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Rep, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, and Turkey. Excludes Albania, Bosnia and Herzegovina, and Macedonia in 2011.

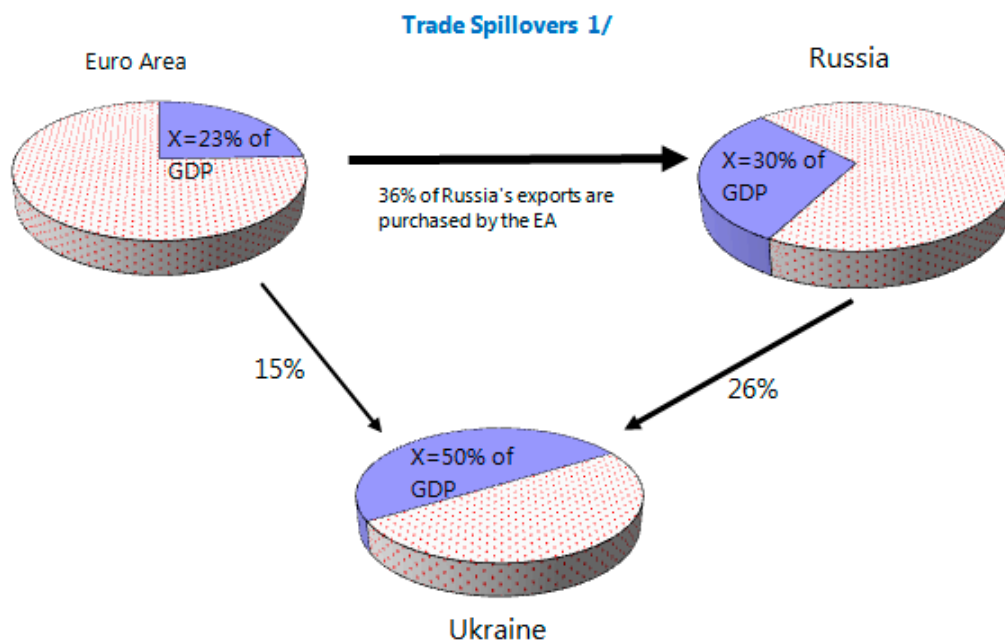
6/ CIS includes Georgia, Kazakhstan, Moldova, and Russia. Excludes Russia in 2011.

Trade channel. This is an important channel. Ukraine exports about 50 percent of GDP (\$75bn), putting it at the median of Central and Eastern European (CEE) countries. The EU and Russia dominate bilateral trade links. Ukraine's high concentration of commodity exports—chemicals, agriculture, metals, minerals, and timber account for about (60%) of all goods exports—makes it vulnerable to global (including non-trading partner) growth swings, through effects on commodity prices. The importance of this channel was evident during the 2008/9 crisis, when deterioration in terms of trade and drops in trading partners' (and global commodity) demand resulted in a significant reduction in export volumes and values. However, imports fell at a faster pace (dragged down deeper by steep drops in domestic demand), resulting in a positive net export contribution to GDP (this stood in contrast to the EA, where the drop in exports exceeded imports).

Financial Spillover Channels. Ukraine’s financial openness is above peer average, with the EU and Russia as important sources of financing. Much of this exposure is in the corporate and household sectors. Banking exposure is lower than in many peer countries, but still significant. Other linkages, such as remittances, are relatively small.



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



Source: IMF staff calculations.

1/ Arrows represent direction of goods export receipts; arrow thickness and associated values indicate shares of countries' export receipts from a given destination in their total export receipts.

Banking channel. Ukraine’s banking sector exposure to the EA is low by regional standards (table), but still large enough to pose risks. 25 percent of assets are controlled by EA banks, which is significant as a percent of Ukraine’s GDP and gross reserves. Russian banks own another 11 percent of system assets (EA periphery banks have a minor presence in Ukraine). Ukraine has already

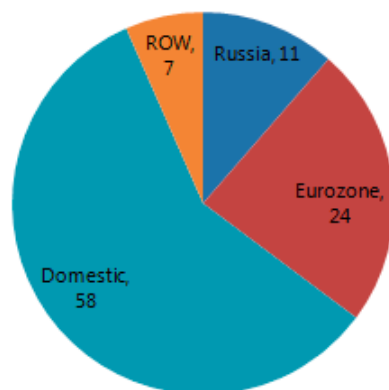
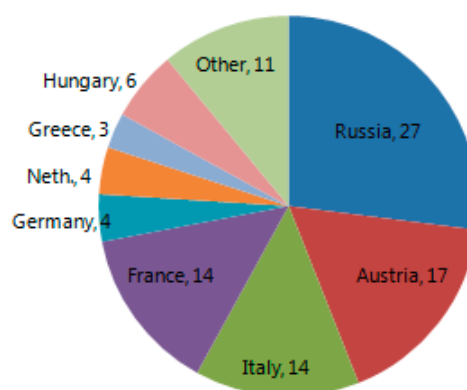
witnessed significant deleveraging since 2008, with external bank debt dropping about 35 percent between end-2008 and end-2011, down to about 15 percent of GDP. BIS data paint a similar story. This exposure could be reduced further for reasons such as heightened risk aversion or a need for dollars (most lending by European banks to Ukrainian banks is in dollars). Loan-to-deposit ratios also remain high among EA subsidiaries in Ukraine, providing an additional incentive to deleverage. During the 2008–09 crisis, foreign ownership of local banking systems was a source of strength in many CEE countries. In Ukraine, many parent banks agreed to recapitalize their subsidiaries in the context of two rounds of diagnostic tests (total bank-related FDI in 2009–10 was in the range of US\$4.5 billion. But many European banks with exposure to Ukraine are now in a weaker financial position than in 2008–09.

Euro Zone Bank Presence in Selected CEE Countries and Ukraine

(Percent ownership of domestic banking system)

Parent Bank Residence	Bulgaria	Hungary	Poland	Romania	Serbia	Ukraine
Austria	9	21	5	38	18	7
France	5	4	5	14	6	6
Germany	15	12	10	8	3	2
Greece	28	0	2	18	15	1
Italy	15	14	13	8	21	6
Spain	0	0	1	0	0	0
Other foreign	7	37	33	0	9	20
Domestic	21	12	31	14	28	58
Total	100	100	100	100	100	100

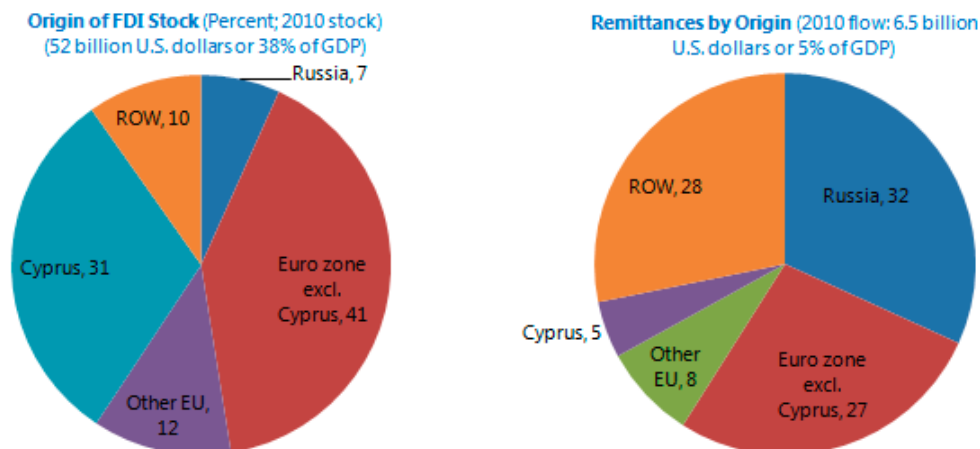
Sources: Citigroup EM Outlook (July 21, 2011); DB EM Monthly (July 2011), and NBU (end-2010 for Ukraine).

Bank Ownership (Percent of end-2010 assets)
(Banking system assets = 86% of GDP)**Foreign Bank Presence** (Percent of total foreign presence)

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

Foreign Direct Investment. EA countries are an important source of FDI (Chart). Ukraine has received around 4 percent of GDP in FDI annually in recent years (US\$6 billion in 2010), and has a stock of FDI of about US\$52 billion. About 70 percent of inward FDI is sourced from the EA. However, a significant portion of this (31 percent of overall) is from Cyprus, much of which is reportedly round-trip investments from Ukraine, or possibly Russia. Should external conditions

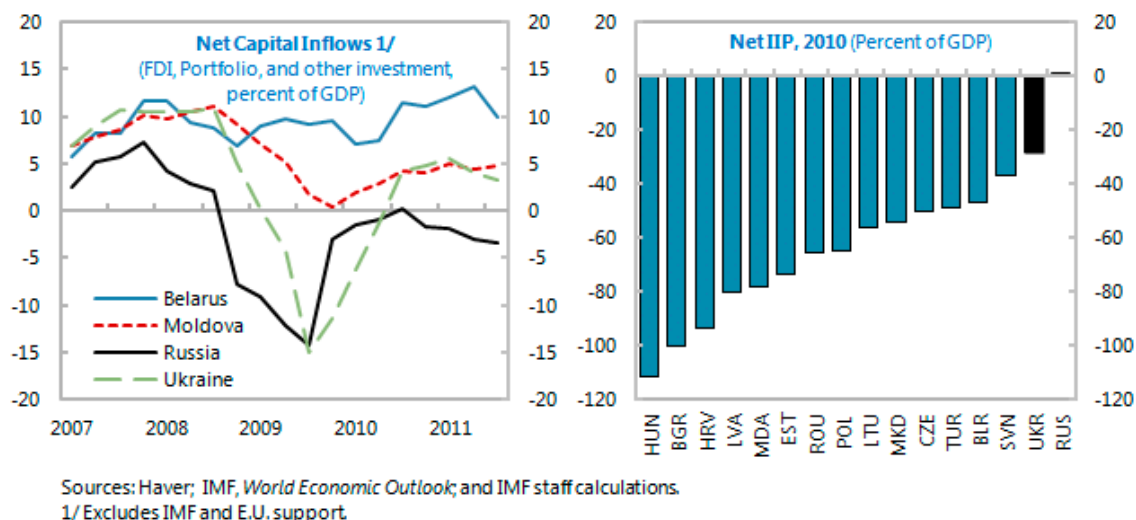
worsen, Ukraine could see reduced amounts of FDI (and may be more vulnerable to reductions in FDI than its peers, given its weaker investment climate).



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

Remittances. The euro area and Russia are important sources of remittances, but overall amounts are small, and have been relatively stable. Ukraine receives about USD6 billion annually in remittances: 41 percent from the EU (32 percent from the EA), 27 percent from Russia, and 12 percent from the U.S. Annual flows have been fairly steady (between US\$4 and 7 billion).

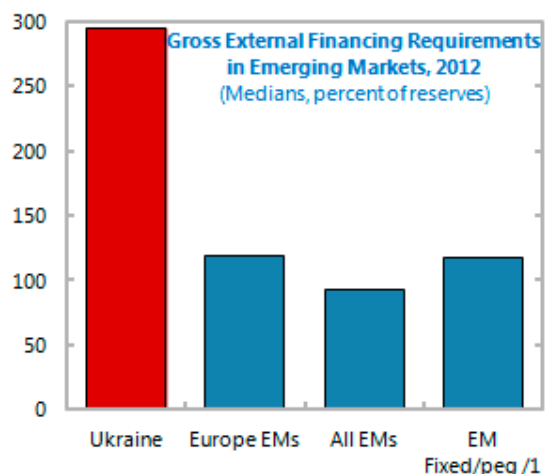
Other Capital flows. Shocks emanating from the EA could dampen external and domestic confidence and lead to capital outflows or lower rollovers for corporates and sovereigns, and trade finance could decline. Households' confidence in the banking sector is skittish based on experience in past crises, and tensions (inflation, market turbulence, threat of depreciation, political and economic shocks in neighboring countries) can quickly lead to fx savings withdrawals by households, as seen in 2008–09, and again in the second half of 2011. However, in contrast to many other EM countries, foreigners have little domestic presence in Ukraine's local t-bills. Foreign investors own less than 5 percent of local government paper in Ukraine (less than US\$0.6 billion).



Asset valuations. Ukraine could also take losses on the value of EA-originated assets, though Ukrainian banks' foreign assets are mostly in the form of currency and deposits. About 45 percent of bank foreign assets (\$3.5 billion, or 3 percent of total assets of the Ukrainian banking sector) are held in the EA, which is roughly equally split between dollars and euros. Ukrainian direct portfolio investment (both equity and debt securities) in the EA is negligible.¹

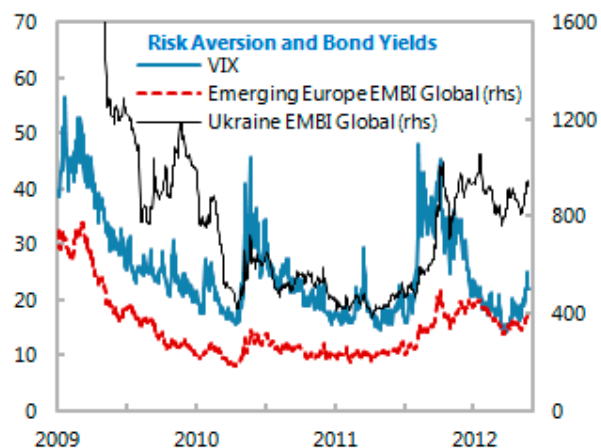
Financing risks. Ukraine's high overall gross external financing requirements, combined with high investor risk perceptions towards Ukraine, leave it vulnerable to shifts in market confidence and risk aversion. Cross-country data on GEFR-to-reserves indicate that Ukraine is well-above EM medians (chart). Any reduction of external financing would put significant pressure on reserves and the exchange rate that could have severe repercussions. Ukraine's sensitivity to global risk perceptions can be seen in the high correlation of Ukraine's EMBI spreads relative to the VIX, a widely used measure of market risk (correlation between Ukraine's EMBI spreads and the VIX is about 0.75).

¹ Sources: National Bank of Ukraine, and IMF Coordinated Portfolio Investment Survey <http://cpis.imf.org>.



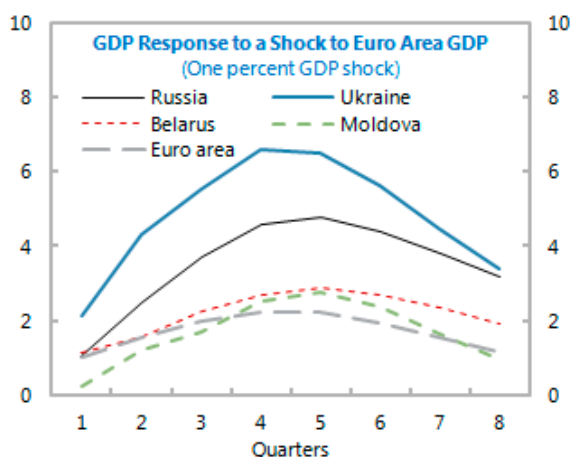
Sources: IMF staff estimates.

1/ Countries classified as other than floating exchange rate according to 2010 IMF Annual Report on Exchange Arrangements.



Source: Bloomberg.

Implications for growth (VAR analysis). A VAR analysis helps to quantify the possible impact of a EA shock. We find strong co-movement between real GDPs of the EA and Ukraine (and Russia and Ukraine) in response to a shock to EA real GDP. A one-percent shock to EA real GDP brings a significant impact on Ukraine, peaking after 4 quarters.² A VAR analysis (not shown) also indicates that a shock to Russian GDP has a significant impact on Ukraine (which can also be interpreted as the part of the EA effect that is transmitted through Russia). This reinforces common perceptions of the importance of developments in the Russian economy in Ukraine. It also suggests that were Russia to be supported by higher oil prices, it could act as a brake against some of the spillovers from a EA shock.



Sources: Haver; and IMF staff estimates.

² The impulse-response function is identified using Cholesky decomposition, imposing a recursive causal structure from the top variables to the bottom variables. This implies, for example, that a shock to Russia's GDP will have a contemporaneous effect on GDPs of Ukraine but the effect on oil prices and euro area GDP will emerge with a lag. All variables are measured in log, and the model is estimated using two lags ($k=2$). The analytical results are robust to alternative specifications, including different ordering in the Choleski decomposition, estimation over the sample period before the 2008 crisis, and the addition of U.S. GDP. The responses are statistically significant for about four quarters, and a similar pattern is also found in the regression with the pre-crisis sample (2001:Q1–2008:Q2).

Policy implications. A look at proposed policy responses suggests some limits to first round defenses (if other countries in the region react to a common external shock with, for example, depreciation, and interest rate defense). Additional steps may be needed, depending on circumstances (e.g., including capital controls, deposit freezes, and stronger cross-country collaboration (e.g., Vienna 2) to achieve initial stability.

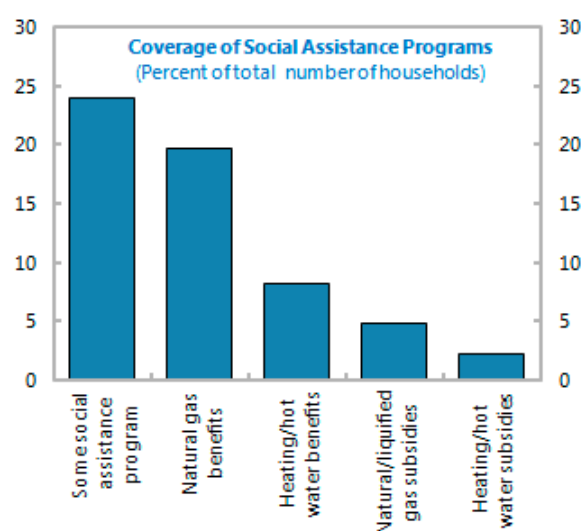
Possible Shocks and their Impact	
Nature/Source of Shocks	Expected Impact and Transmission Channel if Shock is Realized
<p>1. The euro area sovereign crisis intensifies and global growth conditions slow down</p> <ul style="list-style-type: none"> Commodity prices are depressed, leading to further worsening of current account and balance of payments pressure Slow down or evaporation of external financing. 	<ul style="list-style-type: none"> Ukraine exports about 50 percent of GDP, with bilateral trade links dominated by EU and Russia. Commodity exports (chemical, agriculture, metals, minerals and timber) account for about 60 percent of exports). In 2009, Ukraine suffered a 40 percent decline in nominal goods exports and a 15 percent drop in real GDP. Euro area and Russian banks own about 24 and 11 percent, respectively, of Ukraine's financial system and gross external financing requirements are large (about 40 percent of GDP). The sovereign has limited access to financial markets and spreads are high and composition is shifting towards shorter maturities. Higher funding cost would exacerbate external financing tensions, and lead to exchange rate pressures.
<p>2. Fiscal consolidation goes off track and structural reforms stall</p> <ul style="list-style-type: none"> Changes in political leadership or policy complacency may weaken the implementation of fiscal cuts Proposed energy sector reform may stall further. 	<ul style="list-style-type: none"> Higher-than-expected fiscal multipliers could lead to a sharper downturn, making it more difficult to meet consolidation targets. EA sudden loss of investor confidence could push up yields or dampen financing. Insufficient energy and social reform may keep growth low for a protracted period, undermine fiscal consolidation.
<p>3. Banks' and corporates' asset quality deteriorates with the slowdown and/or funding pressures arise from confidence loss in run up to election</p>	<ul style="list-style-type: none"> Global liquidity shortage, contaminate bank and corporate balance sheets by slowing down rollovers, exacerbating currency mismatches, or trigger foreign cash withdrawal. Possible shortages of collateral could elevate funding pressures. NPLs could increase due to recession, especially from the SOE sector. This would weaken banks' capital base and corporate balance sheets. The banking system is increasingly exposed to the sovereign (which has limited market funding options), including through the purchase of fx-linked bonds. Further policy slippages risks deposits and fx cash withdrawal, crowding out private credit, depressing activity and creating more NPLs. Higher interest rates and shorter rollovers would exacerbate the crunch and hurt growth further. Bank recapitalization needs may be difficult to source from market and may trigger contingent liabilities from possible government guarantees of bank debt.
<p>4. Oil/ Energy price surge</p> <ul style="list-style-type: none"> Geopolitical instability could trigger an oil/gas price shock. 	<ul style="list-style-type: none"> Higher oil/gas prices would increase import bills adding to balance of payment pressures and resulting inflationary pressures could undermine confidence in domestic currency and would erode purchasing powers.

Annex V. Household Utilities: Social Assistance Reform

Social assistance programs for household utilities are poorly targeted. Of the total utilities' social assistance budget (0.3 percent of GDP), about 30 percent is distributed to wealthy households while the poorest households receive less than 8 percent. In 2010, the average transfer value per capita to the wealthiest quintile of households (UAH 1,200) was UAH 500 higher than for the poorest quintile.

Targeting preferential categories of citizens and significant use of benefits over subsidies has skewed the system towards the wealthy. The current system of benefits and subsidies aims to

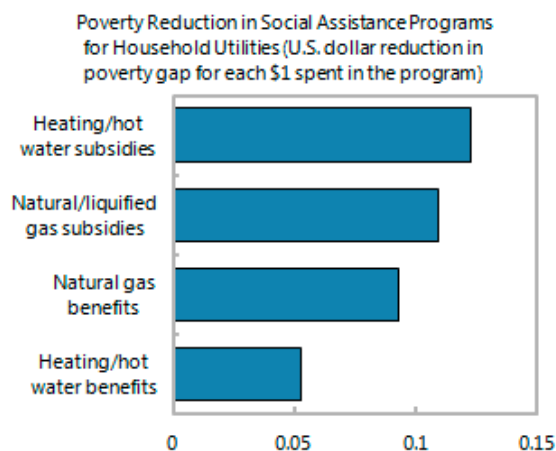
provide advantages for special categories of people (e.g. war veterans, Chernobyl victims) and citizens engaged in socially important professions or with certain social attributes (e.g., age, health or social status). Consequently, gas benefits are received by 20 percent of households, predominantly going to wealthier households. In contrast, gas subsidies based on household income levels cover only 5 percent of households but even there governance challenges have resulted in high income earners receiving higher average per capita transfers than those with lower income.



Source: 2010 Household Survey, State Statistics Service of Ukraine.

The poorly targeted nature of these programs harms their ability to reduce poverty. About 85

percent of individuals below the poverty line do not receive any transfers for household utilities. Cost-benefit analysis suggests that only 5–12 cents on the dollar spent in social assistance programs for household utilities go toward reducing the poverty gap (hryvnia equivalent needed to bring all poor to just above the poverty line).



Sources: 2010 Household Survey; State Statistics Service of Ukraine; and IMF staff estimates using ADePT's Social Protection module.

Transitioning to a well-targeted social assistance system will be essential as end-user gas and heating tariffs rise. If efficiently distributed, the current financial envelope (defined as a fraction of GDP) is sufficient to fully subsidize all households with a utility bill-to-income ratio above 10 percent, even once domestic tariffs reach market prices (assuming gradual increases over a decade).

Costs of Social Assistance Programs for Household Utilities

	Billions of Ukrainian hryvnia	Percent of GDP
Current transfer schemes	2.7	0.25
<i>Of which:</i> to households with utility/income ratio above 10 percent	0.7	0.06
Targeted subsidy to households with utility/income ratio above 10 percent		
Under current prices	3.1	0.28
Under market prices 1/	6.6	0.34

Source: IMF staff estimates.

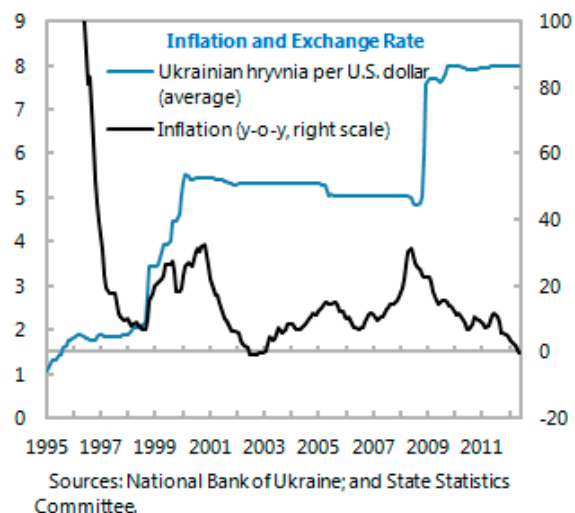
1/ Assumes market prices are phased in over 10 year period.

Annex VI. Ukraine: Evidence on Monetary Policy Transmission Mechanism

With a de facto fixed exchange rate regime and weak liquidity management, the NBU's foreign currency interventions by in large determine dynamics of monetary aggregates and complicate reaching officially announced inflation objectives.

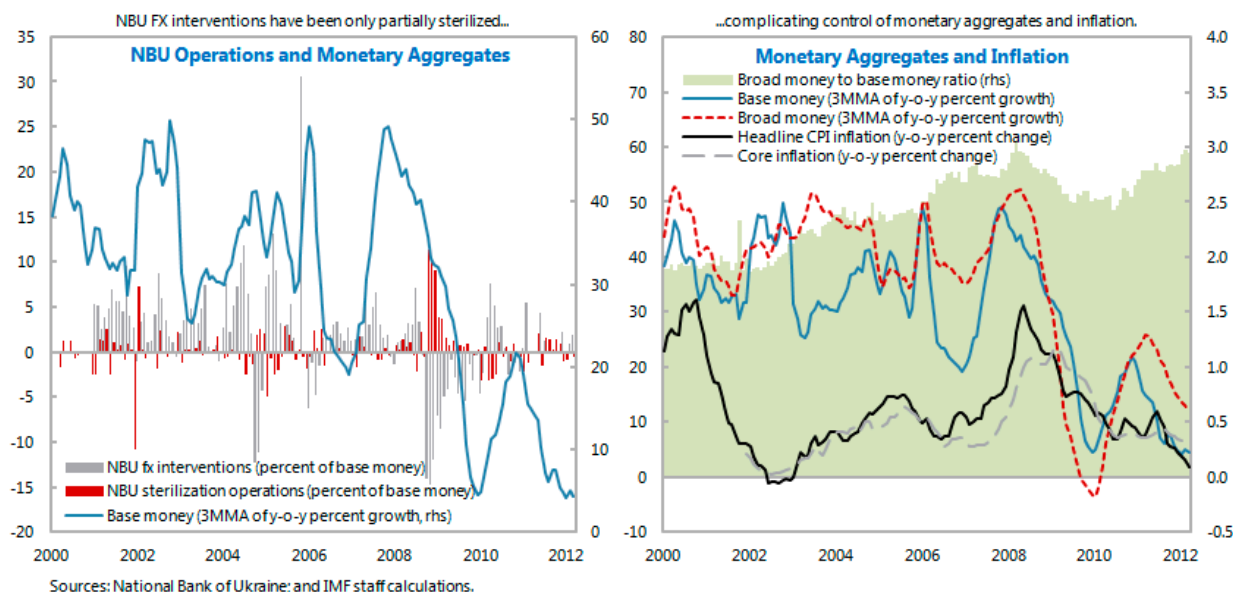
Although Ukraine does not operate a pegged regime, a stable exchange rate has been de facto a key policy objective since mid-1990s. The role of the exchange rate as a monetary target

goes back to mid-1996, when the NBU first introduced a band around the U.S. dollar. Aside from a number of short-lived periods of forced float coupled with sizable adjustments of the band's width and level—primarily during 1998–2000 and 2008–09 financial crises—the NBU has kept the hryvnia broadly stable against the U.S. dollar. There is a widespread view in Ukraine that this policy helped to break away from the hyperinflation of the early 1990s and contributed to the stabilization after the 1998 crisis. At the same time, it has also constrained policy flexibility: Ukraine is highly exposed to terms of trade shocks and its domestic business cycle is strongly correlated with world commodities' prices.



The exchange rate regime has taken a clear precedence over monetary policy targets, complicating the NBU's control over money supply. In the context of large (but volatile) capital inflows and windfall gains from generally favorable terms of trade shocks, dynamics of monetary aggregates have been largely driven by the NBU's foreign exchange interventions. Liquidity management operations only partially sterilized massive liquidity injections and were often misguided by concerns over the strength of the NBU's own balance sheet and overplayed fears of speculative capital inflows. In this setting, the NBU found it difficult to square its exchange rate policy with achieving its monetary and inflation objectives. In principle, the NBU's annual Monetary Policy Fundamentals lays out key policy targets for the monetary aggregates, inflation, and exchange rate that should guide the NBU's policy conduct. In practice, steering the exchange rate within the targeted band has taken priority while other policy targets were rarely met.¹ The NBU has repeatedly failed to deliver on officially announced inflation objectives.

¹ See Schaechter, A., 2006, What Monetary Policy Framework Fits Ukraine, Selected Issued Paper, SM/06/407.



Ukraine: Monetary Policy Targets, 2001–10 1/

	Base money, percent		Broad money, percent		Inflation, percent		UAH/\$ rate, average	
	Target 2/	Outcome	Target 2/	Outcome	Target 2/	Outcome	Target 2/	Outcome
2010	9-13	16	...	23	...	9	...	7.94
2009	6	4	8	-6	...	12	...	7.79
2008	...	32	35-40	30	15.9	22	...	5.26
2007	...	46	28-33	52	7.5	17	4.95-5.25	5.05
2006	22-27	17	27-32	35	8.5-9.5	12	5.00-5.20	5.05
2005	20-26	54	28-33	54	6.0-7.0	10	5.27-5.31	5.12
2004	26-32	34	32-39	32	5.8-6.3	12	5.38-5.42	5.32
2003	17-20	30	22-27	46	6.0-7.0	8	<5.48	5.33
2002	11-13	34	18-20	42	9.8	-1	<5.6	5.33
2001	12	37	23-24	42	12.3	6	<5.44	5.37

Source: National Bank of Ukraine.

1/ Monetary Policy Fundamentals for 2011 were not formally formulated.

2/ Targets are as specified in Monetary Policy Fundamentals (before revisions). Red highlights correspond to outcomes that are outside of the targeted range or above the point target; green highlights are for outcomes within range or below point target.

Empirical evidence suggests that banks' lending rates in Ukraine are sensitive to overall liquidity conditions in the banking system, directly affecting spending decisions of households and corporates.² A response coefficient of lending interest rates to movements in

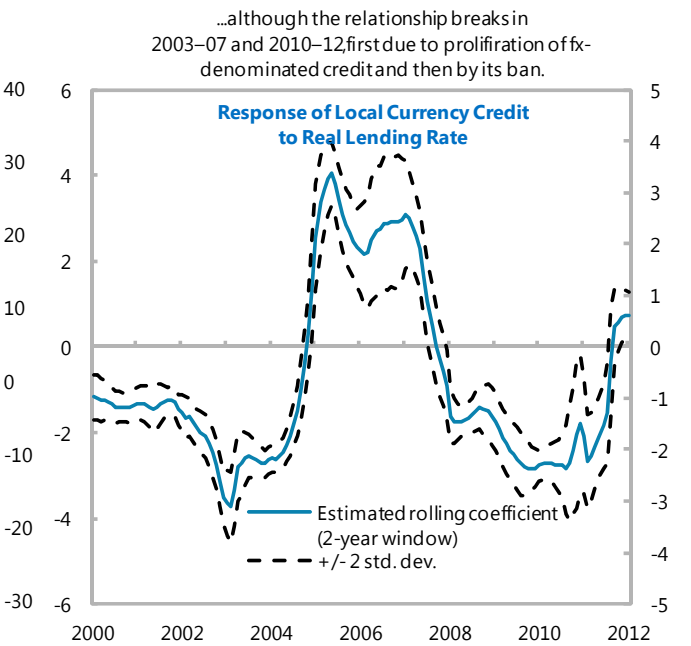
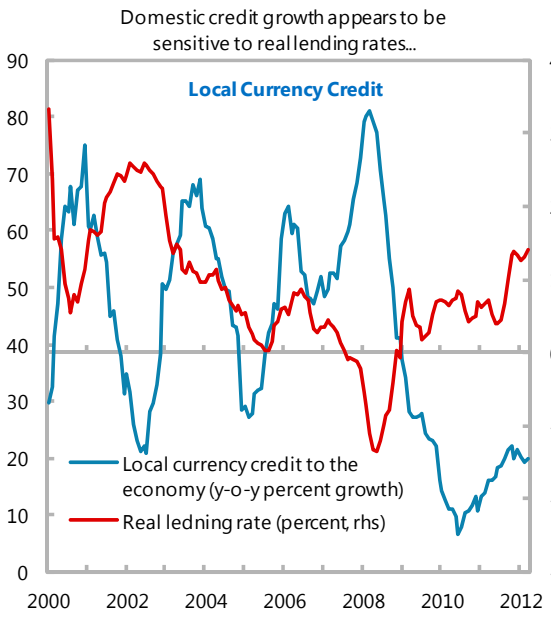
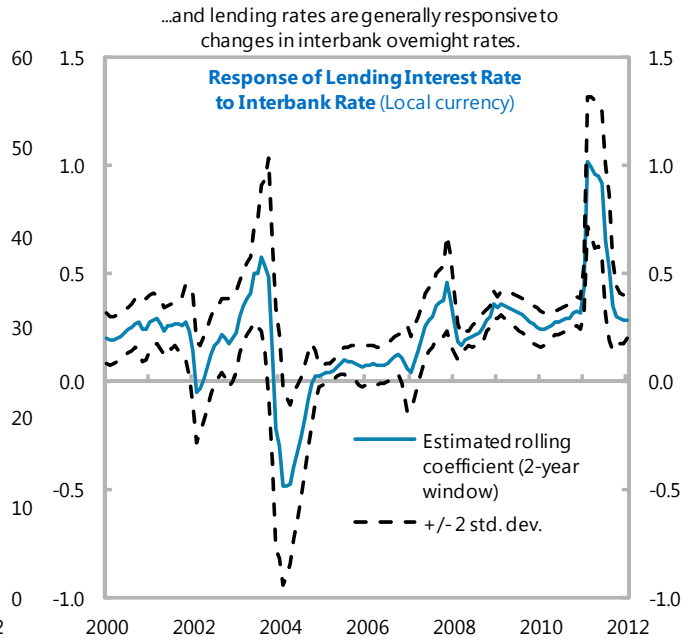
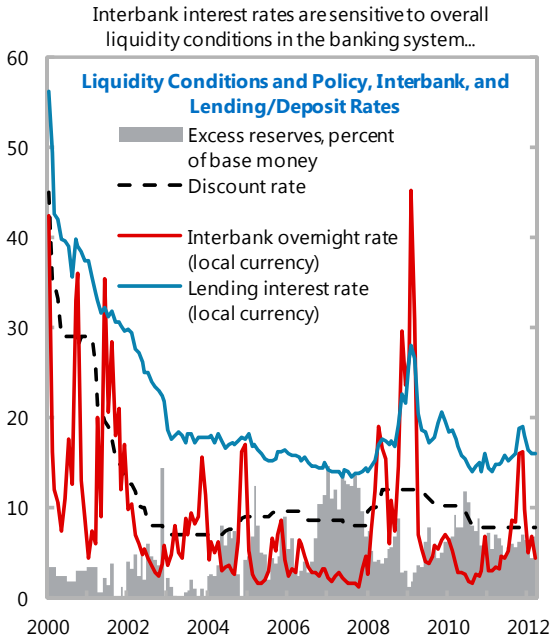
² This mechanism is consistent with the conventional interest rate channel of monetary policy transmission. In Ukraine, interest rate channel works primarily through short-term rates. In countries with deeper financial markets, unanticipated changes in monetary policy would lead to changes in long term rates and asset prices, boost

(continued)

overnight interbank rates—which could be influenced by the NBU through its liquidity management operations—estimated over a rolling 24-month window suggests that the pass-through has been significant in 2000–02 and since mid-2007 to the present. The strength of the interest rate pass-through seemed to depend strongly on overall liquidity conditions. This is reflected by the response coefficient taking larger values in periods when banks' excess liquidity stood low and was tightly managed (including in the context of 2008 and 2010 SBA programs). With sticky prices, changes in nominal lending rates determined the real cost of credit and thus affected overall credit growth and domestic demand in the economy. As an illustration, local currency credit growth peaked at about 80 percent (year-over-year) in early 2008 which coincided with historically high liquidity in the banking system and highly negative real lending rates. The pass-through of changes in real lending rates to credit growth seemed to break down in 2003–07 and 2010–12. The first episode is likely driven by proliferation of foreign currency lending as during that period the average annual credit growth of foreign currency credits to households and corporate was 160 percent and 36 percent, respectively. The second episode is likely associated with the legal ban on foreign currency lending to unhedged borrowers that squeezed those borrowers into local currency credits notwithstanding rising real interest rates.

Sterilization operations failed short of what was needed and were often guided by concerns over the strength of the NBU's own balance sheet and fears of speculative capital inflows. To the extent that there are significant frictions in cross border capital mobility (including due to the presence of capital controls), the NBU could have afforded some degree of flexibility in adjusting its policy rates in the context of its monetary policy operations, deviating from the interest rate parity. In practice, however, the NBU has been reluctant to aggressively adjust a menu of policy rates for its open market operations and standing facilities, directly affecting liquidity conditions and interest rates in the interbank market with an aim to influence aggregate demand and inflation.

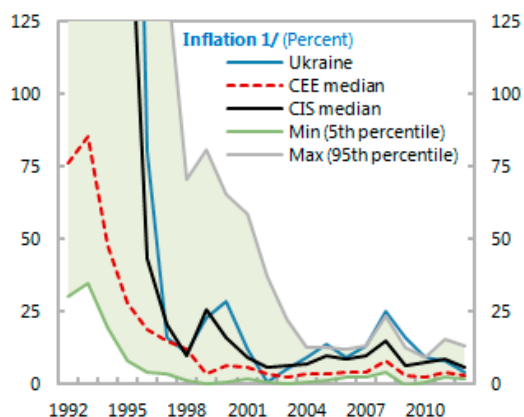
household wealth, and thus increase consumption. In Ukraine, however, this channel of transmission is likely to be weak due to its low degree of financial development and limited ability of market participants to use asset wealth to finance consumption and investment.



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

Despite continued remonetization of the economy, Ukraine's inflation remained well above that for most other regional peers and, by in large, has been a monetary phenomenon. Empirical

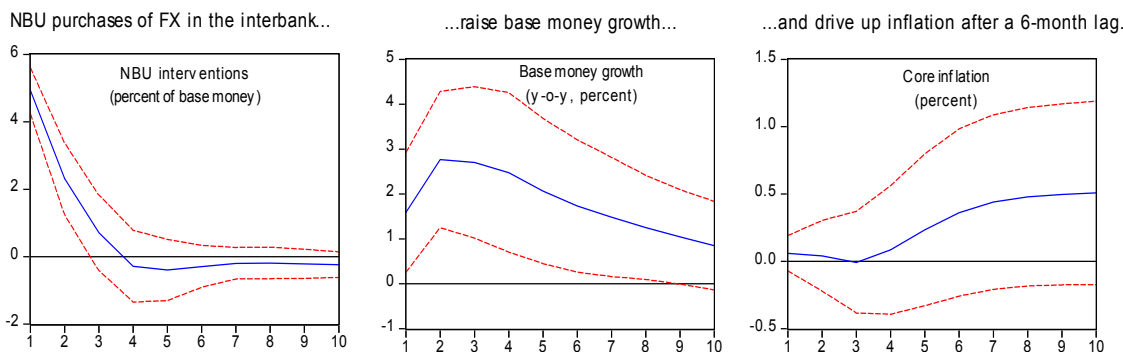
evidence suggests that there was a rather strong link between the intervention-driven fluctuations in monetary aggregates and inflation outcome. Impulse response functions based on a simple three-variable vector autoregression model estimated over a sample of monthly data from 2000–11 seem to suggest that a one-standard deviation innovation in NBU foreign currency interventions—which in the studied sample is estimated to be rather large at about 4½ percent of base money—significantly increases growth in base money, adding (with a lag of about six/eight months) about ½ percent to core inflation.



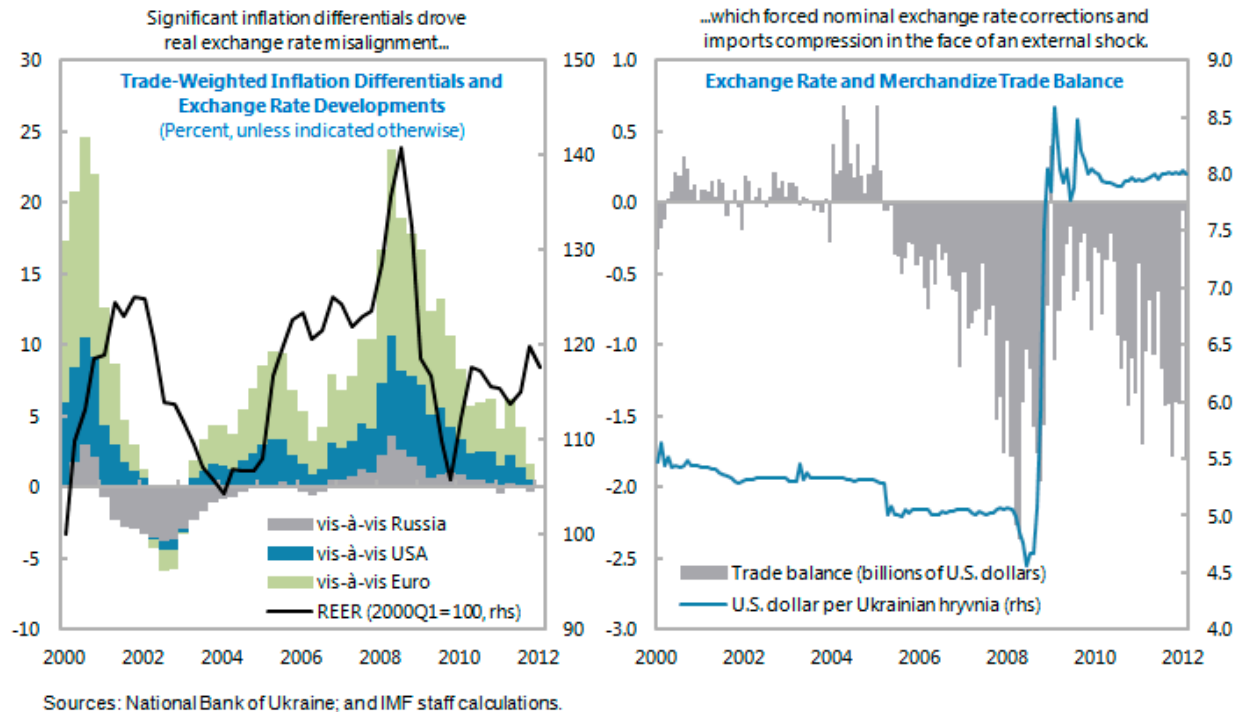
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

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

Responses to CholeskyOne S.D. Innovation in NBU interventions \pm 2 S.E.



Large inflation differentials vis-à-vis main trading partners pushed the real exchange rate away from levels consistent with fundamentals. Between 2004 and 2008, Ukraine's real effective exchange rate appreciated by over 40 percent—as at times inflation exceeded that in main trading partners by 20–30 percent—fueling domestic demand and increasingly pushing trade balance deficit into red, notwithstanding high international demand for its traditional exports (agricultural and steel products). Mounting exchange rate misalignment made Ukraine vulnerable to external shocks, making eventual nominal exchange rate correction virtually inevitable.



Furthermore, the quasi fixed exchange rate regime contributed to financial dollarization and over-leveraging. As in many other countries in Eastern Europe, stability of the nominal exchange rate was taken for granted and led to significant mispricing of currency risks. With borrowers attracted by low interest rates on loans in foreign currency, FX-denominated credit to corporate and households increased rapidly from 7 percent of GDP and 0.1 percent of GDP in 2000 to 23 percent of GDP and 22 percent of GDP in 2008, respectively. At the same time, Ukrainian corporates and banks with access to international capital markets have also accumulated large external liabilities which, at the beginning of the crisis in 2008, amounted to 24 percent of GDP and 23 percent of GDP, respectively. In this setting, a realignment of nominal exchange rate produced devastating balance sheet effects.

To effectively implement its newly strengthened mandate of safeguarding price stability, the NBU needs to allow greater exchange rate flexibility. In the current environment of elevated uncertainty and external funding pressures, monetary and exchange rate policies should be more flexible to respond swiftly to shocks, while protecting international reserves. To focus more squarely on its main policy objective, the NBU should continue pressing ahead with foreign currency market liberalization and increasingly allow greater exchange rate flexibility. The NBU should break away from its current practice of frequent intervention in the interbank foreign currency market and heavy-handed administrative measures (e.g., a mandatory ID requirement with any purchase of cash

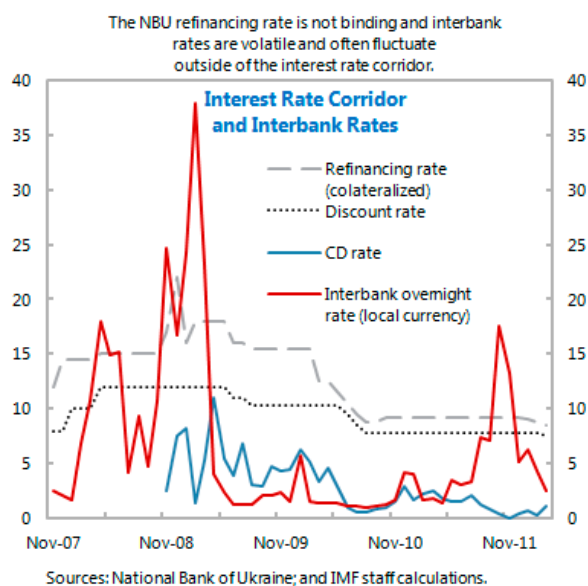
foreign exchange). To avoid undermining confidence in the hryvnia and to safeguard private sector balance sheets, the pace of these actions need to be carefully gauged against conditions in the foreign currency market.

Enhancing the NBU’s liquidity management framework will be key to strengthening monetary policy transmission.

The money market is highly segmented and not effective at redistributing liquidity across the banking system. At the same time, an overly wide spread (over 500 bps) between deposit and lending facilities of the NBU—aggravated by less-than-automatic access to standing facilities—encourages banks to be overly conservative in the use of reserve funds (since the cost of running short is high) and discourages development of a well functioning interbank market. As a result, the NBU often simultaneously lends to and absorbs from the banking system and the interbank rate has been very volatile,

undermining transmission of monetary policy signals to other markets and retail lending rates.

The NBU should enhance its liquidity management framework and be more aggressive in managing liquidity fluctuations. In this regard, more reliable standing facilities should be made available, with access guided by price and availability of suitable collateral, and the overnight rate should be brought closer to the middle of a narrower policy rate corridor.



Monetary policy needs to become more credible and transparent. Expectations could have considerable significance for effectiveness of monetary policy transmission: as the NBU’s ability to deliver on its inflation objectives becomes firmly established, private sector wage and price expectations will become more forward-looking, speeding up demand adjustment to changes in policy stance. Anticipated policy changes will be priced into the yield curve, reducing a need for large policy swings. Therefore, strengthening the NBU’s credibility (through safeguarding its independence) and improving predictability of its policy actions (through greater transparency and stronger communication) will be key to anchoring expectations and improving the effectiveness of monetary policy.



UKRAINE

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 15, 2012

Prepared By

The European Department in Consultation with Other
Departments, the World Bank, and the European Bank for
Reconstruction and Development

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FUND RELATIONS

(As of May 31, 2012)

I. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	1,309.44	100.00
Holdings	12.91	0.99

II. Outstanding Purchases and Loans:	SDR Million	%Quota
Stand-By Arrangements	8,500.00	619.53

III. Latest Financial Arrangements:

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

IV. Projected Payments to Fund¹

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

	Forthcoming				
	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Principal	1,484.38	3,656.25	2,390.63	968.75	...
Charges/Interest	98.98	116.02	28.16	8.76	1.91
Total	1,583.36	3,772.27	2,418.79	977.51	1.91

V. 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

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

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. Reflecting greater flexibility in the exchange rate from April 2008, the exchange rate arrangement was reclassified as a managed float with no predetermined path for the exchange rate. As of December 29, 2008, the NBU fixed the official exchange rate of the hryvnia against the dollar at Hrv 7.7 per U.S. dollar and resorted to interventions with the aim of keeping the market exchange rate close to the official rate. Since 2009, the official exchange rate has been allowed to fluctuate, but has remained close to Hrv 8.0 per U.S. dollar. Effective February 2, 2009, the classification of the de facto exchange rate arrangement had been changed from managed floating with no predetermined path for the exchange rate to other managed arrangement, retroactively to April 30, 2008, due to the revision of the classification methodology. The arrangement was then reclassified to a stabilized arrangement against the dollar, effective March 1, 2010, and reconfirmed again in January 2011. The current classification of the de jure exchange rate arrangement is characterized as a transition to a free floating exchange rate is planned as the financial system recovers and the transmission mechanisms mature.

On September 24, 1996, Ukraine accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement, and two remaining restrictions were eliminated in May 1997. A number of 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, many of which were removed by May 2010 and the remaining ones were removed in the context of the 2010 SBA-supported program. Ukraine currently maintains multiple currency practices arising from (i) the use of the official exchange rate for certain government transactions, and (ii) the requirement that a Ukrainian resident who sells the previously purchased foreign exchange not used within 10 days (including when FX was returned to the resident because the counterpart failed to fulfill its obligations under an import contract) shall transfer 100 percent of the positive difference from the sale price, on a quarterly basis, to the State budget.

VI. 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.

VII. 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).

VIII. Safeguards Assessments:

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

IX. UFR/Article IV Consultation:

Ukraine is on a 12-month consultation cycle. The last Article IV consultation was concluded on June 2, 2008 and a report was published on <http://www.imf.org/external/pubs/cat/longres.aspx?sk=22163.0>

Stand-By Arrangement. A 29-month SBA in the amount of SDR 10.0 billion (US\$15.4 billion, 729 percent of quota) was approved by the Executive Board on July 28, 2010 (IMF Country Report No. 10/262).

RELATIONS WITH THE WORLD BANK

(May 2012)

Country Partnership Strategy

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

The Bank’s assistance to Ukraine in the new CPS will be calibrated to match the scope and instruments of support to the strength of the authorities’ commitment, capacity and track-record in key areas of potential engagement. Specifically, investment loans will be offered where governance risks are manageable, where a track record of implementation has been established and capacity has been built and where there is broad consensus on the general policy framework. Analytical and advisory services will be offered to help strengthen reform consensus and build capacity. Development policy lending will be contingent on demonstrated progress in tackling key governance weaknesses and thereby on evident commitment and leadership in overcoming vested interests to carry out a coherent reform and development strategy.

World Bank Program

The current investment lending portfolio includes eleven operations for a total amount of US\$ 1.8 billion of which 60 percent is undisbursed. Among the projects in the public sector are a Public Finance Modernization Project (US\$50 million), a State Tax Service Modernization Project (US\$40 million), and a Statistical System Modernization Project (US\$32 million). In the area of rural development, under the Rural Land Titling and Cadastre Development Project (US\$89.7 million), the

Bank supports the establishment of a secure land cadastre system to enable land transactions to be efficiently processed and protected. The Hydropower Rehabilitation Project and additional financing (US\$166.0 million) were approved in June 2005 and November 2009, respectively, and the Power Transmission Project (US\$200 million) was approved in August 2007. The Bank Board of Executive Directors also approved a new Energy Efficiency Project (US\$200 million). In infrastructure, the Bank approved a Roads and Safety Improvement project in 2009 for US\$400 million (currently under implementation). The Bank also has an Urban Infrastructure Project (US\$140 million), designed to provide financing to local governments and utilities for priority investments in water and wastewater. In the financial sector, the Second Export Development Project (EDP2; US\$154 million plus additional financing of US\$150 million), which builds on the success of the first project, promotes the export sector access to finance. The Bank has been supporting the modernization of administering social benefits through a Social Assistance System Modernization project (US\$99 million) since November 2005.

The investment lending program for the first two years of the CPS envisages base level support in the range of USD 500 million per annum. The current investment lending pipeline for FY13 includes a follow up to the existing Roads and Safety Improvement project and an additional financing to the State Statistical System Development project. In FY14, indicative lending includes an operation to support scaling up targeted social assistance, a second Urban Infrastructure project and a Gas Sector Efficiency and Modernization project. Financing amounts are still indicative and the total lending envelope may change based on the government's demand and the Bank's lending capacity. In FY15–16, additional investment lending may be envisaged in the following areas: (i) transport and trade facilitation; (ii) energy efficiency and energy security; (iii) municipal services and governance; (iv) health services and financing; (v) private sector development and access to financing.

The calibrated engagement strategy leaves scope for an upward revision of lending amounts through the addition of DPLs should reforms accelerate and consistent progress on governance be made. The Second Programmatic Financial Rehabilitation Development Policy Loan could be delivered quickly and a new cross-sectoral DPL series (building on the earlier DPL I–III series) supporting improved economic governance and competitiveness could be launched in FY13–15 subject to the government's request for IBRD resources, Ukraine's performance, IBRD's financial capacity, demand from other borrowers, and global economic developments.

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

European Bank for Reconstruction and Development (EBRD) and other bilateral donors will continue and be expanded where possible.

Indicative IBRD Knowledge Services, FY12–13

Pillar 1: Improving public services and public finances	Pillar 2: Improving policy effectiveness and economic competitiveness
Structural and Governance Reforms TA PEFA Update Capital Budget Effectiveness Assessment (SAFE TF) Measuring Governance in Health Support of Health Reform Pilots (IDF Grant) Healthcare Quality and Population Health Impacts in Ukraine Improving Implementation for an Effective Response to the AIDS Epidemic in Ukraine Education Dialogue (BOOST) Municipal Demand Side Governance: Improving Accountability in Water and Sanitation Sector Modernization of District Heating Systems in Ukraine Improving Creditworthiness of Ukrainian District Heating Companies (PPIAF) Preparation of municipal energy efficiency projects (CTF) Facilitating financing of municipal energy	Structural and Governance Reforms TA Labor Mobility TA Financial Sector TA (Programmatic) Gas Sector TA Governance of Large State-Owned Enterprises TA EC-WB trust fund for gas sector restructuring Naftogaz corporatization strategy (PPIAF) Land Governance Assessment Framework (LGAF) PPP framework administration and fiscal risks (SAFE TF) Auditing Road Infrastructure Projects (IDF Grant)

Bank-Fund Collaboration

In the October 2010 Joint Management Action Plan on Fund-Bank collaboration on Ukraine, the staff teams agreed that the Fund and the Bank would support Ukraine's efforts to: (i) pursue fiscal consolidation whilst finding fiscal space to increase public investments needed to support private sector growth and to tackle pressing social issues, (ii) move forward with energy sector and utility tariff reforms whilst protecting the poor, (iii) complete rehabilitation and strengthen oversight of the banking system, (iv) strengthen the monetary policy framework, and (v) improve the investment climate. The teams agreed to the following division of labor and coordination:

- **Restoring confidence and fiscal sustainability:** Strengthening public finances and tackling long-standing problems through advancing structural reforms would underpin medium-term fiscal sustainability and growth. The Fund program and the Bank's support are designed to support the authorities' efforts to lower budget deficits and to: (i) tackle key budgetary rigidities to gradually reduce the footprint of the public sector on the economy; and (ii) support the reallocation of resources from transfers and other current spending toward growth-enhancing capital investments and better targeted social support. To this end, the Bank, in coordination with the Fund, has recommended a series of structural measures to reform the pension system. The Fund and Bank teams work closely through their programs to push the implementation of a sequence of reforms aimed at putting the pension system on sound financial footing and reducing its strain on public finances. In the context of administrative reforms in Ukraine, the Bank and Fund will continue to provide advice aimed at ensuring a leaner and more efficient public service. The Bank will continue to provide project financing for the public sector, including a Public Finance Modernization Project, a State Tax Service IT Modernization Project, a Statistical System Modernization Project, and the ongoing investments to modernize social assistance services. The Bank also plans to focus on improving the efficiency of public spending. The Bank and Fund will also coordinate on supporting the authorities' efforts to strengthen debt management (and extend and strengthen the domestic yield curve). An assessment of SOEs financial reporting has been finalized by the Bank, identifying areas where financial reporting can be strengthened to improve transparency and decision making.
- **Reforming and modernizing the energy sector whilst improving targeting of safety nets:** Energy sector reforms will continue to aim at improving energy efficiency of the economy, eliminating the need for budgetary support to Naftogaz, and encouraging investment in gas exploration, extraction, and transportation. The Bank's support for the authorities' energy sector reforms will continue to focus on infrastructure modernization through a sequence of investment loans, including in areas of hydropower rehabilitation, power and gas transmission, and energy efficiency. In the context of the SBA, the Fund will focus on supporting efforts to phase out Naftogaz's deficit, including through a program of steady gas prices and utility tariff increases to advance cost recovery and reduce fiscal and quasi-fiscal deficits generated by the company. The Bank and the Fund will continue to work together on supporting reforms that depoliticize price-setting mechanisms of public utilities and improve payment discipline. To improve transparency of reporting in the gas sector, the Bank will support and advise the authorities in securing membership to the EITI. The Bank team will continue its advice on improving targeting of social assistance to protect poor households from higher utility tariffs

and other necessary fiscal reforms. The Bank and Fund teams will work closely to support implementation of this reform agenda.

- **Restoring and safeguarding banks' soundness:** Finalizing full rehabilitation of the financial sector will facilitate the resumption of credit to the real sector and efficient credit allocation, and thus support economic growth. In the context of the SBA and the PFRL, the Fund and the Bank will coordinate closely in supporting the authorities' goal of developing and implementing restructuring strategies for the state owned banks. In this context, the Bank and Fund staff will continue to serve as observers on the Bank Recapitalization Board. The teams will also work closely on supporting further development of a framework that properly recognizes and facilitates the resolution of impaired loans, including development of a strategy to pro-actively address barriers to nonperforming loans' effective resolution and any necessary changes to the existing legislation and regulations, including tax treatment. The Fund and the Bank will also coordinate in supporting legislative and regulatory reforms and implementation aiming at strengthening consolidated supervision and enforcing ultimate controllers disclosure (following the recent approval of the related legislation), and enhancing the bank resolution framework. The Bank will continue its technical assistance to the Deposit Guarantee Fund (DGF) and the NBU on bank resolution and selected banking supervision issues.
- **Developing a more robust monetary policy framework:** Focusing monetary policy squarely on domestic price stability with greater exchange rate flexibility under a more independent NBU will facilitate inflation reduction, discourage dollarization and excessive risk-taking, and provide a buffer against frequent external shocks. The Fund will lead in this area, including through policy advice, and also by providing technical assistance on strengthening monetary policy and operations frameworks and establishing necessary preconditions for moving toward inflation targeting regime over the medium term. The Fund will continue to provide technical assistance as needed for implementing the authorities' strategy for liberalization of the foreign currency market. It will also work with the authorities as needed on addressing remaining shortcomings in the governance of the NBU identified in the context of the recent Safeguards Assessment.
- **Improving investment climate:** Deep and sustained improvements of the business environment is key for converting economic stabilization into strong and sustained economic growth. In support of this objective, the Bank will lead in this area supporting measures and reforms to reduce entry and exit barriers (including joint Bank-Fund work on developing a new insolvency and corporate restructuring framework), to enable the creation of new businesses and to allow a faster reallocation of resources in the economy. The Bank would also support

measures to improve fair competition and to overcome governance and regulatory barriers to trade and FDI. The Fund will provide support for the authorities' efforts as appropriate.

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

**Ukraine: Bank and Fund Activities in Macro-Critical Structural Reform Areas,
January 2012–March 2013**

Work Programs	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank	Fiscal, Structural and Governance TA	Ongoing	TA through June 2013
	PEFA	Ongoing	June 2012
	Capital Budgeting TA	Ongoing	TA through December 2012
	Investment Loans in Tax Administration IT modernization, PFM, and Statistics Office	Ongoing	
	Gas sector reform TA	Ongoing	2012-2014
	District heating sector analytical work (completed) and energy efficiency project	Ongoing	Project delivery in 2013
	Social Assistance Project and TA, preparation of a second-generation Social Assistance Project	Ongoing	
	PFRL 2	Ongoing (in the form of TA)	Board discussion postponed, date TBD
	TA provision to NBU, government, and DGF on: selected bank supervision issues, problem bank resolution and DGF capacity building, restructuring and privatizing banks recapitalized by the state, new financial sector consumer protection framework; planned TA on selected NBFI and capital market development issues	Ongoing	TA through June 2013
	TA provision on SOE restructuring and governance	Planned	TA through June 2013
2.IMF	Article IV Consultation	May, 2012	Board discussion expected June 2012
	Second and subsequent reviews under SBA	TBD	Board discussion TBD
	TA provision to NBU and government: on bank restructuring, local currency market development and de-dollarization, monetary policy, FX market liberalization, financial stability, corporate insolvency, addressing NPLs	Ongoing	TA through early 2013
	TA provision to MoF: on medium-term framework and budgeting, tax administration modernization	Ongoing	TA through early 2013

RELATIONS WITH THE EBRD

(May 2012)

Ukraine joined the EBRD in 1992, and since then the EBRD has been active in supporting Ukraine's transformation toward a market economy. As of end-April 2012, EBRD's portfolio in Ukraine reached €4.4 billion, most of it in the private sector. The Bank's exposure in Ukraine is the second largest after Russia, accounting for 1/8th of the Bank's overall portfolio. Financial sector and industry are two largest sectors of operations in Ukraine, accounting for 3/4th of the total operating assets. Operations in the infrastructure and energy sectors are also significant. The EBRD's main contribution in Ukraine has been through funding of projects with significant transition impact potential in the private and public 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.

During the financial crisis of 2008–09, the EBRD pursued a country specific crisis response program for Ukraine in coordination with various stakeholders, including the authorities, other IFIs and international donors. Despite the increased country risk, in 2009 the EBRD invested €1.1 billion in Ukraine, a record level for the country. Almost two-thirds of the total was invested in the banking sector, helping to support stability and confidence. During the crisis, the EBRD also undertook a complete reassessment of business needs in the corporate sector, which suffered from a terms-of-trade shock and financial sector de-leveraging, resulting in investments of over €250 million in 2009. A further €220 million was invested in the infrastructure and energy sectors. All in all, in 2009, the EBRD invested over €600 million in the form of equity and subordinated capital, assisting in restructuring and strengthening of balance sheets of banks and enterprises.

The Bank's country strategy for 2011–14 was approved in April 2011. Its focus is on addressing Ukraine's important transition challenges in all key sectors, including strengthening energy efficiency and energy security; unlocking Ukraine's agricultural and industrial potential; providing good quality and reliable infrastructure; and dealing with the legacy of the crisis in the financial sector.

In 2011, the Bank invested over €1 billion whilst focusing its operations on the revival of the corporate sector, in order to compensate for the absence of bank-mediated lending in Ukraine. The Bank supported twelve projects in agribusiness, totaling €190 million and nine transactions in the manufacturing sector totaling €228 million. In infrastructure and energy, the Bank invested €143 million with the private sector, including support for the coal recycling operations and agreed on a €200 million sovereign loan to help modernize hydro power stations operated by Ukrhydroenergo. In the financial sector, the Bank took equity stakes in two banks and provided significant support to cross-border trade. The Bank also engaged in policy dialogue on support and modernization in the agribusiness sector; restructuring of and reorganization of state owned enterprises (including Ukrainian Railways, Ukrenergo and NAK Naftogaz); and local currency capital market development. In cooperation with other IFIs and business association, the Bank has worked to enhance business

environment in Ukraine including by taking an active role in the Domestic and Foreign Investors Advisory Council established by the President of Ukraine.

Over the years, the Bank has been active in developing of the local private sector and encouraging FDI. The Bank has supported a number of medium and large local clients, including Obolon, Astarta and CentraVis. Small and medium enterprises have been reached via credit lines offered to them via the partner banks. The Bank has actively participated in financing of several leading international investors (including Lafarge, Bosch and Louis Dreyfus) as well as cross-border transactions with sponsors from other countries of operation. In May 2010, the Bank rolled out in Ukraine its hallmark Business Advisory Services (BAS) Programme, which is expected to help private enterprises to adapt to the demands of a market economy and undertake restructuring after the crisis.

The Bank has worked to promote the development of domestic capital markets, including by helping to successfully establish KievPrime, a credible local currency inter-bank index. It is engaged in policy dialogue with the authorities and other IFIs, including the IMF, on market-friendly policies for encouraging longer-term lending in hryvnia after the crisis. In 2011, the Banks prepared an assessment of local currency market development challenges and prospects.

The Bank continues to pursue its strategic goal of supporting environmental protection and energy efficiency and security. The EBRD supported local private business in the oil and gas sector by financing, and more recently taking an equity position, in downstream operator Galnaftogas. A number of banks have benefited from the energy efficiency credit lines and related capacity building support. In the power and energy sectors, the Bank has helped support the implementation of the March 2009 EU-Ukraine memorandum of understanding, which is the cornerstone of EU-Ukraine cooperation in the field of energy. In particular, the Bank is expected to assist with the modernization and rehabilitation of the main trans-European energy networks of Ukraine. It also plans to invest in modern and energy efficient generation, transportation and distribution of energy. The Bank will also support the diversification of the supply sources and promote alternative fuels. These aims will be complemented by support to reforms in the energy sector to advance its liberalization and promote private sector involvement. Together with other IFIs, the EBRD continues to explore mechanisms for supporting the authorities as they pursue the modernization of Ukraine's gas transit system. In the area of nuclear safety, the Bank is working to improve the safety standards at the existing nuclear power plants (NPPs), the safe decommissioning of Chernobyl NPP and the creation of a safe confinement for its Unit 4.

In the infrastructure area, important recent projects include municipal transport projects in the capital (including Kiev Metropolitan and Kiev municipal bus company) and regional centers, the development of the Odessa sea port, the modernization of the pan-European road network and the first investment in the media and telecommunications sector in favor of Volia cable operator.

STATISTICAL ISSUES

(May 2012)

I. Assessment of Data Adequacy for Surveillance

General: Data provision has some shortcomings, but is broadly adequate for surveillance. Among Ukraine's economic and financial data, there are some shortcomings, particularly in national accounts, government finance statistics (GFS), and external sector statistics.

National Accounts: The National Accounts (NA) are broadly in line with the 1993 SNA. An STA multitopic technical assistance mission in April 2010 flagged financial account and sector balance sheets, as well as estimates of financial intermediation services indirectly measured, as the parts of the system that remain to be developed. In line with previous recommendations, a number of changes were implemented in 2009–10 that improved compilation of the quarterly national accounts (QNA). Volume measures of GDP have been rebased using 2007 as the reference period but a number of recommended methodological improvements remain to be implemented. Seasonally adjusted data are not disseminated on a quarterly basis. Government regulations regarding revisions policy restrain the State Statistics Committee of Ukraine's ability to improve data accuracy through flexible revisions for the annual NA and the QNA. Starting from 2011, Ukraine is one of the beneficiaries of the *STA TA project on Capacity Building for Sustainable Compilation of Real Sector Statistics in Eastern Europe*, which entails two/three missions per year on national accounts and price statistics, as well as training activity.

Price statistics: The weights of CPI are updated annually; geometric means are used at the very first level of price aggregation (beginning with observations January 2010) and scientific sampling of outlets was introduced beginning with observations in January 2011, with the results being published within six days of the end of the reference month. However, their geographical coverage is limited to urban areas and data validation practices fall somewhat short of internationally accepted best practices. The CPI excludes price changes for owner occupied housing. The lack of appropriate price indices hampers production of accurate long-term GDP volume series. Efforts to develop imports and exports price indices are underway.

Government finance statistics: Compilers are cognizant of the *GFSM 2001* methodology and reference materials. However, the lack of a strong legal framework for compiling GFS and its incomplete statistical coverage are significant shortcomings. The full adoption of the *GFSM 2001* system depends on strengthening of primary data sources, government accounting reform (undertaken under the International Public Sector Accounting Standards), and successful completion of the GFS component of the World Bank project on the development of statistics. A lack of clarity on the stock of VAT refund claims prevents a full assessment of the underlying fiscal performance.

Monetary statistics: The authorities use the Standardized Report Forms (SRF) for reporting monetary data to STA and EUR. In addition, data beginning from December 2001 have been converted into the SRF framework, and published in *IFS* since September 2006, and are available online.

Balance of payments: The compilation system relies heavily on the International Transactions Reporting System, customs declaration database, and enterprise surveys, providing a broad coverage of data on a timely basis. Nevertheless, direct data collection through enterprise surveys and a more intensive use of available data sources would improve data quality in the areas of financial services, travel, compensation of employees, workers' remittances, and reinvested earnings. Goods statistics could benefit by improving the methodology for estimating the c.i.f./f.o.b. conversion coefficient as well as by bringing reporting forms and instructions in line with the international guidelines. Efforts are also needed to reconcile direct investment data provided by the survey enterprises and ITRS, and to determine the sources of large FX cash held outside of the banking system classified under currency and deposits. In line with 2012 STA TA, improvements are needed regarding the compilation of external debt on a remaining maturity basis and direct investment by improving the coverage of debt instruments data and the valuation of equity.

II. Data Standards and Quality

Participant in the SDDS since January 10, 2003.	Data ROSC published on August 19, 2003.
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III. Reporting to STA

The country's IFS page has been published since July 1996. On monetary statistics, data have been published since September 2006 using the SRF framework in the *IFS* and are available online. The authorities also report regularly the quarterly data on Financial Soundness Indicators. These data are disseminated on the IMF's website with observations beginning in 2005. Data on international investment position has been compiled and reported since 2002.

**Ukraine: Table of Common Indicators Required for Surveillance
(May 30, 2012)**

	Date of latest observation	Date received	Frequency of data ⁶	Frequency of reporting ⁶	Frequency of publication ⁶	Memo Items:	
						Data Quality—Methodological soundness ⁷	Data Quality—Accuracy and reliability ⁸
Exchange Rates	5/29/2012	5/30/2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	5/24/2012	5/30/2012	W	W	M		
Reserve/Base Money	5/29/2012	5/30/2012	D	D	M	O, LO, O, O	O, O, O, O, NA
Broad Money	5/29/2012	5/30/2012	D	D	M		
Central Bank Balance Sheet	4/2012	5/15/2012	M	M	M		
Consolidated Balance Sheet of the Banking System	4/2012	5/15/2012	M	M	M		
Interest Rates ²	5/29/2012	5/30/2012	D	D	M		
Consumer Price Index	4/2012	5/10/2012	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	4/30/2012	5/25/2012	M	M	M	O, LO, LO, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	4/30/2012	5/25/2012	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	4/30/2012	5/25/2012	M	M	M		
External Current Account Balance	4/ 2012	5/25/2012	M	M	M	O, LO, LO, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	4/ 2012	5/25/ 2012	M	M	M		
GDP/GNP	Q1 2012	May 2012	Q	Q	Q	O, LO, O, O	O, LO, O, O, LO
Gross External Debt	Q4 2011	3/21/2012	Q	Q	Q		

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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

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

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



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/72
FOR IMMEDIATE RELEASE
July 6, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Ukraine

On June 29, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ukraine.¹

Background

Ukraine had a strong economic recovery in 2010–11, following the deep recession ensuing from the 2008–09 global crisis. However, recovery is now slowing. Lower demand for Ukraine's exports and slow credit growth are weighing on economic growth, which is projected at 3 percent this year. Inflation is projected to rise to 7.4 percent during the year, reflecting wage pressures and rising food prices. Weakening external demand is expected to widen the current account deficit to 6.5 percent of GDP.

Risks remain elevated in an uncertain global environment. A significant contraction in global demand, commodity price shocks, or deleveraging by European banks would pose risks to external stability given Ukraine's high external financing requirements.

Following a 3.1 percent of GDP government deficit improvement in 2011, the fiscal position is now under pressure. Public debt fell from 41 to 36 percent in 2011 and pension reform

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

improved medium-term fiscal prospects. This year, a supplementary budget has increased wage and pension expenditures and absent increased revenue collection to finance this, staff projects the general government deficit at 3¼ percent of GDP, compared to a target of 1.8 percent. The state-owned gas company's deficit is projected to reach 2 percent of GDP this year, adding to the weight of the general government deficit on public finances.

The current tight monetary stance aims at addressing external risks and containing inflation. However, this combined with deleveraging by banks has constrained credit growth. Liquidity tightening as well as prudential and administrative measures have contributed to exchange rate stability.

Banking sector reforms have advanced although balance sheets remain weak. The banking system appears well capitalized. Nonetheless, profitability is near zero, nonperforming loans remain high, and banks balance sheets remain exposed to currency movements. Measures have also been taken to deregulate the economy and to simplify the tax and customs codes that have the potential to improve the business environment.

Executive Board Assessment

Executive Directors welcomed the progress made by Ukraine since the 2008–09 crisis, including the rebound in growth, and the decline in inflation and in the general government deficit. Directors also commended the authorities' efforts to advance several reforms, particularly the approval of the pension law and the new tax and customs codes. They noted, however, that the country faces lingering vulnerabilities due to low reserve cover, large external and fiscal funding needs, and the difficult external environment. Directors stressed the need for strengthened policies and reforms to reduce these vulnerabilities, build buffers for domestic and external stability, and improve medium-term growth prospects.

Directors underscored that fiscal consolidation remains a priority. They welcomed the authorities' determination to meet the 2012 deficit target and encouraged them to identify quickly contingency measures to safeguard against possible shortfalls. Over the medium term, continued efforts will be needed to strengthen public revenue, reform the public sector, and reorient spending towards growth-enhancing priorities.

Directors stressed that a comprehensive reform of the energy sector is critical to reduce the strain on the budget and gain energy independence. They urged the authorities to gradually increase gas and heating tariffs and enhance payment compliance. Increases in domestic energy prices will be essential to bring supply and demand into balance, alongside increased investment in domestic energy production. Energy efficiency improvements and better-targeted subsidies to protect the poorest should also be important components of the energy sector strategy.

Directors advised that monetary policy should focus more on price stability. They noted that a tighter monetary stance would be warranted if balance of payments or inflationary pressures intensify. Directors concurred that gradually increasing exchange rate flexibility would help mitigate external shocks, strengthen reserves, and preserve competitiveness. Increased flexibility should be supported by efforts to reduce balance sheet mismatches in the financial sector, along with fiscal, monetary and wage policies consistent with maintenance of price stability.

Directors welcomed the progress made in the banking sector. They urged the authorities to address the remaining weaknesses, notably the high level of non-performing loans, low profitability, and currency mismatches, to allow the sector to fully support economic growth. Directors welcomed the plans to reduce banking system exposure to foreign exchange risks, including through limited sales to banks of foreign currency linked bonds issued by the government. More broadly, Directors encouraged the authorities to press ahead with their efforts to unwind crisis era policies.

Directors welcomed progress under the President's Economic Reform Plan which aims at promoting growth, improving the business climate, and attracting investment. Achieving these objectives will require implementation of comprehensive structural reforms, including stronger governance and further privatization.

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Ukraine: Selected Economic and Social Indicators, 2009–12

	2009	2010	2011	2012 Proj.
Real economy (percent change, unless otherwise indicated)				
Nominal GDP (billions of Ukrainian hryvnias)	913	1,083	1,317	1,473
Real GDP	-14.8	4.1	5.2	3.0
Contributions:				
Domestic demand	-26.4	7.3	11.5	4.1
Consumption	-10.2	5.6	9.2	4.9
Investment	-16.2	1.7	2.3	-0.8
Net exports	11.6	-3.1	-6.4	-1.1
Unemployment rate (ILO definition; percent)	8.8	8.1	7.9	7.8
Consumer prices (period average)	15.9	9.4	8.0	3.8
Consumer prices (end of period)	12.3	9.1	4.6	7.4
Core inflation (period average) 1/	19.4	8.6	7.7	5.2
Core inflation (end of period) 1/	14.9	7.9	6.9	5.3
Nominal monthly wages (average)	5.5	17.7	17.5	13.8
Real monthly wages (average)	-8.9	7.6	8.8	9.6
Public finance (percent of GDP)				
General government balance 2/	-6.3	-5.8	-2.7	-3.3
Overall balance (including Naftogaz operational deficit)	-8.7	-7.4	-4.2	-5.3
Cyclically-adjusted general government balance 3/	-2.6	-3.1	-2.3	-3.3
Structural general government balance	-2.6	-3.1	-2.3	-3.8
Public debt (end of period) 4/ 5/	35.4	40.5	36.0	34.7
Money and credit (end of period, percent change)				
Base money	4.4	15.8	6.3	4.0
Broad money	-5.5	22.7	14.7	5.8
Credit to nongovernment	-2.2	1.1	9.5	1.9
Velocity	1.9	1.8	1.9	2.0
Interbank overnight rate (annual average, percent) 6/	12.6	3.4	7.1	2.3
Balance of payments (percent of GDP)				
Current account balance	-1.5	-2.2	-5.5	-6.4
Foreign direct investment	4.0	4.2	4.2	4.6
Gross reserves (end of period, billions of U.S. dollars) 7/	26.5	34.6	31.8	24.4
Months of next year's imports of goods and services	4.3	4.2	3.6	2.6
Percent of short-term debt (remaining maturity)	67.4	71.5	55.2	39.6
Net reserves (end of period, billions of U.S. dollars)	15.5	20.3	17.6	13.6
External debt (percent of GDP)	88.2	86.0	76.4	69.8
Goods exports (annual volume change in percent)	-24.2	9.3	7.1	4.4
Goods imports (annual volume change in percent)	-41.6	18.1	20.3	7.3
Goods terms of trade (percent change)	-13.8	0.3	7.6	-1.3
Exchange rate				
Hryvnia per U.S. dollar, end-of-period 6/	8.0	8.0	8.0	8.0
Hryvnia per U.S. dollar, period average 6/	7.8	7.9	8.0	8.0

	2009	2010	2011	2012 Proj.
Real effective rate (CPI, percent change) 8/	-17.6	6.0	0.1	2.6
Memorandum items:				
Nominal GDP (billions of U.S. dollars)	117.2	136.4	165.2	...
Per capita GDP (2011): \$3,624 (WEO)	Percent of population below poverty line (2006): 8.0			
Quota (2011): SDR 1,372 million (2,166 million U.S. dollars)				

Sources: State Statistics Committee of Ukraine; Ministry of Finance; National Bank of Ukraine; World Bank, *World Development Indicators*; and IMF staff estimates and projections.

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

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

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

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

5/ Other debt creating flows include bonds issued to (i) recapitalize banks in 2009–11, and (ii) settle arrears on VAT refunds in 2010.

6/ Latest data as of end-May, 2012.

7/ Assumes no further Fund disbursements under the SBA program.

8/ Latest data as of end-April, 2012.