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FOR AGENDA

EBS/08/114

November 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Ukraine—Request for Stand-By Arrangement**

Attached for consideration by the Executive Directors is a paper on Ukraine's request for a Stand-By Arrangement, which is tentatively scheduled for discussion on **Wednesday, November 5, 2008**. A draft decision appears on page 32. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Ukraine indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Ms. Pazarbasioglu (ext. 35967) and Mr. Flanagan (ext. 36724) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the European Bank for Reconstruction and Development, the European Commission, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

UKRAINE

Request for Stand-By Arrangement

Prepared by the European Department in Consultation with Other Departments

Approved by Juha Kähkönen and Adnan Mazarei

November 3, 2008

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

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

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

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

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I. Introduction

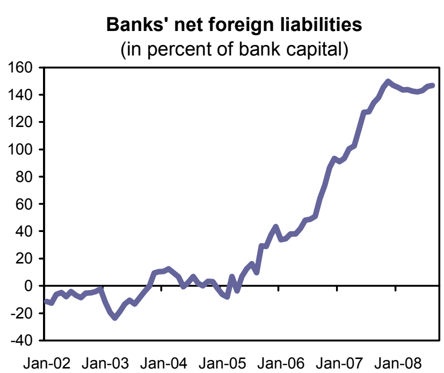
1. **Ukraine's economy has grown very rapidly since 2000;** average growth has been in excess of 7 percent. Initially, this reflected supply-side factors: utilization of large excess capacity and productivity gains built on a host of structural reforms. Since 2005, real demand growth averaged about 15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

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

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

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

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



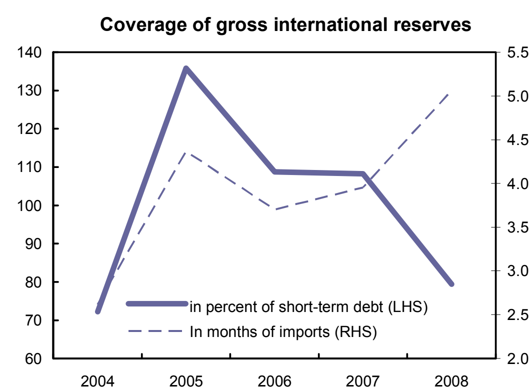
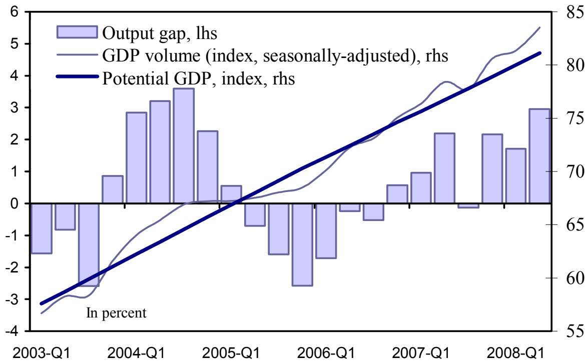
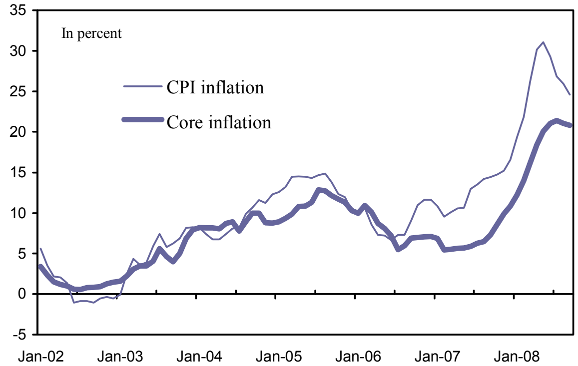


Figure 1. Ukraine: Recent macroeconomic developments

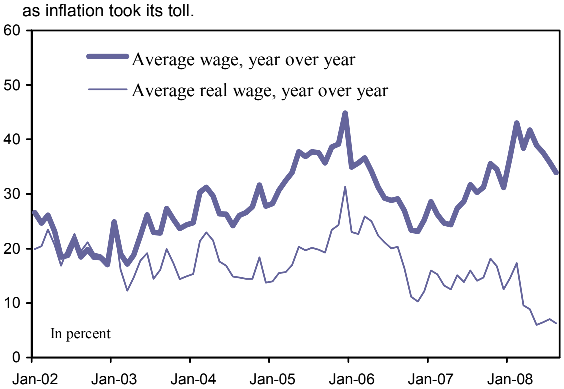
The economy has been showing signs of overheating since the beginning of 2007.



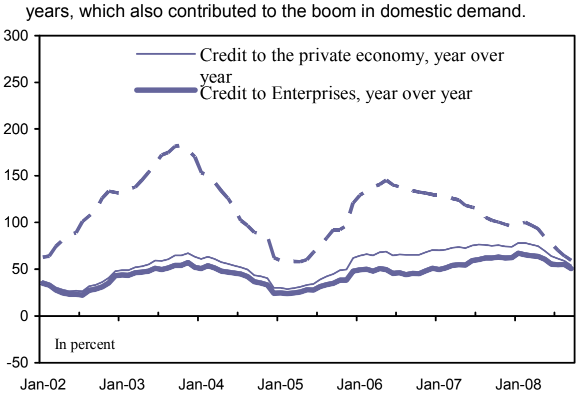
Inflation increased sharply, in part due to unfavorable supply shocks, to reach over 30 percent in early 2008.



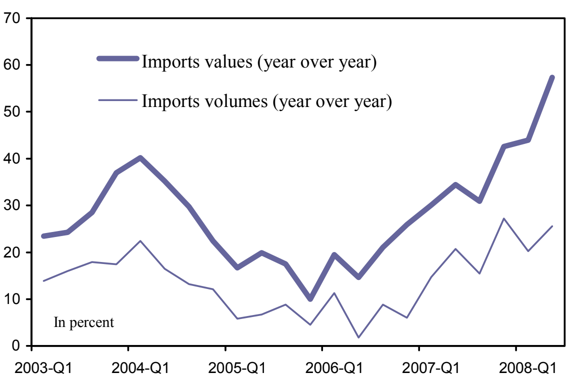
Nominal wages accelerated markedly. Real wage decelerated of late, as inflation took its toll.



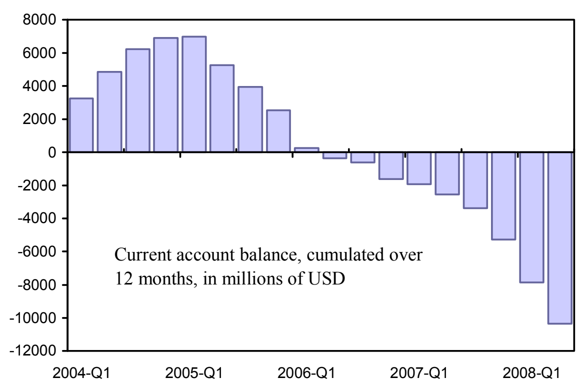
Annual credit growth has averaged 70 percent in the last three years, which also contributed to the boom in domestic demand.



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

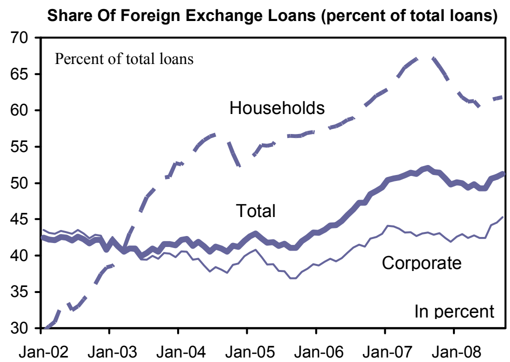


Against this background, the current account balance has worsened rapidly.

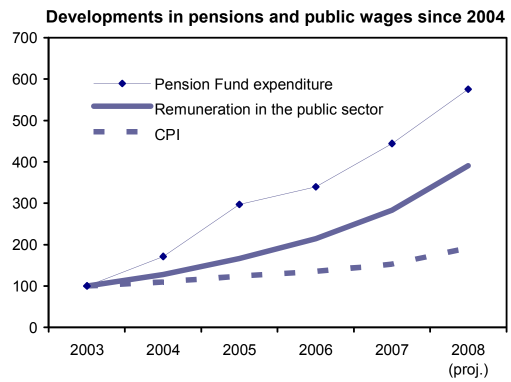


Sources: Ukrainian authorities; IMF *World Economic Outlook;* OECD; and staff estimates.

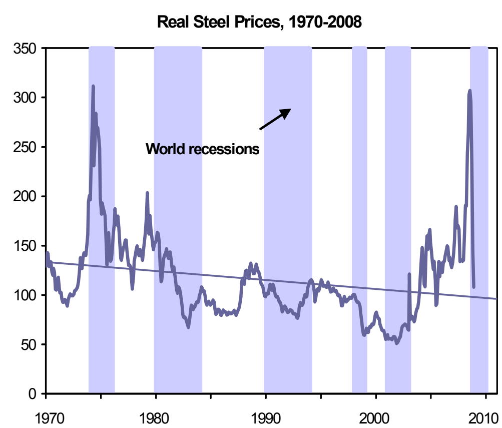
- **Household and corporate balance sheets** weakened, with increased borrowing from banks in foreign currency, encouraged by low interest rates and a rigidly managed exchange rate regime. Many corporates, however, are thought to be hedged by large export revenues and significant (and under reported)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



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



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



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

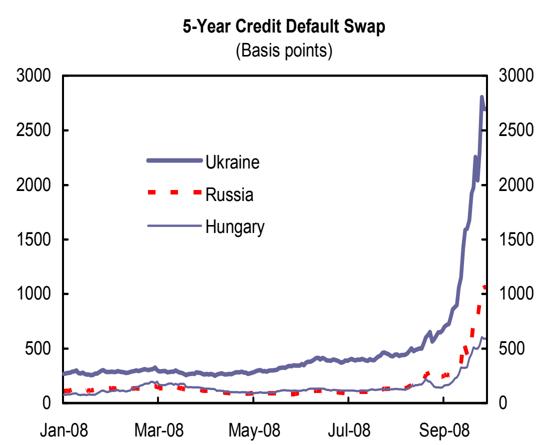
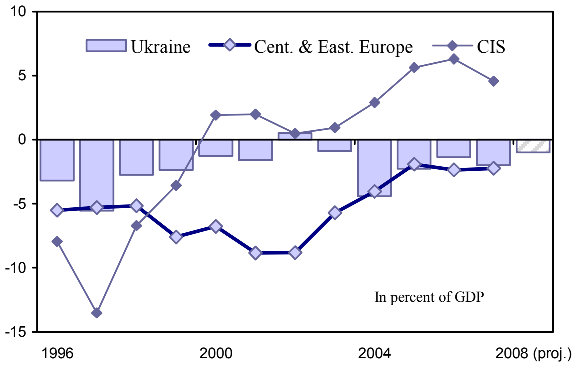
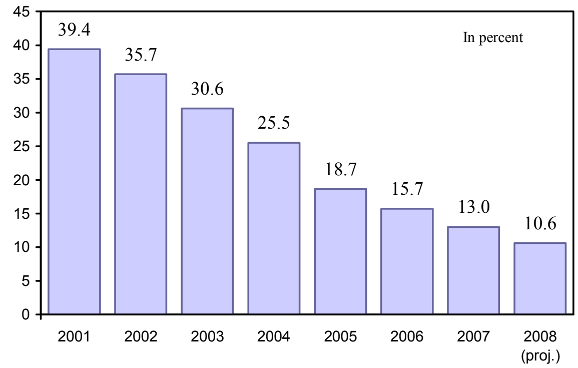


Figure 2. Ukraine: Fiscal Policy Indicators

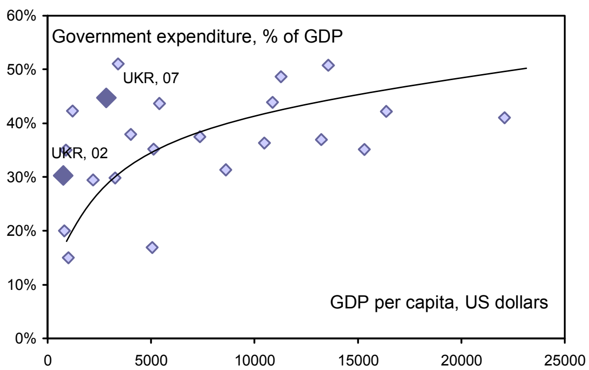
A long history of low government deficits ...



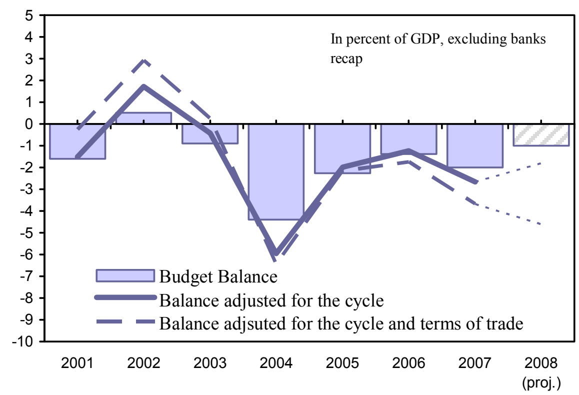
… has given Ukraine one of the lowest public debt levels among CEE and CIS economies.



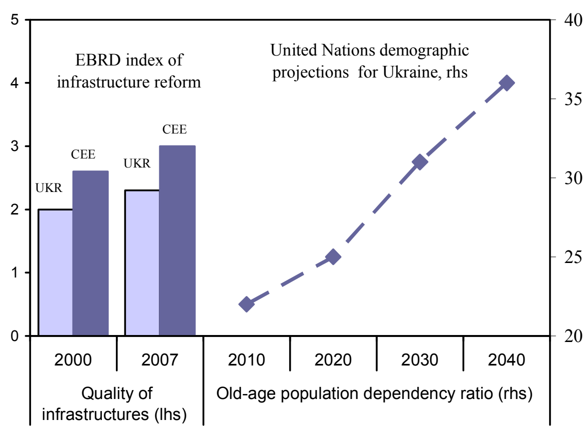
… But rapid revenue growth has been used to finance a large increase in the size of the government.



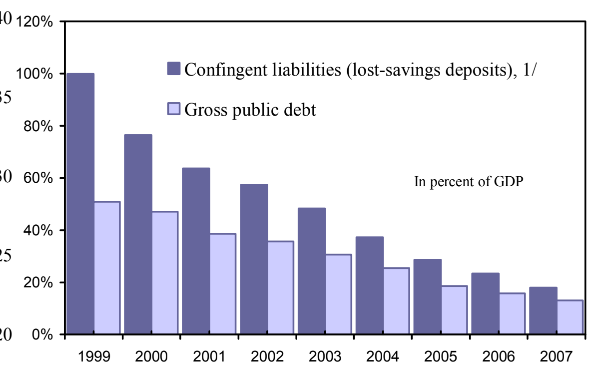
And fiscal policy has recently tuned expansionary.



Looming expenditures on pension and infrastructures further cloud the picture...



… as does a significant outstanding stock of contingent liabilities.



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

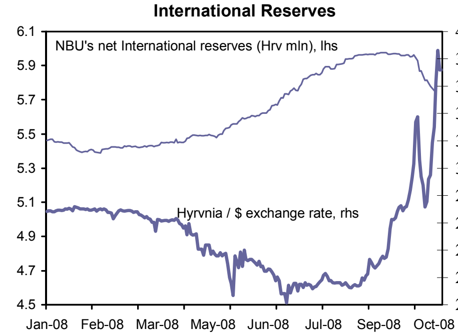
exceed 4,000 bps. Fitch and S&P have both downgraded Ukraine (keeping it on negative outlook), while Moody's has also just downgraded a number of Ukrainian enterprises, and placed the sovereign on negative outlook.

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

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

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

HRV / $ Exchange Rate and NBU's International Reserves



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

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

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

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

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

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

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

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

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

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

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

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

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

12. Limitation on hryvnia transactions by non-resident banks to export-import operations.

Source: NBU Resolutions 319, 328 and 336.

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

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

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

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

Under expected adverse macroeconomic conditions in 2009, current capital buffers are likely to be fully absorbed by the deterioration in banks' portfolios. A drop in real GDP growth of 9 percent, a nominal depreciation of the Hrv of 30 percent, high interest rates, and a sharp drop in real prices, will result in a sharp increase of bad loans (category 5 loans), which are estimated to rise to 15 percent by end 2009 (in mid-2008, they stood at 1 percent). As a result, the capital buffers of most banks would be wiped out.

The required capital injection to return to minimum CAR levels is estimated to be about Hrv 78 bn, corresponding to over 8 percent of 2008 GDP (Hrv 34 bn for domestic banks and 44 bn for foreign banks). The large impact on banks' portfolio is the result of several risk factors including (i) over 85 percent of retail loans are denominated in foreign currency, of which the majority are to unhedged borrowers; (ii) the high concentration of corporate loans in sectors which are expected to suffer a large contraction in 2009; and (iii) a large external debt rollover risk for the corporate sector in the amount of $30 bn in 2009 (Table).

Table. Ukraine: Bank Scenario Analysis

	Baseline scenario				Soft landing scenario				Hard landing scenario			
	Capital injection to return to Oct. '08 CAR		Capital injection to meet 10% CAR		Capital injection to return to Oct. '08 CAR		Capital injection to meet 10% CAR		Capital injection to return to Oct. '08 CAR		Capital injection to meet 10% CAR	
	Hrv bn	As percent of '08 GDP	Hrv bn	As percent of '08 GDP	Hrv bn	As percent of '08 GDP	Hrv bn	As percent of '08 GDP	Hrv bn	As percent of '08 GDP	Hrv bn	As percent of '08 GDP
All banks	104	10.8	78	8.1	66	6.8	41	4.2	140	14.5	115	11.9
Domestic	47	4.9	34	3.5	30	3.1	17	1.8	51	5.3	51	5.3
Large	36	3.8	30	3.1	23	2.4	17	1.7	43	4.4	43	4.4
Small	11	1.2	5	0.5	7	0.7	1	0.1	9	0.9	9	0.9
Foreign	56	5.8	44	4.5	36	3.7	24	2.5	64	6.6	64	6.6
Large	49	5.1	41	4.3	31	3.3	24	2.5	59	6.1	59	6.1

Source: NBU and staff estimates. Large banks (34 institutions) account for 81percent of total system assets.

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

II. The Authorities' Program

A. Objectives and Strategy

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

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

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

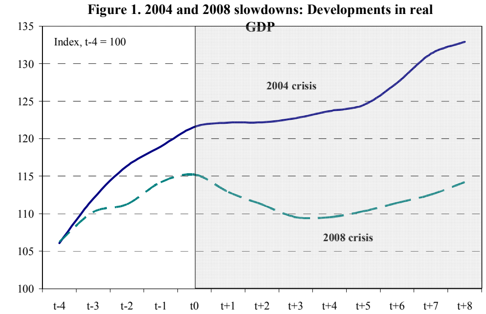
B. Macroeconomic Framework

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

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

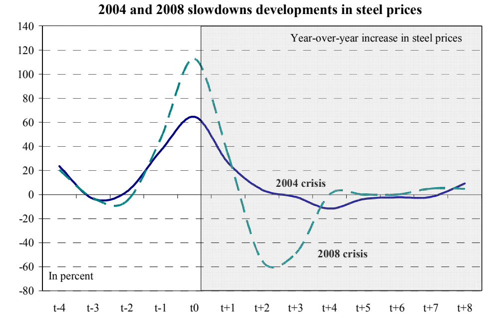
Ukraine experienced a sharp economic slowdown earlier in the decade. In late 2004, as the Orange revolution gathered steam, political instability led the country close to a financial crisis. A run on the banking system and currency took place and, over two months, 13 percent of system wide deposits were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

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



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

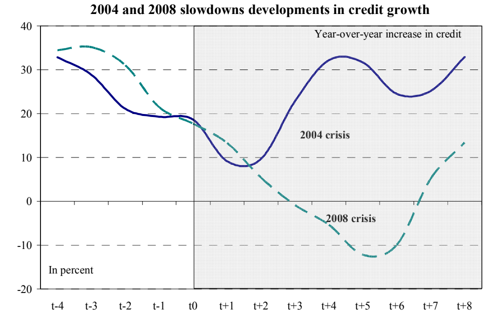
2004 and 2008 slowdowns developments in steel prices



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

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

2004 and 2008 slowdowns developments in credit growth



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

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

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

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

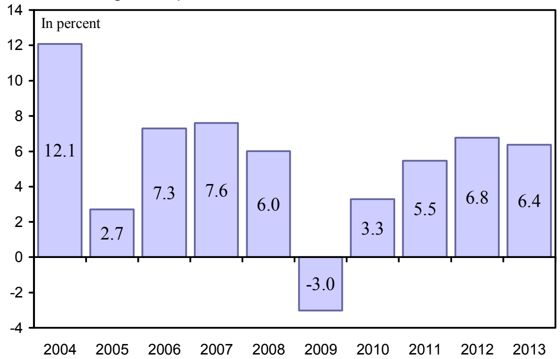
C. The Program for 2009

Monetary and Exchange Rate Policy

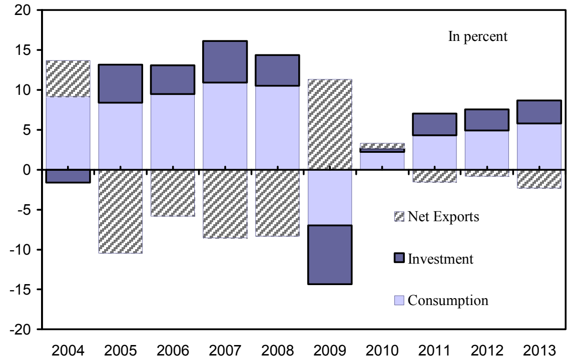
14. **The program supports implementation of a flexible exchange rate regime** (MEFP ¶8)**.** The authorities introduced the first steps toward a managed float in March 2009, and agree that greater exchange rate flexibility will help them better absorb the external shocks they now face. Other strategies,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

Figure 3. Ukraine: Medium-term outlook

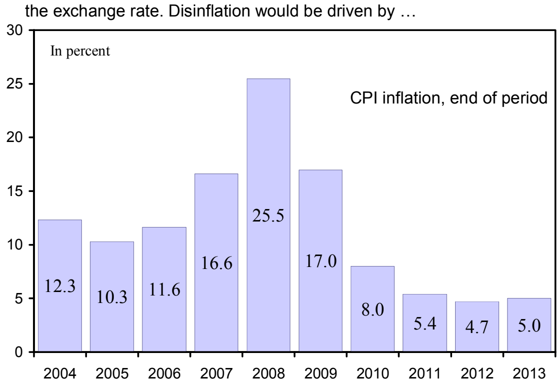
After the 2009 adjustment, real GDP growth would gradually recover and converge to its potential rate.



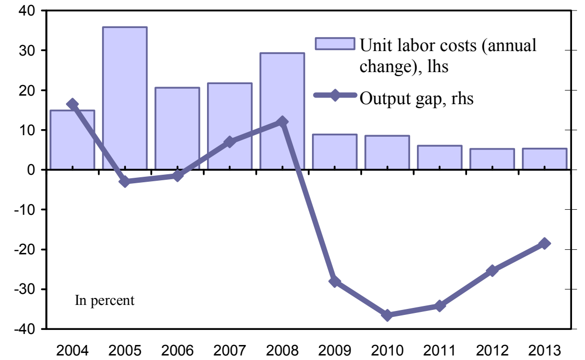
The recovery would initially be driven by net exports, but domestic components, notably investment, would rebound rapidly.



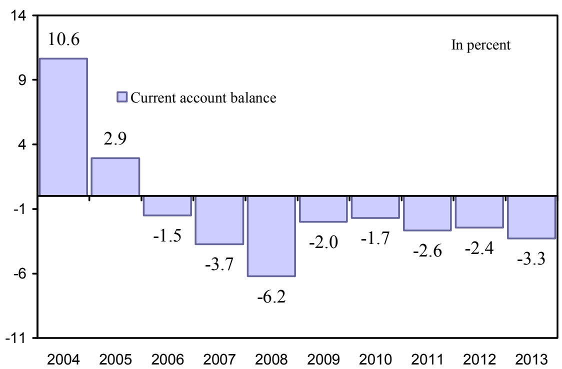
Inflation would decline in 2009, despite the expected depreciation of the exchange rate. Disinflation would be driven by …



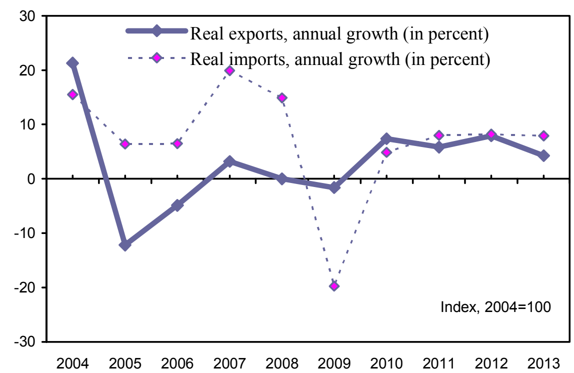
… the opening of a large negative output gap and policies consistent with moderate increases in unit labor costs.



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



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



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

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

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

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

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

Financial sector policy

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

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

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

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

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

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

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

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

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

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

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

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

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

Fiscal policy

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

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

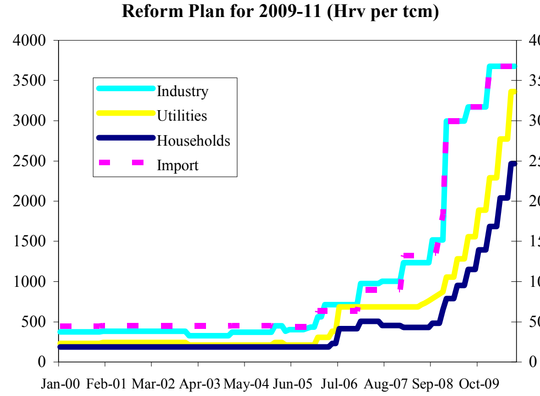
23. **The authorities saw a more balanced incomes policy as key to achieving the fiscal targets** (MEFP ¶16)**.** Implementing existing policy plans would have led to an increase of 33 percent in the minimum wage and 20–34 percent for pensions and other social

payments. Against slow 12 percent nominal GDP growth (due to the terms of trade shock), this would have put heavy pressure on corporate margins (where the minimum wage often binds, at least for tax purposes) and on the budget (squeezing capital and current spending). The authorities' strategy involves canceling pending increases, adjusting indexation provisions, and delaying convergence of the minimum wage to the subsistence minimum. In sum, these measures would deliver zero real growth of incomes, balancing protection of the population against adjustment (through unit labor costs, since productivity trends are expected to continue). They may need to be continued into 2010 if the shock to Ukraine's terms of trade is long lasting. The absence of such measures would represent a serious risk to program objectives and would not help wage earners: the likely result would be higher inflation and depreciation as the economy endogenously eliminated unsustainable real wage imbalances.

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

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

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



expanded simply by raising the low eligibility threshold and by allocating more funding to these programs.

Ukraine: Various Social Safety Net Programs Currently in Place

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

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

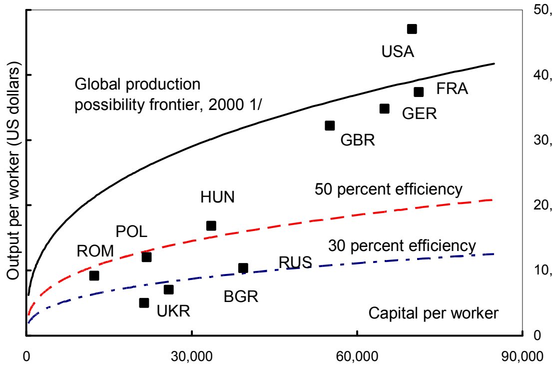
The private sector

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

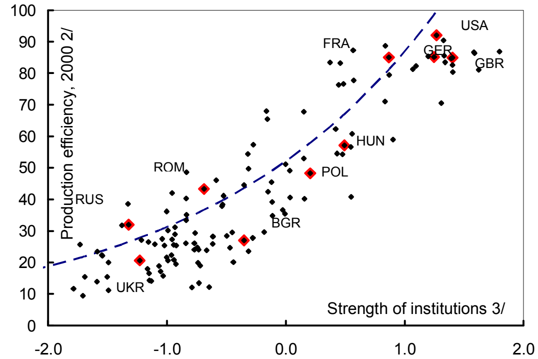
27. **The authorities also saw it as important to reignite structural reforms to spur new investment and growth** (Table 9, Figure 4) (MEFP ¶20). They expected the recently adapted law on joint stock companies to improve the business environment, and signaled a

Figure 4. Ukraine: Potential output and structural reforms

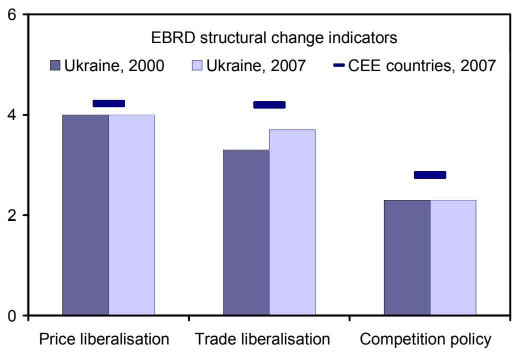
Ukraine's output remains far below its long-term potential, even when compared with other transition economies ...



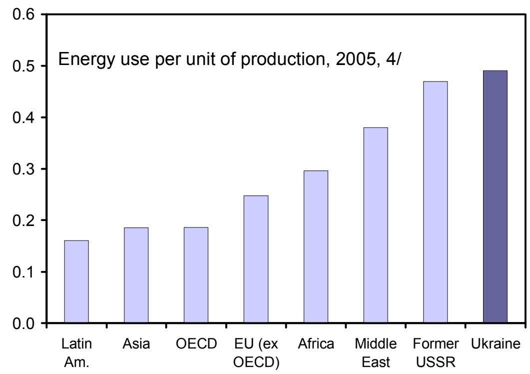
… reflecting, among other things, weak market-supporting institutions ...



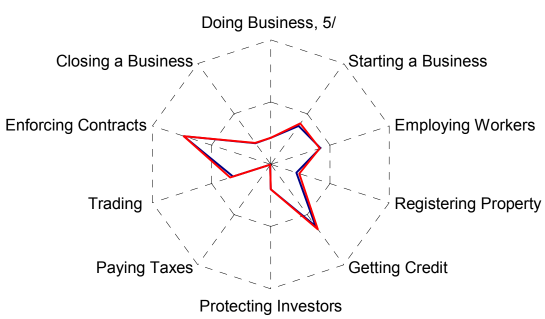
… lagging liberalization reforms ...



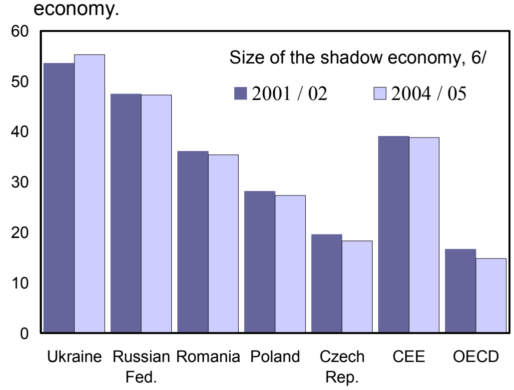
… and enormous energy inefficiency.



The business environment remains difficult, with a particular weakness in the area of tax administration.



This is contributing to a persistently large shadow economy.



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

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

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

III. PROGRAM MODALITIES

Program financing

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

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

	2006	2007	2008	2009	2010
Gross external financing requirements	26,771	40,027	54,460	63,829	62,226
Current account deficit (assumed constant from 2008)	1,617	5,272	*11,686*	*11,686*	*11,686*
Amortization of private sector debt	12,583	18,953	28,762	38,172	39,415
Amortization of public debt	1,692	1,525	1,198	1,448	1,576
Short-term capital outflows	10,880	14,277	12,814	12,523	9,550
Available financing	27,201	40,455	50,105	44,769	50,727
FDI	5,740	9,221	11,659	9,204	10,120
Portfolio flows	2,822	4,423	64	614	1,064
Debt financing	20,680	36,241	38,245	34,233	43,621
Implied rollover rate (percent)	*145*	*177*	*128*	*85*	*106*
Reserve accumulation (- denotes increase)	-1,999	-8,980	138	718	-4,077
Current account adjustment (Cumulative) 1/	0	0	0	8,983	9,153
Remaining financing gap = net use of fund resources	-430	-428	4,355	10,077	2,346
Memorandum items					
Gross Reserves (US$ million)	22,256	32,436	31,445	30,727	34,804
Gross Reserves (in percent of ST debt)	109	108	79	75	78

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

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

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

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

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

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

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

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

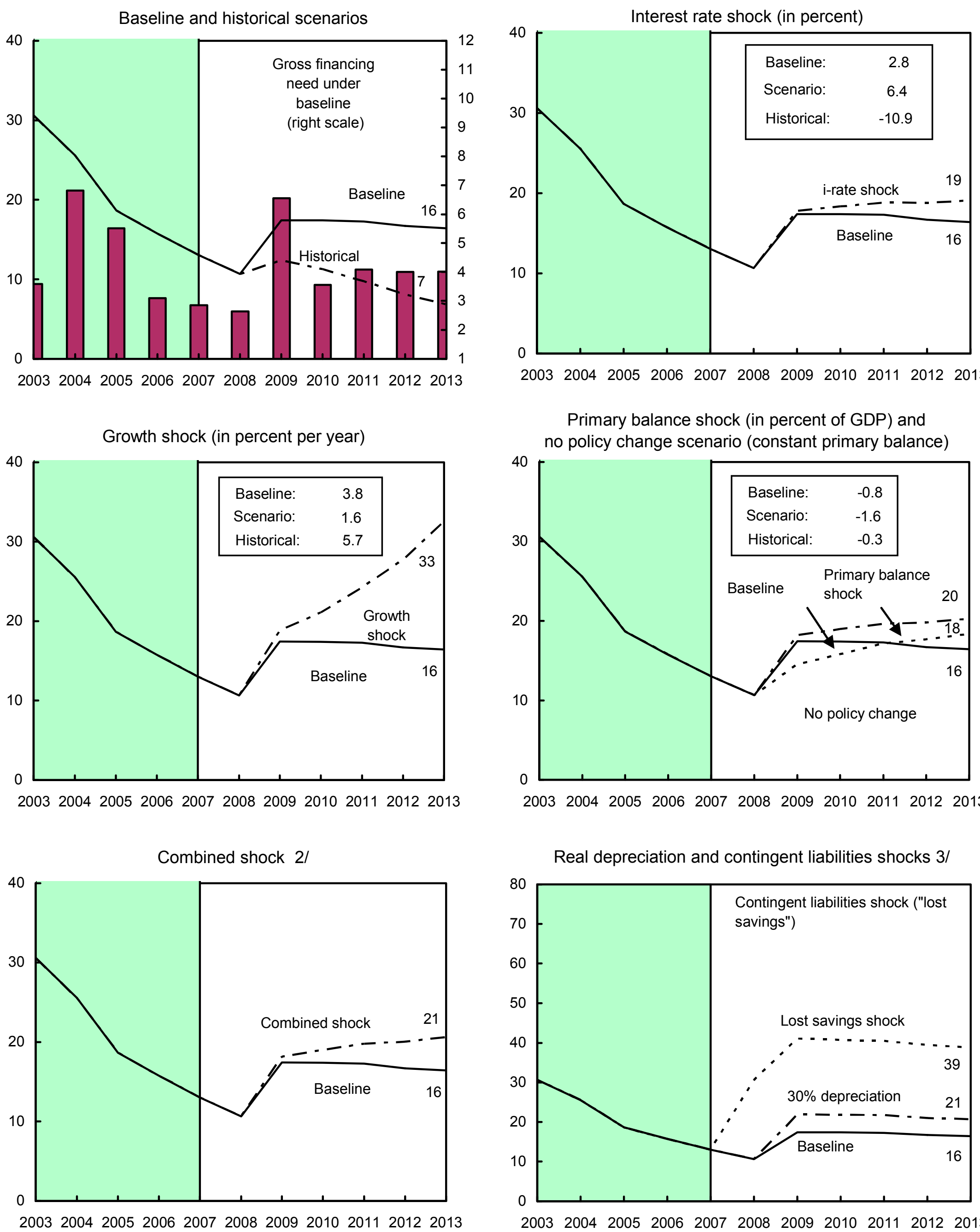
experiencing a capital account crisis, it is also facing a massive terms of trade shock that requires large current account adjustment, as well as substantial problems in the banking sector. The SRF is geared towards "large short-term financing need resulting from a sudden and disruptive loss of confidence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

Box 4. Exceptional Access Criteria

Staff assesses that Ukraine meets the criteria for exceptional access:

- **Criterion 1—exceptional balance of payments pressure in the capital account.** Ukraine is experiencing both a current and a capital account crisis. The current account is under tremendous pressure due to adverse terms-of-trade developments, and the capital account is being undermined by external financing shortfalls, exacerbated by a banking crisis and related deposit run.
- **Criterion 2—sustainable debt position.** Preliminary calculations by staff indicate that there is a high probability that debt will remain sustainable. Total external debt, at about 50 percent of GDP in 2008, will initially rise due to valuation effects. However, thereafter, external debt is projected to show very favorable dynamics as the current account adjusts and access to debt financing remains curtailed. Stress tests show that external debt would remain sustainable under a variety of shocks, although it would remain at higher levels in the event of substantial further shocks to the current account. Ukraine's low public debt—less than 10 percent of GDP—allows the government to absorb considerable foreign and domestic liabilities, particularly from the banking sector, without threatening fiscal sustainability (Tables 10–11, Figures 5–6).
- **Criterion 3—access to private capital markets.** Ukraine has reasonable prospects to regain access to private capital markets by mid 2010. Global credit-crisis uncertainties notwithstanding, the program would restore the banking sector to health (eliminating a major impetus to outflows), end currency overvaluation, restore competitiveness and unlock investment opportunities (all encouragements for FDI).
- **Criterion 4—strong policy reform program.** The policies outlined above suggest a reasonably strong prospect for success. The authorities would be taking strong and difficult policy measures, many of which upfront, and tailored directly to Ukraine's problems, as explained above. The upfront package would demonstrate decisively that despite political instability, the authorities have the institutional and political capacity to deliver. The core elements of the program have been explained to the leaders of the main political parties, and they have committed to support them.

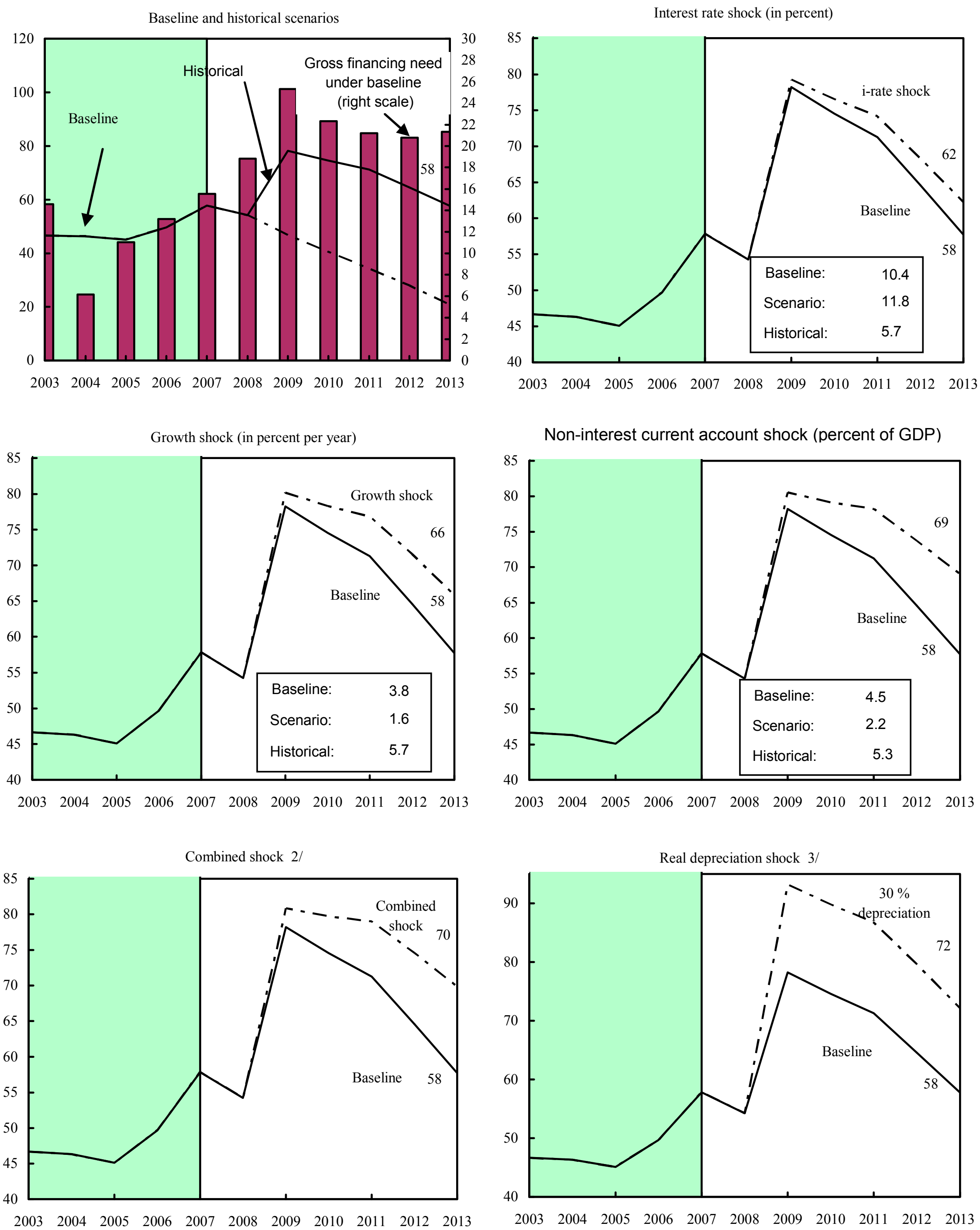
Figure 5. Ukraine: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



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

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

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

Capacity to repay the Fund and financial risks to the program

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

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

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

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

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

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

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

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

Program monitoring

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

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

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

Source: IMF staff calculations.

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

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

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

Monetary and Exchange Rate Policies

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

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

Banking Sector Issues

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

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

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

Fiscal Policies

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

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

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

IV. Staff Appraisal

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

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

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

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

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

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

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

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

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

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

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

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

V. PROPOSED DECISION

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. Ukraine has requested a Stand-By Arrangement in an amount equivalent to SDR 11,000 million for a period from November [5], 2008 through November [4], 2010.

2. The Fund approves the Stand-By Arrangement for Ukraine set forth in EBS/08/114, 11/03/2008 and decides that purchases may be made under the arrangement on the condition that the information provided by Ukraine on the implementation of the measures specified as prior actions in Table 3 of the Memorandum of Economic and Financial Policies attached to the letter from the Minister of Finance, the Governor of the National Bank, the Prime Minister and the President of Ukraine dated October 31, 2008 is accurate.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

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

	2004	2005	2006	2007	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)						
Nominal GDP (billions of hryvnias)	345	441	544	713	993	1,112
Real GDP	12.1	2.7	7.3	7.6	6.0	-3.0
Contributions:						
Domestic demand	9.1	13.2	13.1	16.1	14.4	-14.3
Net exports	3.0	-10.5	-5.8	-8.5	-8.3	11.3
Unemployment rate (ILO definition; percent)	8.6	7.2	6.8	6.4	6.0	9.5
Consumer prices (period average)	9.0	13.5	9.1	12.8	25.6	21.0
Consumer prices (end of period)	12.3	10.3	11.6	16.6	25.5	17.0
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	37.1	10.5
Real monthly wages (average)	16.9	20.4	18.4	15.0	9.1	-8.7
Public finance (percent of GDP)						
Cash balance excluding banks. recap (both injection and interests)	-4.4	-2.3	-1.4	-2.0	-1.0	0.0
Augmented balance, including effects of banks recap. 3/	-4.4	-2.3	-1.4	-2.0	-2.0	-4.5
Privatization proceeds	3.1	5.0	0.4	0.6	0.2	0.1
Net domestic financing	-0.1	-3.3	-0.4	0.3	1.8	4.4
Net external financing	1.4	0.6	1.3	1.0	0.0	0.0
Public debt 3/	25.5	18.7	15.7	13.0	10.6	17.4
Of which: external debt (foreign currency denominated)	19.2	14.1	12.5	10.2	7.4	10.0
Money and credit (end of period, percent change)						
Base money	34.1	53.9	17.5	46.0	33.0	10.9
Broad money	31.9	54.4	34.5	51.7	37.2	9.4
Credit to nongovernment	30.2	61.8	70.6	74.0	40.9	-9.8
Velocity	2.7	2.3	2.1	1.8	1.8	1.9
Interbank overnight rate (annual average, percent)	6.3	4.2	3.6	2.3	…	…
Balance of payments (percent of GDP)						
Current account balance	10.6	2.9	-1.5	-3.7	-6.2	-2.0
Foreign direct investment	2.6	8.7	5.3	6.5	6.2	6.8
Gross reserves (end of period, billions of U.S. dollars)	9.5	19.4	22.3	32.4	31.4	30.7
In months of next year's imports of goods and services	2.6	4.4	3.7	4.0	5.1	4.5
Debt service (in percent of exports of goods and services)	5.3	4.9	5.1	3.9	2.8	4.2
Goods exports (annual volume change in percent)	18.2	-8.5	2.7	3.2	0.3	0.8
Goods imports (annual volume change in percent)	13.8	13.0	12.5	20.3	16.0	-19.7
Goods exports	51.5	40.7	36.1	35.2	35.3	39.9
Goods imports	45.8	42.0	40.9	42.7	44.8	46.4
Share of metals in merchandise exports (percent)	39.0	40.1	42.2	41.7	44.5	30.3
Net imports of energy (billions of U.S. dollars)	6.0	6.1	8.1	11.5	17.2	16.0
Goods terms of trade (percent change)	9.6	6.2	-0.2	9.0	7.8	-14.5
Goods and services terms of trade (percent change)	7.8	4.9	1.5	7.4	8.9	-10.5
Exchange rate						
Exchange rate regime		*de facto peg*			*managed float*	
Hryvnia per U.S. dollar, end of period	5.3	5.0	5.0	5.0	…	…
Hryvnia per U.S. dollar, period average	5.3	5.1	5.1	5.0	…	…
Real effective rate (CPI, percent change)	-1.4	12.0	4.8	2.6	…	…

Social indicators

Per capita GDP: US$ 2,282 (2006); Poverty (percent of population): 8.0 (2006; World Bank estimate);
Life expectancy at birth: 68.2 years (2006); Infant mortality (per 1,000): 16.0 (2005); Gross primary enrollment (percent net): 84 (2005)

Sources: Ukrainian authorities; and staff estimates and projections.

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

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

	2004	2005	2006	2007	2008	Latest observation
Financial Market Indicators						
Short-term (ST) interest rate (in percent) 1/	16.3	2.9	2.1	3.8	15.0	24-Oct-08
EMBI secondary market spread (bps, end of period)	264	184	172	303	2,250	24-Oct-08
Foreign currency debt rating 2/	B1	B1	B1	B1	B1	24-Oct-08
Exchange rate NC/US$ (end of period)	5.3	5.1	5.1	5.1	5.9	24-Oct-08
Stock market index (PFTS)	260.1	353.0	498.9	1,174.0	230.9	24-Oct-08
Broad money to gross reserves (percent)	249.1	198.2	232.3	241.7	224.6	24-Oct-08
External Sector						
Exchange rate regime	de facto peg to U.S. dollar				managed float	
Current account balance (percent of GDP)	10.6	2.9	-1.5	-3.7	-6.2	Proj
Net FDI inflows (percent of GDP)	2.6	8.7	5.3	6.5	6.2	Proj
Exports (percentage change of US$ value, GNFS)	40.8	4.8	11.2	28.0	33.4	Proj
Real effective exchange rate (percent change) 3/	-1.4	12.0	4.8	2.6	12.2	Proj
Gross international reserves (GIR) in US$ billion	9.5	19.4	22.3	32.4	31.4	Proj
GIR in percent of ST debt at remaining maturity (RM)	87.4	161.0	108.7	108.3	79.4	Proj
GIR in percent of ST debt at RM and banks' FX deposits	57.3	92.0	79.0	84.7	57.3	Proj
Net international reserves (NIR) in US$ billion	8.0	18.2	21.4	32.0	26.7	Proj
Total gross external debt (ED) in percent of GDP 4/	46.3	45.1	49.7	57.8	54.3	Proj
o/w ST external debt (original maturity, in percent of total ED)	35.0	28.2	28.4	27.5	29.6	Proj
ED of domestic private sector (in percent of total ED)	57.2	65.2	72.3	81.0	80.9	Proj
ED to foreign official sector (in percent of total ED)	17.8	16.2	11.0	7.4	6.0	Proj
Domestically issued public debt held by non-residents (in percent of GDF	0.6	1.5	0.6	0.6	0.3	Proj
Total gross external debt in percent of exports of GNFS	74.4	87.1	106.8	128.0	121.4	Proj
Gross external financing requirement (in US$ billion)	6.4	14.1	16.2	18.7	26.4	Proj
Public Sector (PS) 6/						
Overall balance (percent of GDP)	-4.4	-2.3	-1.4	-2.0	-2.0	Proj
Debt-stabilizing primary balance (percent of GDP) 5/	-5.9	-5.4	-2.9	-3.4	-3.0	Proj
Gross PS financing requirement (in percent of GDP) 7/	7.6	3.6	2.4	3.0	3.1	Proj
Public sector gross debt (PSGD, in percent of GDP) 8/	25.5	18.7	15.7	13.0	10.6	Proj
o/w Exposed to rollover risk (in percent of total PSGD)	42.8	51.1	54.2	56.4	52.9	Proj
Exposed to exchange rate risk (in percent of total PSGD)	75.2	75.6	79.1	78.6	69.3	Proj
Public sector net debt (in percent of GDP)	23.3	13.9	11.7	10.3	9.2	Proj

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

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

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

	2000	2006	2007	2008	2009	2010	2011	2012	2013
Current account balance	1,481	-1,617	-5,272	-11,686	-2,703	-2,534	-4,352	-4,564	-6,969
Merchandise trade balance	779	-5,194	-10,572	-17,779	-8,725	-7,829	-8,584	-9,609	-11,017
Exports	15,722	38,949	49,840	66,490	54,201	61,591	68,138	75,001	81,985
Imports	-14,943	-44,143	-60,412	-84,269	-62,926	-69,420	-76,722	-84,610	-93,002
Services (net)	796	2,126	2,420	3,475	5,419	5,843	5,332	6,556	4,933
Receipts 2/	3,800	11,290	14,161	17,669	17,072	18,110	18,430	20,774	20,321
Payments	-3,004	-9,164	-11,741	-14,194	-11,653	-12,267	-13,098	-14,218	-15,388
Income (net)	-942	-1,722	-659	-1,311	-3,606	-5,138	-6,098	-6,944	-6,781
o/w: Interest on public debt 3/	-655	-892	-1,001	-1,144	-1,555	-1,896	-1,894	-1,913	-1,870
Current transfers (net)	848	3,173	3,539	3,928	4,209	4,590	4,998	5,432	5,896
Financial and capital account	-690	4,088	15,130	7,193	-8,092	4,265	9,439	14,103	18,020
Direct investment and capital transfers (net)	586	5,740	9,221	11,659	9,204	10,120	11,089	12,573	13,777
Portfolio investment (excluding government bonds)	-195	2,822	4,423	64	614	1,064	1,464	2,164	2,564
Bonds and medium and long-term loans (net)	-87	6,406	15,763	8,284	-5,386	2,630	4,480	5,999	7,472
Private sector loans	271	5,797	13,931	8,757	-5,380	2,420	3,320	4,120	4,920
Bonds and loans (official)	-358	609	1,832	-473	-6	210	1,160	1,879	2,552
o/w: Disbursements	179	3,239	4,244	389	1,351	1,786	2,497	2,682	3,099
Repayments 2/ 3/	-537	-2,630	-2,412	-862	-1,358	-1,576	-1,337	-802	-547
o/w: Foreign-currency	...	1,158	1,654	-203	119	-29	885	1,435	2,135
Domestic -currency	...	-549	178	-270	-125	239	275	444	417
Short-term capital (net)	-994	-10,880	-14,277	-12,814	-12,523	-9,550	-7,594	-6,633	-5,793
Errors and omissions	-150	-42	-450	0	0	0	0	0	0
Overall balance	641	2,429	9,408	-4,493	-10,795	1,731	5,087	9,538	11,051
Gross official reserves (- is increase)	-398	-1,999	-8,980	138	718	-4,077	-5,087	-5,432	-3,182
Net use of IMF resources	-604	-430	-428	4,355	10,077	2,346	0	-4,106	-7,869
Memorandum items:									
Total external debt 3/	19,880	53,633	81,939	102,128	106,171	111,566	117,067	120,470	121,922
Total external debt (In percent of GDP)	63.6	49.7	57.8	54.3	78.2	74.6	71.3	64.6	57.7
Current account (in percent of GDP)	4.7	-1.5	-3.7	-6.2	-2.0	-1.7	-2.6	-2.4	-3.3
Excluding transfers	2.0	-4.4	-6.2	-8.3	-5.1	-4.8	-5.7	-5.4	-6.1
Debt service ratio (in percent of exports of goods and services) 2/ 3/		5.1	3.9	2.8	4.2	4.4	3.7	7.1	10.1
o/w: Interest payments	3.4	1.8	1.6	1.4	2.2	2.4	2.2	2.0	1.8
Gross international reserves (end of period)	1,505	22,256	32,436	31,445	30,727	34,804	39,891	45,323	48,505
In months of next year's imports of goods and services	0.9	3.7	4.0	5.1	4.5	4.6	4.8	5.0	4.9
Over next year's official debt service	0.8	5.8	-13.8	10.5	8.9	10.8	5.8	4.4	...
Merchandise export values (percent change)	19.2	11.2	28.0	33.4	-18.5	13.6	10.6	10.1	9.3
Merchandise import values (percent change)	15.4	22.1	36.9	39.5	-25.3	10.3	10.5	10.3	9.9
Merchandise export volume (percent change)	16.5	2.7	3.2	0.3	0.8	10.7	8.0	7.6	6.9
Merchandise import volume (percent change)	3.5	12.5	20.3	16.0	-19.7	5.0	8.3	8.3	8.0
Goods terms of trade (percent change)	-8.2	-0.2	9.0	7.8	-14.5	-2.3	0.4	0.5	0.4
Goods and services terms of trade (percent change)		1.5	7.4	8.9	-10.5	-0.2	0.9	0.8	0.8

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

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

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

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

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

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

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

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08
Ownership								
Number of banks	170	173	173	174	175	176	178	197
Private	168	171	171	172	173	174	176	195
Domestic	133	131	129	128	126	127	127	145
Foreign	35	40	42	44	47	47	49	50
o/w: 100% foreign-owned	13	18	17	16	17	17	18	18
State-owned	2	2	2	2	2	2	2	2
Foreign-owned banks' share in statutory capital	27.6	29.8	32.8	35.0	35.0	36.7	40.5	39.8
Concentration								
Share of assets of largest 10 banks	52.4	53.0	52.5	51.6	49.7	49.8	49.4	...
Share of assets of largest 25 banks	74.3	74.6	75.4	75.2	75.2	75.0	74.9	...
Number of bank with assets less than $150 million	109	113	100	97	85	86	83	...
Capital Adequacy								
Regulatory capital to risk-weighted assets	14.2	14.0	14.0	13.9	13.9	13.3	13.4	13.6
Capital to total assets	13.3	12.9	12.4	12.5	12.5	13.1	12.9	13.0
Asset Quality								
Credit growth (year-over-year)	70.7	73.0	75.6	75.1	74.1	76.2	64.1	54.1
Credit to GDP ratio	45.2	47.7	51.6	55.6	60.1	62.7	60.8	63.1
Change of loan to GDP ratio (percentage points)	12.6	13.3	14.3	14.6	14.9	15.0	9.2	9.3
NPLs to total loans 1/ 2/	17.8	17.6	16.5	14.8	13.2	13.1	13.6	14.5
NPLs (excl. part of timely serviced substandard loans) 1/ 3/	4.2	4.2	3.7	3.3	3.2	3.2	3.7	3.6
NPLs net of provisions to capital	93.6	99.1	94.2	82.2	72.9	70.6	74.4	78.1
Specific provisions to NPLs 4/	23.1	20.8	23.7	25.9	26.3	26.7	26.3	26.0
Specific provisions to total loans	4.8	4.7	4.7	4.5	4.2	4.1	4.1	4.3
Foreign Exchange Rate Risk								
Loans in foreign currency to total loans	49.4	50.8	51.2	51.5	49.8	49.4	49.3	51.2
Deposits in foreign currency to total deposits	38.1	38.8	36.5	34.6	32.1	33.1	32.5	31.8
Foreign currency loans to foreign currency deposits	173.3	183.7	206.0	220.8	237.2	238.8	245.5	269.2
Total net open positions in foreign currency to regulatory capital	8.4	9.3	9.1	8.7	7.0	7.7	7.7	7.1
Banks net foreign assets to capital	-93.4	-100.5	-127.1	-137.7	-147.1	-143.8	-143.2	-160.7
Total foreign currency assets (incl. loans) to total foreign currency liabilities (incl. deposits)	106.3	108.3	106.4	107.6	105.3	106.3	107.7	107.5
Total short-term foreign currency assets (incl. loans) to total short-term foreign currency liabilities (incl. deposits)	158.6	149.7	129.7	131.5	115.6	130.7	133.6	158.5
Liquidity Risk								
Liquid assets to total assets	12.6	11.4	11.8	11.0	10.3	8.9	9.2	8.9
Customer deposits to total loans to the economy	74.9	71.2	67.9	67.2	65.3	62.4	61.8	59.8
Long-term assets to long-term liabilities	89.7	91.0	93.4	94.7	95.3	93.7	93.5	92.3
Short-term assets to short-term liabilities	120.6	118.2	112.9	110.7	110.0	114.2	114.2	119.4
Earnings and Profitability								
Return on assets (after tax; end-of-period)	1.6	1.6	1.4	1.4	1.5	1.4	1.3	...
Return on equity (after tax; end-of-period)	13.5	12.7	11.3	11.6	12.7	11.4	11.2	...
Net interest margin to total assets	5.3	4.9	4.9	4.9	5.0	4.8	5.0	...
Interest rate spreads (percentage points; end-of-period)								
Between loans and deposits in domestic currency	7.2	5.9	6.5	5.4	5.8	6.3	7.6	...
Between loans and deposits in foreign currency	5.4	5.6	5.5	5.5	4.9	5.2	8.3	...
Between loans in domestic and foreign currency	3.6	2.5	3.0	2.7	3.2	4.4	5.3	...
Between deposits in domestic and foreign currency	1.8	2.2	1.9	2.8	2.3	3.3	6.0	...
Number of banks not complying with banking regulations								
Not meeting capital adequacy requirements for Tier I capital	0	0	0	1	0	0	0	0
Not meeting prudential regulations	1	0	1	1	1	2	1	2
Not meeting reserve requirements	1	0	0	0	1	0	0	0

Sources: National Bank of Ukraine; and staff estimates.

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

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

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

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

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

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

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

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

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Program scenario					
Output and prices										
Nominal GDP (billions of hryvnias)	345	441	544	713	993	1112	1309	1478	1682	1909
Real GDP growth (percent change)	12.1	2.7	7.3	7.6	6.0	-3.0	3.3	5.5	6.8	6.4
Output gap	3.3	-0.6	-0.3	1.4	2.4	-5.6	-7.3	-6.8	-5.1	-3.7
Real domestic demand growth (percent change)	8.8	15.3	13.8	15.5	12.8	-12.0	2.4	6.5	7.0	8.0
Consumer prices (percent change; end of period)	12.3	10.3	11.6	16.6	25.5	17.0	8.0	5.4	4.7	5.0
Consumer prices (percent change; average)	9.0	13.5	9.1	12.8	25.6	21.0	12.5	6.7	5.1	4.9
Core inflation (end of period) 2/	12.0	13.8	7.2	13.4	22.0	13.1	7.0	5.5	5.0	5.0
Wages										
Minimum wage (percent change; average)	15.5	39.3	21.4	17.9	23.8	16.7	12.5	12.0	11.0	10.5
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	37.1	10.5	11.8	11.3	11.0	11.1
Real monthly wages (average)	17.1	20.4	18.4	15.0	9.1	-8.7	-0.6	4.3	5.7	5.9
Public finances (percent of GDP)										
Augmented balance, including effects of banks recap. 3/	-4.4	-2.3	-1.4	-2.0	-2.0	-4.5	-2.1	-2.1	-2.1	-2.1
p.m. Balance excl. banks recap. (upfront cost and interests)	-4.4	-2.3	-1.4	-2.0	-1.0	0.0	-1.3	-1.3	-1.3	-1.4
Revenue and grants	37.1	41.8	43.7	42.3	42.8	42.2	41.5	41.3	41.3	41.2
Expenditure and net lending (cash basis)	41.5	44.1	45.1	44.3	43.8	42.2	42.8	42.6	42.7	42.5
of which: current expenditure	35.0	39.9	40.5	38.7	38.3	37.2	37.2	36.6	36.3	36.7
Privatization receipts	3.1	5.0	0.4	0.6	0.2	0.1	0.5	0.5	0.5	0.6
Net domestic financing	-0.1	-3.3	-0.4	0.3	1.8	4.4	1.0	0.8	0.9	0.8
Net external financing	1.4	0.6	1.3	1.0	0.0	0.0	0.5	0.7	0.7	0.7
Public debt (in percent of GDP; end of period) 4/	25.5	18.7	15.7	12.5	10.6	17.4	17.4	17.3	16.7	16.4
Domestic	6.3	4.6	3.3	2.7	3.3	7.4	8.0	8.2	8.2	8.2
External (foreign currency denominated)	19.2	14.1	12.5	9.8	7.4	10.0	9.4	9.0	8.5	8.2
Money and credit										
Base money (percent change, eop)	34.1	53.9	17.5	46.0	33.0	10.9	16.8	13.1	13.9	12.9
Credit to nongovernment (percent change, eop)	31.6	61.9	70.7	74.0	40.9	-9.8	16.9	13.8	15.7	15.1
Share of fx credit in total credit	42.1	43.2	49.4	49.8	57.5	60.0	53.5	53.6	53.4	53.2
External sector										
Current account balance (percent of GDP)	10.6	2.9	-1.5	-3.7	-6.2	-2.0	-1.7	-2.6	-2.4	-3.3
Total external debt (percent of GDP)	46.3	45.1	49.7	57.8	54.3	78.2	74.6	71.3	64.6	57.7
Goods exports, value (percent change)	40.8	4.8	11.2	28.0	33.4	-18.5	13.6	10.6	10.1	9.3
Goods imports, value (percent change)	23.7	21.8	22.1	36.9	39.5	-25.3	10.3	10.5	10.3	9.9
Foreign direct investment (percent of GDP)	2.6	8.7	5.3	6.5	6.2	6.8	6.8	6.8	6.7	6.5
Gross official reserves (end of period)										
In billions of U.S. dollars	9.5	19.4	22.3	32.4	31.4	30.7	34.8	39.9	45.3	48.5
In months of imports of goods and services	2.6	4.4	3.7	3.9	5.1	4.5	4.6	4.8	5.0	4.9
External debt service (in percent of exports of goods and servic	5.3	4.9	5.1	3.9	2.8	4.2	4.4	3.7	7.1	10.1
Hryvnia per U.S. dollar (end of period)	5.3	5.0	5.0	5.0	…	…	…	…	…	…
Goods terms of trade (percent change)	9.6	6.2	-0.2	9.0	7.8	-14.5	-2.3	0.4	0.5	0.4
Goods and services terms of trade (percent change)	7.8	4.9	1.5	7.4	8.9	-10.5	-0.2	0.9	0.8	0.8
Savings-Investment Balance (percent of GDP)										
Foreign savings	-10.6	-2.9	1.5	3.7	6.2	2.0	1.7	2.6	2.4	3.3
Gross national savings	31.8	25.6	23.3	23.2	20.9	21.2	21.1	21.3	22.6	23.0
Nongovernment	33.2	25.8	22.4	22.6	19.5	18.6	19.9	20.0	21.3	21.7
Government	-1.4	-0.3	0.9	0.7	1.4	2.6	1.2	1.3	1.2	1.2
Gross investment	21.2	22.6	24.8	26.9	27.0	23.2	22.7	23.9	25.0	26.3
Nongovernment	18.2	20.6	22.5	24.3	24.6	20.6	20.2	21.4	22.5	23.8
Government	3.0	2.0	2.2	2.7	2.4	2.6	2.6	2.6	2.6	2.6

Sources: Ukrainian authorities; and staff estimates and projections.

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

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

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

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

Table 9. Ukraine: Structural Reforms

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

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

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

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

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

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

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

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

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

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

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

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

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

Table 12. Ukraine: Proposed Access, 2008-2010

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

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

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

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

3/ Phasing is based on program years.

4/ Amounts include augmentations.

Table 13. Ukraine: Indicators of Fund Credit, 2003-2008
(In units indicated)

	2006	2007	2008	2009	2010	2011	2012	2013
			projections					
Existing and prospective Fund credit 1/ 2/								
In millions of SDRs	552	273	3,057	9,500	11,000	11,000	8,375	3,344
In percent of exports of goods and services	2	1	6	21	22	20	14	5
In percent of public sector external debt	6	3	32	101	115	107	95	61
In percent of gross reserves	3	1	15	48	49	43	29	10
In percent of quota	61	31	225	692	802	802	610	244
Existing Fund credit 1/ 2/								
In millions of SDRs	552	273	57	0	0	0	0	0
In percent of exports of goods and services	2	1	0	0	0	0	0	0
In percent of public sector external debt	6	3	1	0	0	0	0	0
In percent of gross reserves	3	1	0	0	0	0	0	0
In percent of quota	61	31	7	0	0	0	0	0
Prospective Fund credit 1/ 2/								
In millions of SDRs	0	0	3,000	9,500	11,000	11,000	8,375	3,344
In percent of exports of goods and services	0	0	6	21	22	20	14	5
In percent of public sector external debt	0	0	32	101	115	107	95	61
In percent of gross reserves	0	0	15	48	49	43	29	11
In percent of quota	0	0	219	692	802	802	610	244
Repurchases and charges due from existing and prospective drawings 2/ 3/								
In millions of SDRs	302	294	260	311	458	495	3,143	5,289
In percent of exports of goods and services	1	1	0	1	1	1	5	8
In percent of public sector external debt service 4/	3	3	3	3	5	5	36	97
In percent of gross reserves	1	1	1	2	2	2	11	17
In percent of quota	22	21	19	23	33	36	229	386
Repurchases and charges due from existing drawings 2/								
In millions of SDRs	302	294	245	58	0	0	0	0
In percent of exports of goods and services	1	1	0	0	0	0	0	0
In percent of public sector external debt service 4/	3	3	3	1	0	0	0	0
In percent of gross reserves	1	1	1	0	0	0	0	0
In percent of quota	22	21	18	4	0	0	0	0
Repurchases and charges due from prospective drawings 2/ 3/								
In millions of SDRs	0	0	15	253	458	495	3,143	5,289
In percent of exports of goods and services	0	0	0	1	1	1	5	8
In percent of public sector external debt service 4/	0	0	0	3	5	5	36	97
In percent of gross reserves	0	0	0	1	2	2	11	17
In percent of quota	0	0	1	18	33	36	229	386

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

1/ End of period.
2/ Under the obligations schedule.
3/ Excluding commitment charges
4/ Public sector debt service including debt service from prospective drawings.

Ukraine—Stand-By Arrangement 2008–2010

Attached hereto is a letter from the Minister of Finance, the Governor of the National Bank of Ukraine (NBU), the Prime Minister and the President of Ukraine, dated October 31, 2008 (the "Letter"), with an attached Memorandum of Economic and Financial Policies (the "Memorandum") and Technical Memorandum of Understanding (the "TMU"), requesting a Stand-By Arrangement from the International Monetary Fund and setting forth:

(a) the objectives and policies that the authorities of Ukraine intend to pursue for the period of this Stand-By Arrangement;

(b) the policies and measures that the authorities of Ukraine intend to pursue during the first year of this Stand-By Arrangement; and

(c) understandings of Ukraine with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Ukraine will pursue for the remaining period of this Stand-By Arrangement.

To support these objectives and policies the International Monetary Fund grants this Stand-By Arrangement in accordance with the following provisions:

1. For a period of 24 months from November 5, 2008, Ukraine will have the right to make purchases from the Fund in an amount equivalent to SDR 11,000 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 3,000 million until February 15, 2009, the equivalent of SDR 4,250 million until May 15, 2009, the equivalent of SDR 6,750 million until August 15, 2009, the equivalent of SDR 7,500 million until November 15, 2009, the equivalent of SDR 9,500 million until February 15, 2010, the equivalent of SDR 9,875 million until May 15, 2010, the equivalent of SDR 10,250 million until August 15, 2010, and the equivalent of SDR 10,625 million until October 15, 2010.

(b) None of the limits in (a) above shall apply to a purchase under this Stand-By Arrangement that would not increase the Fund's holdings of Ukraine's currency subject to repurchase beyond 25 percent of quota.

3. Ukraine will not make purchases under this Stand-By Arrangement that would increase the Fund's holdings of Ukraine's currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on the cash deficit of the general government, or

(ii) the floor on net international reserves of the NBU, or

(iii) the ceiling on base money,

as set out in Table 2 of the Memorandum and further specified in the TMU, is not observed, provided that the ceilings and floors for end-March 2010, end-June 2010 and end-September 2010 will be established at a future review; or

(b) if Ukraine does not carry out its intentions with respect to the following structural performance criteria:

(i) by December 15, 2008, the completion of a diagnostic study covering NBU's group 1 banks, coordinated by the NBU and with participation of reputable audit firms as set out in Table 3 and further specified in paragraph 13 of the Memorandum and paragraph 20 of the TMU, or

(ii) by June 30, 2009, the resolution of all problem banks so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated as set out in Table 3 and further specified in paragraph 13 of the Memorandum and paragraph 22 of the TMU, or

(iii) by April 30, 2009, the passage of a budget consistent with a general government deficit of a zero overall balance as set out in Table 3 and further specified in paragraph 15 of the Memorandum; or

(c) after February 14, 2009, May 14, 2009, August 14, 2009, November 14, 2009, February 14, 2010, May 14, 2010, August 14, 2010, and October 14, 2010, until the respective reviews contemplated in Table 1 of the Memorandum have been completed; or

(d) if, at any time during the period of the Stand-By Arrangement, Ukraine

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Ukraine is prevented from purchasing under this Stand-By Arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Ukraine and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Ukraine will not make purchases under this Stand-By Arrangement during any period in which Ukraine: (i) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), or (c) pursuant to paragraphs 17 and 31 of Decision No. 8955-(88/126), as amended, on the Compensatory Financing Facility, or (d) in respect of a purchase under Decision No. 11627-(97/123) SRF on the Supplemental Reserve Facility, or (e) pursuant to paragraph 1(b) of Decision No. 5703-(78/39) or paragraph 10(a) of Decision No. 4377-(74/114); or (ii) is failing to meet a repayment obligation to the PRGF-ESF Trust established by Decision No. 8759-(87/176) PRGF, or a repayment expectation to that Trust pursuant to the provisions of Appendix I to the PRGF-ESF Trust Instrument.

5. Ukraine's right to engage in the transactions covered by this Stand-By Arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Ukraine. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Ukraine and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this Stand-By Arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Ukraine, the Fund agrees to provide SDRs at the time of the purchase.

7. Ukraine shall pay a charge for this Stand-By Arrangement in accordance with the decisions of the Fund.

8. (a) Ukraine shall repurchase the amount of its currency that results from a purchase under this Stand-By Arrangement in accordance with the provisions of the

Articles of Agreement and decisions of the Fund, including those relating to repurchases, as Ukraine's balance of payments and reserve position improves.

(b) Any reductions in Ukraine's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the Stand-By Arrangement Ukraine shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Ukraine or of representatives of Ukraine to the Fund. Ukraine shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Ukraine in achieving the objectives and policies set forth in the Letter and the Memorandum.

10. In accordance with paragraph 3 of the Letter and paragraph 22 of the Memorandum, Ukraine will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Ukraine has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Ukraine's balance of payments policies.

Kyiv, October 31, 2008

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

Dear Mr. Strauss-Kahn:

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

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

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

Yours sincerely,

/s/
Viktor Pynzenyk
Minister of Finance

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

/s/
Yulia Tymoshenko
Prime Minister of Ukraine

/s/
Victor Yushchenko
President of Ukraine

Memorandum of Economic and Financial Policies

VI. Background

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

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

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

VII. Program Objectives

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

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

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

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

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

VIII. POLICIES FOR 2009

A. Monetary and Exchange Rate Policy

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

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

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

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

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

B. Financial Sector Policy

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

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

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

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

- The National Bank of Ukraine banking supervision department will initiate close contacts with home supervisors of foreign banks and agree to share information on the activities of the foreign banks under their supervision. In cooperation with foreign banks and home supervisors, it will also assess the parent bank funding to Ukrainian subsidiaries, and make joint contingency plans for debt rollover risks.

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

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

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

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

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

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

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

C. Fiscal Policy

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

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

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

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

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

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

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

D. Private Sector Support Policies

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

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

E. Safeguards Assessment

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

E. Program Monitoring

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

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

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

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

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

Table 2. Ukraine: Quantitative and Continuous Performance Criteria 1/

(End-of-period; in millions of hryvnia, unless otherwise indicated)

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

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

1/ Definitions are specified in the Technical Memorandum of Understanding (TMU). Targets for 2010 will be set at the time of the third review.

2/ The ceiling on the cash deficit of the general government will be adjusted downward by the amount that project financing falls short of the projections shown in Section II above. The quarterly ceilings are set taking into account the seasonality of the deficit.

3/ The floor on the cash balance of the general government will be adjusted downward by 100 percent of the fiscal cost of banks recapitalizations. This cost includes the upfront cost for the budget implied by the recapitalization as well as associated subsequent interest payments.

4/ Data are cumulative flows from January 1 of the corresponding year.

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

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

UKRAINE—TECHNICAL MEMORANDUM OF UNDERSTANDING

OCTOBER 31, 2008

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

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

I. QUANTITATIVE TARGETS

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

Definition

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

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

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

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

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

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

- all short-term liabilities of the NBU vis-à-vis non-residents with an original maturity of one year or less;
- the stock of IMF credit outstanding;
- the nominal value of all derivative positions[5] of the NBU and government, implying the sale of foreign currency or other reserve assets against domestic currency.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability[6]		NBU Balance Sheet Accounts
1.	**Gross foreign reserves** *(in convertible currencies)*	
	Monetary gold in vault	1100, 1107
	Foreign exchange in cash, including Russian rubles	1011, 1017
	Demand deposits at foreign banks	1201, 1202
	Short-term time deposits at foreign banks	1211
	Long-term deposits at foreign banks	1212
	SDR holdings and Reserve Position in the IMF	IMF, Finance Department[7]
	Securities issued by non-residents	1302, 1305, 1307, 1308, minus 1306
2.	**Short-term liabilities to nonresidents** *(in convertible currencies)*	
	Correspondent accounts of nonresident banks	3201
	Short-term deposits of nonresident banks	3206, 3207, 3211
	Operations with nonresident customers	3230, 3232, 3233, 3234
	Use of IMF credit	IMF, Finance Department

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

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

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

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

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

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

Definition

6. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,[8] and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts 3230, 3232, 3233, 3234, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency (NBU liability account 3238).

C. Ceiling on Cash Deficit of the General Government

Definition

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

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

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

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

- total receipts from privatization received by the SPF and local governments; plus

- the difference between disbursements and amortization on any bond issued by the government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus

- the difference between disbursements of official foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of official foreign credits by the general government (including of on-lent project loans, and excluding offset-based amortization with Russia); plus

- the net change in government deposits in nonresident banks, or other nonresident institutions; plus

- net proceeds from any promissory note or other financial instruments issued by the general government.

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

Adjustment mechanism

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

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

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

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

II. Prior Actions and Structural Measures

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Reporting Requirements

A. National Bank of Ukraine

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Ministry of Finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. State Tax Administration

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

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

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

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

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

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

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

D. Ministry of Economy and Ministry of Fuel and Energy

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

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

E. State Statistics Committee

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