FOR AGENDA

EBS/08/114
Correction 2

November 5, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to EBS/08/114 (11/3/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 8, Box 1, Title:
for "Crisis" **read** "Crisis 1/"
add footnote 1: "As stated in paragraph 15, staff is still assessing whether any of these controls give rise to exchange restrictions subject to Article VIII, Section 2(a)."

Page 8, Box 1, point 1:
for "deposits (insofar as it applies to both residents and non-residents)" **read** "deposits (applies to both residents and non-residents)"

Page 8, Box 1, point 4:
for "Ukraine" **read** "Ukraine (subsequently repealed)."

Page 8, Box 1, point 6:
for "wiring of foreign currency" **read** "wiring by natural persons of foreign currency"

Page 18, para. 23, line 7:
for "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 population against adjustment (through unit labor costs, since productivity trends are expected to continue)." **read** "The authorities' measures are designed to deliver growth of incomes in line with inflation to protect the population while also allowing for competitiveness gains."

Page 18, para. 23, line 11:
for "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" **read** "The absence of such policies"

Page 45, Table 13:

stub "Existing and prospective Fund credit, In millions of SDRs" **for** "8,375; 3,344" **read** "8,313; 3,281"
stub "Existing and prospective Fund credit, In percent of public sector external debt" **for** "32; 101; 115; 107; 95; 61" **read** "25; 50; 54; 52; 42; 20"
stub "Existing and prospective Fund credit, In percent of quota" **for** "61; 31; 225; 692; 802; 802; 610; 244" **read** "40; 20; 223; 692; 802; 802; 606; 239"
stub "Existing Fund credit, In percent of quota" **for** "61; 31; 7" **read** "40; 20; 4"
stub "Prospective Fund credit, In millions of SDRs" **for** "8,375; 3,344" **read** "8,313; 3,281"
stub "Prospective Fund credit, In percent of public sector external debt" **for** "32; 101; 115; 107; 95; 61" **read** "25; 50; 54; 52; 42; 20"
stub "Prospective Fund credit, In percent of quota" **for** "610; 244" **read** "606; 239"
stub "Repurchases and charges due from existing and prospective drawings, In millions of SDRs" **for** "302; 294; 260; 311; 458; 495; 3,143; 5,289" **read** "315; 304; 239; 315; 501; 552; 3,200; 5,338"
stub "Repurchases and charges due from existing and prospective drawings, In percent of public sector external debt service" **for** "3; 3; 3; 3; 5; 5; 36; 97" **read** "15; 16; 14; 15; 18; 21; 42; 45"
stub "Repurchases and charges due from existing and prospective drawings, In percent of quota" **for** "22; 21; 19; 23; 33; 36; 229; 386" **read** "23; 22; 17; 23; 36; 40; 233; 389"
stub "Repurchases and charges due from existing drawings, In millions of SDRs" **for** "302; 294; 245" **read** "315; 304; 224"
stub "Repurchases and charges due from existing drawings, In percent of public sector external debt service" **for** "3; 3; 3; 1" **read** "15; 16; 13; 3"
stub "Repurchases and charges due from existing drawings, In percent of quota" **for** "22; 21; 18" **read** "23; 22; 16"
stub "Repurchases and charges due from prospective drawings, In millions of SDRs" **for** "15; 253; 458; 495; 3,143; 5,289" **read** "16; 257; 501; 552; 3,200; 5,338"
stub "Repurchases and charges due from prospective drawings, In percent of public sector external debt service" **for** "0; 3; 5; 5; 36; 97" **read** "1; 12; 18; 21; 42; 45"
stub "Repurchases and charges due from prospective drawings, In percent of quota" **for** "18; 33; 36; 229; 386" **read** "19; 36; 40; 233; 389"

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

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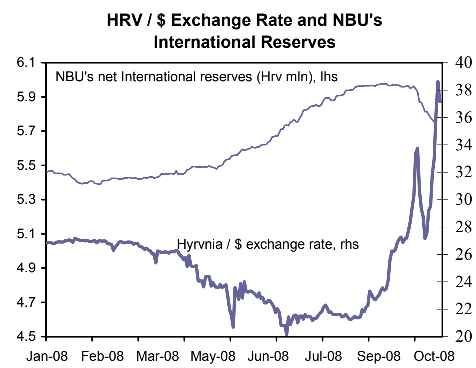
exceed 4,000 bps. Fitch and S&P have both downgraded Ukraine (keeping it on negative outlook), while Moody's has also just downgraded a number of Ukrainian enterprises, and placed the sovereign on negative outlook.

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).



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

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

1. Restriction on early withdrawal of time deposits (applies to both residents and non-residents).
2. Prohibition of early repayment of foreign exchange loans by banks.
3. Limitation on purchases of foreign currency by banks, in order to discharge foreign exchange loans due, to amounts within their open foreign exchange limit.
4. Controls over advanced payments for imports that do not enter the territory of Ukraine (subsequently repealed).
5. Six-day delay for investors wishing to convert hryvnia profits, revenues, or the sale of assets into foreign currency.
6. Ceiling for a monthly wiring by natural persons of foreign currency out of the country in the equivalent of Hrv 15,000 if no supporting documents are presented; Hrv 75,000 otherwise.
7. Limitation on payment order execution to one day within branch, two days within bank, and three days across banks.
8. Limitation of exchange market transactions limited to specific currency pairs.
9. Limitation on ceiling between bid and ask exchange rates to at most 5 percent.
10. Requirement that the foreign exchange open position of banks be calculated for each currency separately.
11. Requirement that hard currency foreign exchange deposits of banks abroad, be restricted to banks resident in the group of hard currency countries.
12. Limitation on hryvnia transactions by non-resident banks to export-import operations.

Source: NBU Resolutions 319, 328 and 336.

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

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

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

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

Fiscal policy

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

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

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

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

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

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

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

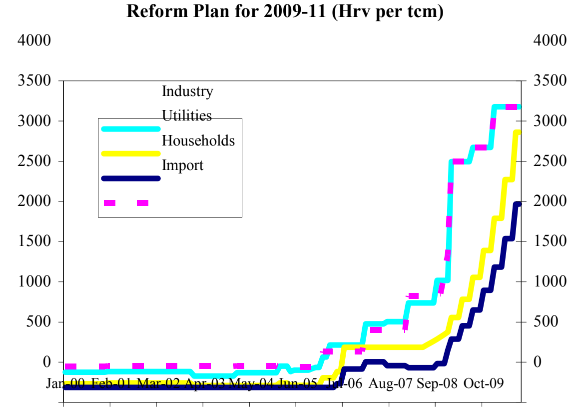


Table 13. Ukraine: Indicators of Fund Credit, 2006-2013

	2006	2007	2008	2009	2010	2011	2012	2013
					projections			
Existing and prospective Fund credit 1/ 2/								
In millions of SDRs	552	273	3,057	9,500	11,000	11,000	8,313	3,281
In percent of exports of goods and services	2	1	6	21	22	20	14	5
In percent of public sector external debt	6	3	25	50	54	52	42	20
In percent of gross reserves	3	1	15	48	49	43	29	11
In percent of quota	40	20	223	692	802	802	606	239
Existing Fund credit 1/ 2/								
In millions of SDRs	552	273	57	0	0	0	0	0
In percent of exports of goods and services	2	1	0	0	0	0	0	0
In percent of public sector external debt	6	3	0	0	0	0	0	0
In percent of gross reserves	3	1	0	0	0	0	0	0
In percent of quota	40	20	4	0	0	0	0	0
Prospective Fund credit 1/ 2/								
In millions of SDRs	0	0	3,000	9,500	11,000	11,000	8,313	3,281
In percent of exports of goods and services	0	0	6	21	22	20	14	5
In percent of public sector external debt	0	0	24	50	54	52	42	20
In percent of gross reserves	0	0	15	48	49	43	29	11
In percent of quota	0	0	219	692	802	802	606	239
Repurchases and charges due from existing and prospective drawings 2/ 3/								
In millions of SDRs	315	304	239	315	501	552	3,200	5,338
In percent of exports of goods and services	1	1	0	1	1	1	5	8
In percent of public sector external debt service 4/	15	16	14	15	18	21	42	45
In percent of gross reserves	1	1	1	2	2	2	11	17
In percent of quota	23	22	17	23	36	40	233	389
Repurchases and charges due from existing drawings 2/								
In millions of SDRs	315	304	224	58	0	0	0	0
In percent of exports of goods and services	1	1	0	0	0	0	0	0
In percent of public sector external debt service 4/	15	16	13	3	0	0	0	0
In percent of gross reserves	1	1	1	0	0	0	0	0
In percent of quota	23	22	16	4	0	0	0	0
Repurchases and charges due from prospective drawings 2/ 3/								
In millions of SDRs	0	0	16	257	501	552	3,200	5,338
In percent of exports of goods and services	0	0	0	1	1	1	5	8
In percent of public sector external debt service 4/	0	0	1	12	18	21	42	45
In percent of gross reserves	0	0	0	1	2	2	11	17
In percent of quota	0	0	1	19	36	40	233	389

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

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

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: