Ukraine

Economic Situation and Reforms

December 1999

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Table of Contents

I. Introduction

1. When Ukraine declared its independence in August 1991, it became the second largest European country in landmass and the fourth largest in population, with 50 million people. It has a well-educated and skilled labor force. Its agricultural soil is extensive and rich: Ukraine used to be the grain-basket of the former Soviet Union. It has good mineral resources (iron ore, coal) and reasonable infrastructure.

2. Despite these favorable conditions, Ukraine has had one of the most difficult economic challenges in Eastern Europe, with a long economic recession going on for 9 years. However, the decline in Gross Domestic Product (GDP) that started in 1991 decelerated gradually over the last few years. In fact, the rate of GDP decline was becoming less negative (-23% in 1994, -12% in 1995, -10% in 1996, -3.2% in 1997) and became positive during the first half of 1998. The recovery of growth until mid-1998 was concentrated in the industrial and construction sectors, with agriculture and livestock still lagging behind with negative rates of growth. In industry, the recovery was widespread, including ferrous and non-ferrous metals, chemicals, petrochemicals, wood and pulp, construction materials, and food and apparel industries.

3. The year 1998 was expected to be the first year after independence with positive rates of growth. However, these positive developments were reversed in the second half of 1998, following the crisis in Russia. As a result of the crisis, there was a sharp drop in exports to Russia and to Asia, particularly in metallurgy, machine-building and chemicals. This decline in exports was somewhat mitigated by good performance in other industries, particularly food processing. But from mid-1998, domestic industrial production was also seriously affected by the lack of imported inputs and the increase in imported input prices, due to the sharp depreciation of the Hryvnia and lack of import financing. As a result, GDP declined by 1.7% in 1998. The expectation is that GDP will decline by 1.0% in 1999, with the year 2000 showing positive rates of growth.

4. The recession in Ukraine since 1991 has been long because the country was highly open and dependent on other Former Soviet Union Republics. The collapse of the FSU cut these production and trade relations. In addition, the country had a large percentage of military industries (25% of enterprises produced military goods), which found themselves without markets after the end of the cold war. Furthermore, due to negligible energy cost during the Soviet times, many industrial processes were very energy intensive (in the early 1990’s, Ukraine consumed 6 times more oil per unit of GDP than in Western Europe). Energy imports are still important representing 15%

of GDP. These high-energy firms became uneconomic when energy cost increased 10 times after independence.

5. The cumulative decline in GDP since 1991 has been 60%, but about one-half of this decline was offset by expansion of the Informal Economy. This has helped to contain the decline in living standards in the country. For the future, the potential for growth in Ukraine is high, particularly in agricultural activities: the country has already demonstrated its capacity to produce twice as much agricultural output as it is producing now.

II. The Early Economic Reform Program

6. The structural weaknesses of Ukraine during the Soviet times meant that major corporate restructuring was needed after independence. Unfortunately, from 1991 to 1995, very little was done: the Government followed a "preservation" strategy. It tried to maintain the status-quo of industrial and agricultural enterprises through the payment of large direct subsidies to them.

7. Relying on Government subsidies for their existence, state-owned enterprises had little incentives to restructure themselves, and remained largely inefficient. These Government subsidies led to large fiscal deficits, monetary financing of these deficits, and hyper-inflation, which reached 10,155% p.a. in 1993, and 401% in 1994.

8. In 1995, Mr. Leonid Kuchma was elected President on the basis of a reform agenda. During 1996 -1998, under President Kuchma, significant progress was made in many areas of economic reforms:

- Prices and international trade were liberalized.
- The small & mass privatization programs were completed.
- The NBU was strengthened and monetary policy was implemented wisely.
- A new currency (Hryvnia-UAH) was introduced successfully in September 1996, without confiscation.
- Ukraine accepted the IMF Obligations under Article VIII (which requires foreign exchange convertibility for current account payments).
- Inflation was reduced to 10% in 1997.
- The exchange rate was maintained within a narrow corridor around 1.9 UAH per dollar.
- The NBU's international reserves increased to US$2.3 billion by the end of 1997.

9. This reform agenda started to yield benefits. As noted above, the rate of decline of GDP was halted by the beginning of 1998.

10. However, despite this progress, during 1997-1998 the fiscal deficit remained high, at about 6% of GDP. This fiscal deficit was financed with short-term external borrowing. As a result, external debt increased from US$4.4 billion in 1994 to US$11.5 billion in 1998. T-bills increased from nil to Hr. 10 billion in the same period. The deficit was also financed through the accumulation of wage and budgetary arrears.

11. In addition, other structural reforms were slow in implementation. As a result, structural reforms did not reach the critical mass needed to revive investments and growth on a sustainable basis. For example:

- Competition was limited by high barriers to enterprise entry and exit. In particular, excessive Government regulations (such as licensing & registration requirements) were slow in being simplified.
- Privatization of large industries was stalled by Parliament.
- Custom procedures (such as stringent quality standards) constrained trade.
- The Government was unable to control its own interference at sector levels, particularly in agriculture and energy.
- The banking and capital market sectors remained weak.
- The legal system remained inadequate to protect commercial contracts/interests.
- Public Administration reform was slow in implementation.

12. Given Ukraine's large fiscal deficit, slow implementation of structural reforms, and large short-term debt repayments, the Country was vulnerable to negative external events. This led to the Financial Crisis of 1998, as discussed below.

III. The Financial Crisis of 1998

13. The Asia Crisis of 1997 started to put pressures on Ukraine's foreign exchange market. But it was the Russian crisis of August 1998 that triggered a financial crisis for Ukraine, which was already vulnerable as noted earlier. As a result of this crises:

- Capital inflows dried up in mid-1998.
- International Reserves fell sharply.
- Large debt obligations due in 1998 could not be rolled over or repaid.
- Interest rates increased sharply.
- The exchange rate came under pressure.

14. Despite the severity of the 1998 financial crisis, Ukraine faced it successfully, much better than Russia:

- It was able to negotiate voluntarily the restructuring of its debt.
- Monetary Policy was handled effectively.
- In September, October and November 1998, the fiscal accounts were in surplus. The deficit for 1998 was contained at 2.5 % of GDP (compared to 6% in 1997).
- Inflation for 1998 was contained to 20%.

15. As a result of these measures, by the beginning of 1999, Ukraine had overcome the risk of a financial collapse. The economic results for 1999 are discussed below.

IV. Economic Situation in 1999

16. Attachment 1 provides some key economic statistics for 1996 to 1999.

(a) The Real Economy.

17. There are strong signals that the economy is finally turning around. Industrial production grew by 18.1% in September 1999 and by 10.1% in October 1999, compared to September and October 1998 (when the economy was at a low point after the crisis). In total, during January-October 1999, industrial production rose by 3.1% compared with the same period last year. Industries oriented towards the domestic market performed well, as a result of the import substitution effect of the Hryvnia's real depreciation. Wood processing and food processing showed strong performances. The electricity industry also performed well, while the chemical and machine-building industries continued to decline. Services -- a sector hit hardest by the Russian crisis -- continued to stagnate with trade turnover and transportation volumes below their pre-fall 1998 peaks.

18. Real GDP (corrected by inflation) grew by 4.6% in September 1999 and by 2.7% in October 1999, compared to the same months of 1998. Given high rates of GDP decline early in the year, GDP declined by 1.2% during the entire period from January to October 1999, compared to the same period last year. For 1999 as a whole, GDP is expected to decline by about 1.0%, a smaller amount than previously anticipated. The year 2000 is expected to show a positive rate of growth.

(b) Prices and Inflation.

19. From 1996 to early 1998, Ukraine made considerable progress in reducing inflation, which was contained to 10% pa in 1997 and to 7%, on a year-to-year basis, during the first eight months of 1998. This progress was due mainly to sound monetary policies. However, due to the sharp depreciation of the Hryvnia in the second half of 1998, inflation reached 4% in September, 6% in October, and 3% in November and December 1998. For the entire 1998, inflation reached 20%.

20. During the months of January to October 1999, inflation was brought back into control. Inflation in October 1999 was 1.1%. The cumulative inflation, for the first ten months of the year, was 11.3% (or 14% on an annual basis). Based on these excellent results, most analysts have now revised downward their projections for inflation in 1999, with December-to-December inflation forecasts of about 15%.

(c) Fiscal Budget Situation.

21. Weaknesses in Public Finance has been at the core of the economic difficulties experienced by Ukraine, despite the progress made in other economic areas. As noted earlier, in 1997 and the first-half of 1998, shortfalls in fiscal cash revenues, accompanied by week expenditure controls -- mainly in health and education -- led to fiscal deficits of about 6% of GDP. These deficits were accommodated mainly by the easy availability of external credits.

22. In the second half of 1998, as international financing dried-up, the dept of the financial crisis motivated the Government to improve its fiscal policies significantly. The transparency of Government operations was improved with the strengthening of the Treasury. With World Bank assistance, the Treasury is now operational, recording most central cash and noncash expenditures, and gradually taking over budgetary payments at the Center and Oblast levels. Also, the tax burden was redistributed in a more rational way. More importantly, Government expenditures were reduced considerably, principally in non-priority areas. Overall, expenditures were cut by 6% of GDP in 1998 in relation to the approved budget. This was enough to offset a decline in fiscal revenues of 3% of GDP with respect to the original plan. As a result of actions in the second half of 1998, fiscal surpluses were shown during several months, reducing the fiscal deficit for 1998 to 2.7% of GDP, a remarkable achievement.

23. The fiscal prospects for 1999 are even more favorable. The 1999 Fiscal Budget is probably the best so far undertaken by the Government since its independence. It envisages Consolidated Revenues amounting to 36.3% of GDP, and Consolidating Expenditures of 38.1% of GDP. The Fiscal Deficit would represent about 1.8% of GDP, compared to deficits of 2.7% of GDP in 1998 and 6% of GDP in 1997. The 1999 Fiscal Budget contains many measures that are important to sustain macroeconomic performance in Ukraine. Some of the important fiscal measures included in the Budget and approved by Parliament include:

- (a) Increases in gasoline taxes that will permit increases in excise taxes from 1.2% of GDP to 2.3% of GDP.
- (b) The tax for the Chernovyl Fund was eliminated.
- (c) The value-added tax liability will be computed in an accrual basis.
- (d) The introduction of a 3% tax on the purchase of jewelry.
- (e) An additional tax of UAH 100 on purchases of automobiles.
- (f) A tax of 1% on the purchase of foreign exchange.
- (g) Payroll taxes were reduced from 48% of the wage bill to 38%, to improve the business environment.

24. In spite of the Presidential elections in October 1999 -- and the pressure to increase Government expenses -- up to September 1999, the Government managed reasonably well its fiscal accounts. Although there was an increased in Government expenditures in October 1999 (principally to settle wage and pension arrears), Budget performance until the end of October 1999 had remained reasonable. Although the fiscal deficit at about 1.8% of GDP is above the target set under the IMF Program (1.5% of GDP), it is manageable.

25. As required under the Constitution, on September 15, 1999, the Government submitted to Parliament a draft 2000 budget providing for a consolidated budget deficit of 1.3% of GDP, based on the IMF methodology. Under the Ukrainian methodology, which puts privatization proceeds above the line, the draft budget has a surplus of 0.4% of GDP. The draft budget lowers the tax burden compared to previous years. Securing the approval of Parliament of a realistic budget for the year 2000 will be a key milestone for the Government.

(d) Monetary and Exchange Rate Situation

26. Tight monetary policies of the National Bank of Ukraine (NBU) can be credited with the significant progress made by Ukraine towards financial stabilization, despite fiscal budget issues. Up to the third quarter of 1997, the availability of foreign financing allowed the fiscal budget deficit to be financed without recourse to borrowing from the NBU. However, the Asia Crisis in September 1997 and delays in Ukraine in fiscal and structural adjustments, started to change investors perceptions of Ukraine. During the first half of 1998, capital outflows accelerated and the NBU had to sell a considerable amount of foreign reserves to protect the exchange rate. Foreign reserves were supplemented by the placement of two large Eurobond issues for a total of US$1.1 billion. However, during the second half of 1998, foreign financing became unavailable to Ukraine. With international reserves declining rapidly, in September 1998, the NBU had to stop selling foreign exchange. The Hryvnia depreciated sharply from about 2.1 UAH/US$ in January 1998 to 3.5 UAH/US$ in September 1998. The NBU introduced administrative measures to reduce demand for foreign exchange.

27. During the first part of 1999, the NBU followed strict monetary policies. In January 1999, the monetary base actually contracted and increased by a small margin in February and March 1999. As a result, exchange rate pressures eased. With the approval of the EFF in late March 1999, the NBU started to remove the foreign exchange administrative controls imposed earlier. Foreign exchange was allowed to be traded in the over-the-counter interbank market. The NBU also lifted the

restriction on the margin by which exchange rates may deviate from the official rate. These foreign exchange liberalization measures resulted in some depreciation of the currency. In addition, a crisis in August 1999, precipitated by fuel shortages, brought the exchange rate to a level of 4.5 UAH/US$ in the official market. However, monetary policy was loose after the summer, with money supply increasing by 4%-5% per month for a few months. This monetary expansion, and the increases in Government expenditures during the month prior to the Presidential elections, led to further depreciation of the Hryvnia. In fact, at the end of November 1999, the free market in Kiev was quoting an exchange rate of 5.05 UHA/US$. Tighter monetary policy in the next few months, however, is likely to maintain the exchange rate from depreciating more sharply, with a rate not exceeding 5.5 UAH/US$ expected by the end of this year. Thereafter, the evolution of the exchange rate will depend on the depth of the economic reform program to be undertaken by the new Government. If a strong program is implemented, the country should be able to serve its international debt and the exchange rate should be stabilized. Otherwise, further depreciation would take place.

28. A low Hryvnia liquidity up to mid 1999 allowed the National Bank of Ukraine to purchases of foreign exchange in the inter-bank market. During this time, the NBU bought US dollars in the open market, bringing its foreign exchange reserves to its current level of US$ 1.3 billion by November 1999.

(e) Balance of Payments Situation.

29. During the last two years, there have been important changes in the composition of Ukrainian exports and imports. Exports to traditional partners (the former Soviet Union, particularly Russia) have declined substantially, from 57% of total exports in 1995/96 to about 40% in 1998. On the other hand, exports to non-traditional partners (particularly China, Turkey and Germany) have performed quite well, partly offsetting the shortfall to Russia. These trends continued during 1999. In terms of composition of exports, the importance of ferrous and non-ferrous metals continued to increase, accounting for more than 40% of exports in 1997/98. Two other important export items, chemicals and machinery, represented 25% of the total. Agricultural exports have continued its decline, representing only 10% of total exports in 1997/98 (down from 20% in 1996). Policy shortcomings in agriculture explain part of the decline in food production and imports.

30. The direction of imports followed a similar pattern, with imports from the former Soviet Union declining from 65% of the total in 1995/96 to 55% in 1998. The major import items continued to be energy products (oil and gas) which represented

about 35%-40% of the total in 1997/98. Other leading imports include machinery and equipment, chemicals, and some food items.

31. Due to the financial crisis, merchandise exports and imports declined by about 18% in 1998, from the levels achieved in 1997. Merchandise exports reached US$13.5 billion in 1998. Merchandise imports amounted to US$16.1 billion. The deficit in the current account was only US$600 million, compared to deficits of around US$1.2-1.3 billion in 1996 and 1997.

32. In 1999, foreign trade fell further. During January-September 1999, foreign trade fell by 19.9% to US$ 16.7 billion, compared to the same period last year. Exports fell by 13.7% to US$ 8.3 billion, whereas imports fell by 25.1% to US$ 8.4 billion. As a result, the foreign trade balance was just slightly negative by US$ 100 million. This improvement in the trade account is important; but foreign trade must recover to support future economic growth.

(f) International Lending

33. Since September 1998 to September 1999, total loan disbursements from the International Monetary Fund and the World Bank, reached US$ 1.6 billion, or over 100% of current gross foreign exchange reserves. In early September 1999, the World Bank disbursed US$ 100 million, within the framework of Financial Sector Adjustment Loan for budget deficit financing. At the same time, the IMF released another enhanced tranche (US$ 185 million) of its Extended Fund Facility.

34. However, in early October 1999, the IMF took the decision to postpone the release of the US$ 90 million tranche until after the Presidential elections, due to the decision by Ukraine to introduce certain export restrictions (including export taxes for sunflower seeds), and the lack of action on agreed upon price increases for utility and communal services.

35. The IMF will revive its lending program to Ukraine only after it has agreed with the new Government on the Budget for the year 2000 and the acceleration of economic reforms to be undertaken by the new Government. The Government and the IMF have stated that they will aim at achieving these conditions before the end of the first quarter of year 2000, when significant debt repayments are due.

36. In early September 1999, Ukraine announced its intention to seek consultations with the Paris Club of official bilateral creditors to discuss a possible debt rescheduling operation. While the share of such creditors in Ukraine's external debt is low accounting for less than 10% of debt service due in 2000-2001, an

agreement with the Paris Club could facilitate Ukraine's debt discussions with private creditors of the London Club. It is unlikely, however, that such discussion would take place before the new Government has put in place a stronger economic reform program.

37. As noted earlier, in year 2000, the Government will need to serve significant amounts of foreign debt (about US$ 3.2 billion in principal and interest rates are due). The new Government will need to take quick action to deal with these repayments and avoid international default. This issue is further discussed below.

V. Economic Goals for the Future

38. The goals for the future are to retain the country's external and internal stability and to revive economic growth. The country will need to contain inflationary pressures, minimize instability in the exchange rate, and complete foreign exchange convertibility. It needs to provide the basis for sustainable economic growth. For this, the country has two major tasks:

- The Government has to continue and accelerate implementation of economic reforms to build private sector confidence and revive growth.

- The Government has to deal successfully with relatively large foreign debt service payments of US$3.2 billion in year 2000.

39. Regarding the first task, President Kuchma has indicated that his second administration will give very high priority to an acceleration of economic reforms. The Presidential Elections of November 1999 gave him a 56% victory, based on a reform platform. President Kuchma has therefore a strong backing of the electorate and a clear mandate to accelerate reforms and improve living standards. The President has already proposed to Parliament that Mr. Valeriy Pustovoitenko should remain as Prime Minister. Over the next few weeks, the details of the economic reform program of the Government will emerge. The key question is not the direction (pro-Western reforms), but the depth of the economic reforms that the new government will implement. There is consensus in the international community in Kiev that the current pace of reforms is not sufficient to bring investments and yield growth. A major acceleration of economic reforms is needed for the country to revive growth and avoid international default.

40. The major areas of economic reform that are needed to revive investments and growth are provided in Section VI below. Many of these reforms have been discussed and endorsed by multilateral financial institutions and private investors. They should provide the Government's agenda of future reforms.

41. Regarding the second goal -- serving Ukraine's external debt -- as noted in Attachment 2, the total external debt of the country, at the beginning of 1999, amounted to about US$11.5 billion. This amount is not large, representing only 35% of GDP. Furthermore, it is owed principally to multilateral and bilateral donors. However, debt service obligations in year 2000 will be significant. As shown in Attachment 3, Debt Service in year 2000 will amount to US$3.2 billion. In that year, two large Eurobonds will mature, involving total debt service of US$1.3 billion.

In addition, other large debt service obligations will include US$ 900 million due to the IMF, US$200 million due to the World Bank, US$220 million due under Gazprom bonds, US$260 million due to Russian and Turkmenistan, and US$300 million due under publicly guaranteed debt. The debt service obligations to Russia and Turkmenistan are related to the supply of oil and gas to Ukraine. The Government has already made arrangements to service this energy-related bilateral debt, including payments through commodity and asset swaps, payment through construction services, and debt cancellation with Russia in connection with agreements on the Air Force and Black Sea Fleets.

42. In order to serve its other foreign obligations, the Government has recently acknowledged that a larger proportion of the state budget in the year 2,000 will be required to repay foreign debt. As a second source of financing, the Government will seek to increase cash receipts from privatization of large state enterprises, particularly telecommunications and electric utilities. Thirdly, the Government believes that in the year 2,000, new foreign borrowing could be possible, both from multilateral institutions and private foreign banks. Fourthly, the Government expects to negotiate, on a voluntary basis, the restructuring of some of the foreign debt due in the year.

43. It is likely that a combination of the above financing options will be able to address debt repayments in the year 2,000, provided that the new Government improves the investment climate in the country, based on an acceleration of economic reforms. The new Government will need to demonstrate its commitment to accelerate economic reforms and to improve Ukraine’s business climate. As noted in Attachment 3, after the year 2,000, the debt service obligations of Ukraine will fall sharply (to US$2.4 billion). This highlights the fact that the size of the total foreign debt of Ukraine is not large, but its maturity is quite short.

VI. Key Structural Reforms in Ukraine

44. International experience of countries that have successfully implemented economic reforms shows that economic reforms must be implemented quickly, on an accelerated basis. Step-by-step reforms do not work because over time, too many resistances are created and vested interests are able to block the reforms. Only a "big-bang", bold program will have a chance to succeed. President Menen of Argentina did this when he took power. President Fujimori of Peru also implemented a bold program during the first months of his administration. In Eastern Europe, those countries that undertook accelerated and bold reforms suffered the lowest declines in output after the collapse of the former Soviet Union and were able to re-start growth more quickly.

45. President Kuchma should now grab the opportunity of starting a new mandate to break from the past and implement reforms on an accelerated basis. This section discusses the key structural sector reforms needed in Ukraine to build private sector confidence and revive economic growth.

(a) Fiscal Reforms

46. The main aim of these reforms should be to eliminate Fiscal Budget Deficits in a sustainable and credible manner. The size of the fiscal deficit of Ukraine (at about 5-6% of GDP until mid 1998) has been at the root of its economic problems. Although the deficit is now at lower levels, there are doubts about whether the deficit can be controlled over the longer term. In order to make the budget situation sustainable over the long term, the Government will need to carry out the following measures:

- Improve the Structure of Government Revenues:
  - Improve Tax Structure
  - Increase the Tax Base
  - Improve Tax Administration
  - Eliminate Tax Exemptions
  - Improve Cost Recovery of Public Services

- Improve Management of Public Expenditures:
  - Improve Treasury Operations
  - Reform the Pension System
  - Reduce Current Expenditures of Government
  - Reduce Subsidies

(b) Public Administration Reform

47. The current Government structure retains many of the problems inherited from the former Soviet Union. It has become now a bottleneck to the country's development, particularly by interfering with private sector activities. The actions that need to be taken are as follows:

- Approve an action plan for the implementation of the Concept of Administrative Reform, under which the role of the Government is limited to non-commercial activities and public goods. The main objective of the Government is to support private-sector led growth, and not to try to compete with the private sector.

- Adopt a reorganization plan of the Apparat of the Cabinet of Ministers, which will change its role and structure. It would eliminate current overlapping of responsibilities and devolve functions to the line ministries. The Apparat of the Cabinet of Ministers, a legacy from the Soviet times, is a main bottleneck for strengthening the policy making in ministries. Its role should be limited to a Secretariat to the Prime Minister.

- Create a high level Public Administration Reform Unit and give it real power to implement the public administration reform program

- Finalize the functional reviews of the Ministry of Economy and Ministry of Finance and start implementation of the operational reviews of these ministries.

- Further consolidate ministries and state committees to minimize duplication and overlapping; and eliminate the remaining branch ministries.

- Complete functional reviews and reorganization for other ministries.

- Undertake Operational Reviews on all ministries and government agencies to simplify processes and procedures.

- Reform financial and other relations between the central and local governments.

- Carry out a Civil Service reform to upgrade the quality of Government staff, including a clear certification system for personnel hiring, payment and advancement linked to good performance, and dismissal rules for civil servants.

(c) Enterprise Development

48. Ukraine's future growth will depend on its success in fostering the formation of small and medium enterprises. In Poland, during the two key years of reform in the early 1990's, about 2 million small enterprises were created. These enterprises provided the basis for growth in the country. Other Eastern European countries had similar experiences: those that de-regulated and liberalize their markets had the best supply responses. To facilitate enterprise development, Ukraine must undertake the following reforms:

- I. De-regulation of Business Activities:

    (i) Issue a decree defining more clearly the Government's De-regulation Strategy (to allow firms to operate in a market economy with more degrees of freedom and less interference from Government agencies).

    (ii) Complete the analysis of business licensing problems and submit legislation to Parliament for required changes in the licensing system.

    (iii) Submit proposal to simplify business registration and start a system based on a one-stop process.

    (iv) Implement the Government's de-regulation program (to be contained in the Government's Decree on De-regulation Strategy mentioned above), including:

        (a) the institutionalization of de-regulation by setting a De-regulation Council that will continuously review all existing and new legislation to assess their impact on businesses.

        (b) Implement further de-regulation measures, inter alia, to: simplify trade and customs procedures; reduce the number of business inspections by government agencies; rationalize tax audits; remove constraints to the purchase and leasing of commercial premises, land and housing; eliminate limits to bank accounts and transactions; eliminate power of administrative agencies to confiscate bank deposits of firms and individuals.

- II. Privatization of State Enterprises:

  (i) Issue regulations for fully transparent processes and procedures for the case-by-case privatization of large state enterprises.

  (ii) Identify, issue the list, and agree on the schedule for the privatization of all large enterprises. Privatize 10 large enterprises in a short period of time to build credibility.

  (iii) Privatize for cash all remaining large state enterprises.

- III. Capital Markets and Accounting reform:

  (i) Secure agreement between the Security Commission and the National Bank on their scope and rules for the regulation of banks.

  (ii) Clarify the role of the Security Commission on TBills and derivatives.

  (iii) Accelerate implementation of the Accounting Reform Program, to develop and implement National Accounting Standards according to International Accounting Standards.

  (iv) Amend the tax system to encourage development of capital markets.

  (v) Enact the Law on a National Depositary System for securities.

  (vi) Enact a satisfactory Bankruptcy Law and issue all necessary clarifications to fill gaps and regulate the licensing of bankruptcy trustees and liquidators.

(d) Pension Reform

49. The Pension system is likely to impose significant fiscal budget costs in the near future. Its main structural problems should be addressed now. The key measures are as follows:

- To help correct financial imbalances of the pension system and to better target benefits, enact legislation to increase the retirement age (currently 55 for women and 60 for men).

- To supplement the "Pay-As-You-Go" state pension system, introduce a regulated mandatory component to the pension system with a fully-funded element, based on capitalizable individual accounts.

(e) Financial and Monetary Sector

50. A healthy financial sector is needed to facilitate the implementation of private sector activities and investments. The current system is not satisfying this need. Some of the key measures to reform the financial sector include:

- Remove all restricting norms on the foreign exchange market, switching to a floating Hryvnia exchange rate system.

- Carry out the restructuring of commercial banks that are now in financial difficulties and complete the restructuring of the Saving Bank.

- Enforce new regulations on loan classification and loss provisioning for all banks.

- Complete the development of the early warning system -- with sensitivity analysis capabilities -- to identify and deal with banks at risk.

- Complete the preparation of contingency plans for dealing with possible troubled banks and expedite arrangements for the liquidation of non-viable banks.

(f) Agriculture Sector

51. The agricultural sector should be one of the main engines of growth in Ukraine. The country today is producing much less that what it used to produce ten years ago. There is no fundamental reason for this situation, as the land today is as good as it used to be. Reform in this sector are needed to re-establish growth and should receive high priority. Some of the key measures are as follows:

- Farm Restructuring. Restructure cooperatives to give ownership of well-defined plots of land to the individual members of the cooperative. Provide guidance and define the processes for the distribution of land by cooperatives to private farmers.

- Ensure the implementation of the current Decrees on competitive procurement of all government purchases of agricultural commodities through agricultural commodity exchanges.

- Privatize the bulk of Government-owned grain elevators.

- Reverse some of the recent back-trackings on agricultural trade liberalization (e.g., export tax on sunflower seeds).

- Further liberalize agricultural markets, including concrete measures to stop any Government interference with the movement of grain.

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- Redefine the role of the Government on the supply of inputs to agriculture, transferring gradually these responsibilities to the private sector.

- Establish a single land registry.

- Pass legislation to permit and facilitate agricultural land privatization.

ATTACHMENT 1

Key Economic Statistical Information

	1996	1997	1998	1999P
Real GDP (% change YOY)	-10	-3.0	-1.7	-1.0
GDP (UAH bn)	81	93	104	130
GDP per Capita (US$)	870	990	850	640
Gross Domestic Savings (% of GDP)	20	19	18	19
Gross Domestic Investments (% of GDP)	23	21	21	20
Fiscal Balance (% of GDP)	-3.2	-5.6	-2.7	-1.8
Fiscal Revenues (% of GDP)	36.7	38.4	36.1	36.3
Fiscal Expenditures (% of GDP)	39.9	44.0	38.8	38.1
Consumer Price Index (% change YOY)	40	10	20	15
Money Supply-M3 (% change YoY)	35	34	25	36
Exchange Rate (end of period, UAH/US$)	1.89	1.90	3.43	5.50
Merchandise Exports (US$bn)	15.5	15.4	13.7	12.3
Non-Factor Service Exports (US$bn)	4.8	4.9	4.7	3.4
Merchandise Imports (US$bn)	19.8	19.6	16.3	13.6
Non-Factor Service Imports (US$bn)	1.6	2.3	2.5	2.6
Trade Balance (US$bn)	-4.3	-4.2	-2.6	-1.3
Current Account Balance (US$bn)	-1.2	-1.3	-0.6	-0.5
Net Foreign Direct Investments (US$bn)	0.5	0.6	0.7	0.5
Gross International Reserves (US$bn)	1.9	2.3	0.7	1.3
External Public Debt (US$bn)	8.8	9.6	11.5	12.8
External Debt Service (US$bn)	1.2	1.2	1.8	2.0
Domestic Public Debt (US$bn equiv.)	1.3	4.6	3.7	2.2

ATTACHMENT 2

External Debt Outstanding (Millions of US$)

(at the end of 1998)

Multilateral:	
IMF	2,795
World Bank	1,586
EBRD	227
EC	333
Bilateral	
Russia/ Gazprom Bonds	3,051
Turkmenistan	458
Germany	501
USA	414
Japan	150
Other	216
Private	
Eurobonds/Private Creditors	1,650
Non-Resident T-Bills	117

TOTAL	US$11,500 million

ATTACHMENT 3

UKRAINE - Foreign Debt Service (in Millions of US$)

	1999	2000	2001
IMF	685	907	663
World Bank	105	196	248
Russia	98	98	98
Turkmenistan	163	161	151
Credit Lines & Public Guarantees	311	302	271
EU/Japan	18	26	53
Gazprom	236	224	213
Eurobonds & Fiduciary Credits	379	1,323	667
TOTAL	1,995	3,237	2,364