Document of
The World Bank

Report No. 32250-UA

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
AND
THE INTERNATIONAL FINANCE CORPORATION
COUNTRY ASSISTANCE STRATEGY PROGRESS REPORT
FOR UKRAINE
FOR 2004-07

May 19, 2005

Ukraine, Belarus and Moldova Country Management Unit
Europe and Central Asia Region

The Country Assistance Strategy for Ukraine was discussed by Executive Directors on October 23, 2003.

Currency Equivalents

Currency Unit = Hryvnia (UAH)

May 2005: US$1=UAH5.05

Abbreviations and Acronyms

AAA
Analytical and Advisory Activities
LIBOR
London Interbank Offered Rate

AIDS
Acquired Immune Deficiency Syndrome
MDGs
Millennium Development Goals

AML/CFT
Anti-Money Laundering and Combating the
MIC
Middle Income Countries

Financing of Terrorism
MIGA
Multilateral Investment Guarantee

APL
Adaptable Program Lending

Agency

BoP
Balance of Payments
NBFI SEC
Non-Bank Financial Institutions

CAS
Country Assistance Strategy

Corporate Secretariat

CEM
Country Economic Memorandum
NBU
National Bank of Ukraine

CFAA
Country Financial Accountability
NGO
Non-governmental Organization

Assessment
ODA
Official Development Assistance

CIDA
Canadian International Development Agency
OECD
Organization for Economic Co-

CIS
Commonwealth of Independent States

operation and Development

CIT
Corporate Income Tax
PAL
Programmatic Adjustment Loan

CoM
Cabinet of Ministers
PER
Public Expenditure Review

CPAR
Country Procurement Assessment Report
PEIR
Public Expenditure and Institutional

CPPR
Country Portfolio Performance Review

Review

DFID
United Kingdom Department for
PFM
Public Financial Management

International Development
PIT
Personal Income Tax

DOD
Debt Outstanding and Disbursed
PSD
Private Sector Development

DPL
Development Policy Loan
ROSC
Report on the Observance of Standards

EBRD
European Bank for Reconstruction and

and Codes

Development
SAARP
Social Assistance Administration

EC
European Commission

Reform Project

EIB
European Investment Bank
SDDS
Special Data Dissemination Standard

ESW
Economic and Sector Work
SIDA
Swedish International Development

EU
European Union

Cooperation Agency

FATF
Financial Action Task Force
SIF
Social Investment Fund

FDI
Financial and Industrial Group
SIL
Specific Investment Loan

FIG
Foreign Direct Investment
SMEs
Small and Medium Size Enterprises

FOB
Free on Board
SOE
State Owned Enterprise

FSAP
Financial Sector Advisory Program
SWAp

Sector-Wide Approach

FY
Fiscal Year
TA
Technical Assistance

GDP
Gross Domestic Product
TACIS
Technical Assistance for the CIS (EU

GEF
Global Environment Facility

Technical Assistance program)

GFATM
Global Fund to Fight AIDS, Tuberculosis
TB
Tuberculosis

and Malaria
UNAIDS
Joint United Nations Program on

GNFS
Goods and Non-factor Services

HIV/AIDS

GOU
Government of Ukraine
UNDAF
United Nations Development

HIV
Human Immune Deficiency Virus

Assistance Framework

IBRD
International Bank for Reconstruction and
UNDP
United Nations Development Program

Development
USAID
United States Agency for International

IFC
International Finance Corporation

Development

IFI
International Finance Institution
VAT
Value Added Tax

IGF
Intergovernmental Finance
WHO
World Health Organization

ILO
International Labor Organization
WTO
World Trade Organization

IMF
International Monetary Fund

IPP
Independent Power Producers

Fiscal Year

Government of Ukraine: January 1 – December 31

THE WORLD BANK GROUP TEAM		
	IBRD	**IFC**
Vice President:	Shigeo Katsu	Assaad Jabre
Director:	Paul Bermingham	Edward Nassim
Team Leader:	Dusan Vujovic	Kutlay Ebiri
Team:	Mark Davis, Luis Alvaro Sanchez, Oleksiy Balabushko, Ruslan Piontkivsky, Sergiy Kulyk, Yulia Snizko, Rostyslav Zhuk, Olena Bekh, Kazuko Ogawa, Dejan Ostojic, Yuri Miroshnichenko, Aleksander Kaliberda, Katerina Petrina, Angela Prigozhina, Svetlana Budagovskaya, Alexei Slenzak, Yuri Chorninkiy.	

TABLE OF CONTENTS

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT AND THE INTERNATIONAL FINANCE CORPORATION COUNTRY ASSISTANCE STRATEGY PROGRESS REPORT FOR UKRAINE FOR 2004-07

I. COUNTRY CONTEXT

A. INTRODUCTION

1. After a decade of severe economic contraction, Ukraine's economy has enjoyed six consecutive years of growth during which GDP expanded by more than 50 percent and poverty fell sharply. Growth derived from a combination of a highly favorable external environment, a revival of the traditional industrial base, and improved macroeconomic policies and management. Sustainable growth is vulnerable to concentration in industries controlled by a small number of financial and industrial groups that acquired a disproportionate influence over public policy and decision-making, a business climate that remains costly to the enterprise sector and skewed towards connected groups, and insufficient diversification.

2. Following an extraordinary presidential election, a new administration takes power with an ambitious program to fundamentally change Ukrainian society and the economy. Although tested by recent events, economic performance remains solid and institutions resilient. This provides a good foundation for Ukraine to deliver the institutional transformation that remains needed to deliver fast, sustainable, and equitable growth and to meet national ambitions for integration in the global economy.

3. This Country Assistance Strategy (CAS) Progress Report documents progress in implementing the CAS for the period 2004-07 discussed by the Board on October 27, 2003, and sets out how the strategy will be adapted to meet evolving needs and opportunities during the next two years. The report begins with an overview of the country context, assessing the political and economic changes that have taken place since the beginning of the current CAS period. It then describes progress made towards achieving CAS outcomes and provides an assessment of the results framework. Finally, it presents the development agenda and program of the new government and outlines how the strategy will be implemented for the remainder of the CAS period. The document was prepared by a joint IBRD and IFC team, and includes inputs from MIGA. The proposed changes to the strategy have been discussed with the Government of Ukraine, and reflect discussions with members of the Verkhovna Rada (parliament), representatives of the business community, civic organizations, think-tanks, NGOs, and development partners.

B. POLITICAL AND ECONOMIC DEVELOPMENTS

4. **Ukraine's political landscape was dramatically changed by the presidential election of 2004 and the related events which became known as the "Orange Revolution".** Widespread public protest followed the second round of the presidential election in November 2004. Ruling that there had been irregularities, the Supreme Court ordered that the second round of the election should be re-run on December 26, 2004. The former Prime Minister, Viktor Yushchenko, emerged as the winner, and was inaugurated as President on January 23, 2005. A new government led by Yulia Tymoshenko was appointed on February 4, 2005. During the crisis, the Verkhovna Rada (parliament) approved a series of changes to the constitution which are expected to result in a shift of powers between the President, Prime Minister and parliament later in 2005.

5. **Ukraine's institutions came through the political crisis well**. Notwithstanding widespread street protests, the crisis was resolved by institutions. Parliament overwhelmingly approved new constitutional arrangements and the appointment of the new government. The Supreme Court showed independence from the executive. The National Bank managed a threatened banking crisis well. Media (in particular television) coverage became much more balanced. The security forces stayed out of the crisis, and maintained a modest presence on the streets. Street demonstrations were almost universally peaceful. Meanwhile, the previous alignment of political blocks in parliament has fundamentally shifted. Parliamentary elections scheduled for March 2006 will occupy an increasing proportion of leadership time and energy as they approach.

6. **The new administration has taken office with an ambitious agenda.** President Yushchenko announced that membership of the European Union is Ukraine's top priority. The new government outlined an ambitious program designed to deliver sustained economic growth, maintain macroeconomic stability, improve the efficacy of the state institutions, fight corruption and reduce the shadow economy, advance social inclusion, and deepen Ukraine's evolution as a modern democratic society. The change has been accompanied by a significant increase in international goodwill and investor interest in Ukraine.

7. **Ukraine has had several years of strong growth and improved macroeconomic performance, but the return of inflation and looser fiscal policy are a source of concern.** Ukraine's economy grew more than 50 percent between 1999 and 2004. The 12.1 percent rate recorded in 2004 was the highest in Europe. Growth in 2005 is projected at 7 percent. Past improvements in fiscal management and sustained export-led growth improved Ukraine's external position and lowered public and publicly guaranteed debt from 67 percent of GDP in 1999 to 25 percent in 2004.[3] Ukraine's credit rating has been steadily upgraded, providing improved access to international financial markets, with spreads now around 180 basis points above LIBOR.[4] Inflation has emerged as a significant concern, reaching 14 percent in March 2005, as a result of sharp increases in food (meat) and energy prices and increased social spending. The authorities have commenced corrective measures to contain fiscal imbalances, and a modest revaluation of the domestic currency. Appendix C provides a more detailed discussion of recent economic developments.

8. **Poverty has fallen sharply, and MDG targets on maternal and child mortality have been exceeded, but the threat of TB and AIDS remains unabated.** Strong growth has helped poverty to fall from above 30 percent in 1999 to 19 percent in 2003, and further reductions are expected in 2004 and 2005. The reduction in poverty has been faster than in most neighboring countries. Large cities performed better than small towns and rural areas which have fewer employment and economic opportunities. The level of inequality in Ukraine (Gini coefficient 0.3) is lower than in many Western European countries. HIV/AIDS and tuberculosis continue to be a concern. The number of HIV cases increased by 25 percent in 2004, and some estimates are that 1 percent of the population may be infected.

9. **Significant barriers to sustained long-term growth still exist.** Although Ukraine has extensive human capital, natural resources, and industrial potential, it faces significant medium term barriers to sustained growth. The excess capacity that facilitated recent rapid industrial growth will soon disappear, and the quality of infrastructure is emerging as a constraint. High levels of sectoral and regional concentration of industries, the absence of technological sophistication, high costs of doing business, limited access to finance and weak domestic competition hamper Ukraine's ability to remain competitive in the presence of a possible further deterioration of terms of trade. Ukraine's low productivity has been absorbed mostly through low wages – the labor force is among the lowest paid in Europe. Future high

---

3 The current account surplus exceeded 10 percent of GDP in 2004. At US$13 billion, international reserves are at record levels, and close to four months of imports.

4 Moody's presently rates Ukraine B1, Standard and Poors BB-, and Fitch BB-.

economic growth, beyond factor accumulation, will require sustained increases in factor productivity, which can come only from sustained improvement in the quality of the supporting institutions.

C. Progress Towards CAS Outcomes

10. **The Ukraine CAS was an early pilot results-based CAS**. It developed a framework with which to track progress in reaching long-term development objectives and selected CAS outcomes. The results matrix was compatible with the government program approved by parliament following wide consultation. It built on the positive experience of working with outcomes and milestones during implementation of the Programmatic Adjustment Lending series during the previous CAS.

11. **The process of monitoring results continues to evolve.** With much of 2004 dominated by political developments, it proved difficult to establish a formal results monitoring structure with the government.[5] The primary monitoring mechanism therefore remained that which was put in place for the PAL program. Going forward, a number of additional processes are planned to monitor the revised CAS results. Specifically, the framework will build on the arrangements to monitor implementation of the proposed new development policy loan (DPL) program and selected investment projects; the annual portfolio review will be expanded to include discussion of overall CAS progress against target results; the Bank will coordinate with the EC on their planned annual progress reports on the implementation of the EU - Ukraine Action Plan; and the framework will link to the statistical services project. The arrival of a new government provides the opportunity to mainstream and implement this process over the next two years, during which time the framework and indicators can be expected to evolve in the light of experience. This is likely to involve a more targeted and flexible approach, while retaining a focus on measurable outcomes. Box 1 gives a summary of progress towards meeting CAS outcomes, and Annex B9 provides the results matrix.

12. **It remains early to judge the results of the Bank's activities, but there is evidence of significant value added.** Dialogue with the government through the PAL program and analytic work has advanced policy and institutional reforms. By contrast, the contribution of investment projects has been uneven. Three investment projects that closed during the CAS period (Treasury, Export Development, and ODS Phase-Out (GEF)) each had satisfactory outcomes, and together they represent some of the most successful operations the Bank has supported in Ukraine. There has been a significant improvement in the performance of the infrastructure portfolio, whose projects (one in water and two in energy) each experienced early implementation delays, but are now performing well and on schedule for successful completion before the end of the CAS period. Implementation of projects on HIV/AIDS and TB, land titling and private sector development, on the other hand, has been more problematic, and restructuring is needed to achieve objectives. All investment loans, including those ultimately successful, take significantly longer to prepare and implement than in similar countries.

13. **The Bank's analytic and advisory program focused on growth, poverty, agriculture, energy, environment, trade, and WTO accession**. Broad consultation and dissemination included dialogue with those now in government, and there is consistency between the government's announced program and the Bank's findings and recommendations. A series of short policy notes were quickly prepared for the incoming government. The program allowed the Bank to contribute to the development of the economic content of the EU Action Plan, which is consistent with the PAL and proposed DPL programs. The existing stock of knowledge, together with that planned, positions the Bank to provide effective advice and assistance during the rest of the CAS period.

---

[5] For example, the project to improve statistical services which was approved by the Bank's Board in March 2004 was only ratified by the Verkhovna Rada in May 2005.

14. **Lending has proceeded at a slower pace than planned.** In the face of increasing political uncertainty, the Bank proceeded with new loans at a pace less than that foreseen in the CAS document. After 18 months of implementation, only two new loans have been approved (PAL-2 for US$250 million, and Statistical Development for US$30 million), and none in the last 12 months. As of March 31, 2005, the portfolio comprised 11 investment operations (including one GEF) with an aggregate net committed loan amount of US$649.8 million, of which US$92.7 million (14.3 percent) has been disbursed. Implementation continues to be burdened by cumbersome procedures, and disbursement ratios remain well below regional and Bank-wide averages. Four projects are in problem status.

BOX 1: SUMMARY OF PROGRESS TOWARDS ACHIEVING CAS OUTCOMES

The Bank's AAA and lending program contributed significantly towards:

- Institutional reforms and improved macroeconomic policies that underpinned continued economic growth.
- The consolidation and rapid development of the financial sector, and Ukraine's removal from the FATF blacklist in 2004.
- Maintaining sound fiscal and budgetary policies.
- Advancing land ownership rights and agriculture sector reform, albeit achieving slower than expected progress in implementing the single registry system.
- Transparency and accountability in solving accumulated energy sector problems, including the resolution of old debts and new governance and ownership structures necessary to attract needed investment.
- Better understanding of the nature and dynamics of poverty, and reduced poverty levels.
- Improved diagnostic, programming and implementation capacity in line ministries (e.g. education and health) to enable the development of new sector strategies.
- Facilitating and accelerating the process of WTO accession through capacity building and timely preparation of policy advice.
- Improved public finance management, and the development of an agenda (government White Paper) to secure further improvements.

More limited progress was made in the areas of:

- HIV/AIDS and TB, where Ukraine, notwithstanding engagement from the Bank and other donors, has yet to build full public recognition of the problem and achieve tangible results.
- Environmental sustainability, where the Bank-supported upgrading of the system of pollution fees and fines failed to produce an implementable result, generate resources and visible incentive effects.
- Delivering impact through accelerating the pace of implementation of investment loans.
- Implementation of a results-measurement system.

D. DEVELOPMENT AGENDA AND GOVERNMENT PROGRAM

15. **The new government has announced an ambitious program.** Entitled "Meeting the People", it offers a vision of Ukraine characterized by equitable job creation, family values, low levels of corruption, strong social service provision, and integration into the global economy through WTO accession and EU integration. A description of the key elements of the program is outlined in Appendix B. The EU-Ukraine Action Plan signed by the government and the European Commission in February 2005 provides a structured framework to advance the European integration agenda.

16. **The first three months has been marked by intense activity, a number of achievements, but also some uncertainty.**[6] The government, entering office with little time to plan following the protracted electoral cycle, with an ambitious agenda, and facing high expectations, has taken some time to settle. Recurring themes in the first few months are public accountability, improved governance, respect for the rule of law, and a determination to root out corruption and reduce the shadow economy. Public pronouncements confirm the intention to proceed quickly with deep reforms, but have not always been

[6] For a summary of achievements in the first one hundred days, see *Ukraine: Proposed First Development Policy Loan* dated May 2005.

consistent as to how they will be done. The government made an early decision to honor the large increases in pensions and minimum wages approved prior to its appointment.[7] In the budget amendment that was necessary to finance these, it aimed to reduce the inherited deficit by eliminating exemptions and privileges, attacking smuggling, and improving customs and tax administration. Revenues through April are ahead of ambitious targets. The dollar peg was relaxed, albeit modestly, after several years of a de facto fixed exchange rate, a step long advocated by the IMF and the Bank. Proposals for structural reform are under preparation in several sectors, and will emerge in the coming weeks. Some of the more fundamental changes may need to await a new parliament. Nevertheless, initial evidence suggests a reduction in state capture by large financial and industrial groups.

17. **There are signs that the enterprise sector is unsettled by mixed messages and uneven implementation.** The sudden revaluation accompanied by inconsistent messages from the authorities caused public concern. The enterprise sector was not prepared for the suddenness of the changes in tax and customs practices, and reports disruptions to business and trade. Although it is planned that the review of previously privatized enterprises will look at a smaller rather than a larger number, delays in announcing those to be reviewed have added to uncertainty. Administrative interventions to reduce inflation (in particular, the prices of fuel and meat) have raised concerns about the depth of commitment to market solutions. Pushing ahead quickly with legislative changes reflects a wish to deliver change, but without adequate consultation, including review for consistency with EU norms, risks not delivering expected results. In this environment, the Bank is seeking to engage quickly to assist the formulation of a prioritized and sequenced plan of concrete actions to implement what is a sound, if not yet specific, government program. It proposes to do this through a new DPL program, a reinvigorated investment lending portfolio, and a more flexible and responsive analytic program.

II. WORLD BANK GROUP ASSISTANCE STRATEGY

A. OBJECTIVES OF THE CAS PROGRAM GOING FORWARD

18. **The mission statement presented in the original CAS document remains valid** (see Box 2). The Bank will continue to support Ukraine's European choice, which has now moved to the center of the government program. Specifically, the Bank will assist the government in prioritizing and sequencing the program and transforming key development objectives into actionable interventions that will lead to tangible results. The Bank and the European Commission will work to ensure coordination between their respective monitoring efforts and those of the government.

BOX 2: CAS 2004-2007 MISSION STATEMENT

To assist Ukraine in building institutions necessary for sustainable and equitable growth and for poverty reduction. To support Ukraine's aspirations with regard to increasing integration with the EU and with the WTO. To help provide Ukraine's citizenry greater voice and to foster stronger accountability of government.

19. **Adapting to opportunity.** Ukraine's development needs have not changed substantially since the CAS was prepared; what has changed is the opportunity to address them. The Bank's challenge is to adapt its engagement during the remainder of the CAS period to respond to this opportunity. Guiding principles include a focus on results, strong client orientation, flexibility of the program and instruments,

[7] Revised pension legislation and the 2005 budget support a 17 percent increase in minimum pensions to about \$66 per month. The budget also implements quarterly increases of the minimum public wage until they catch up with the minimum pension on September 1, 2005. By that time, the nominal minimum public wage will have increased by 40 percent above the level of December 2004.

ability to respond quickly to emerging opportunities, and simplification of procedures and project design to lower the cost of doing business with the Bank. Opportunity is underpinned by the readiness of the new government to undertake fundamental reforms, indications of greater political consensus, and improved public finances and access to capital markets following several years of sound economic performance.

20. **Financing needs are less prominent.** Ukraine has much improved access to international capital markets at competitive rates, and thus depends less on the Bank as a source of finance. The Bank's relevance will therefore be determined by its ability to respond quickly through a flexible combination of advisory services and lending adapted to meet country needs and conditions. Policy-based lending will be designed to help translate announced government objectives into results, with a stronger focus on monitoring medium-term outcomes rather than year-by-year conditionality. On the investment side, the Bank will help the government identify priority projects that address bottlenecks in social, economic and physical infrastructure and provide fast, world-class solutions. This assumes a more effective delivery platform for investment projects that reflects the recommendations of the Bank's MIC task force and recent changes to operational policy. The Bank's analytic work is integral to the success of the overall program. It will focus on thematic and sector issues aligned with government priorities and provide the knowledge base to underpin lending operations. Greater flexibility in programming will be introduced to provide space to respond to requests for fast advice.

B. POLICY AGENDA AND EXPECTED OUTCOMES

21. **The development goals identified in the CAS remain largely valid**. However, priorities have shifted, necessitating an adjustment in both the program and the results framework. The framework revises outcomes to be in line with the expected sequencing of government actions in the remainder of the CAS period and to reflect progress to date. It seeks to provide a more realistic and focused set of outcomes that are consistent with the EU Action Plan, yielding an opportunity for joint monitoring by the government, the EU and the Bank. Annex B9 sets out the key outcomes the Bank expects to influence through its interventions following the format used in the CAS. The following paragraphs describe the main outcomes.

22. **Removing impediments to economic growth.** The government intends to reduce the size of the shadow economy, provide a level playing field that encourages competition, ease the regulatory burden on businesses, and tackle emerging infrastructure constraints. Concrete outcomes in support of this intention include improved efficiency in the operations of customs and tax administration and an overhaul of business regulatory framework (permit system, etc.). The government also aims to improve the technical performance, governance and financial viability of the energy sector; provide better access to financing and extension services for new businesses in agriculture (farms and rural SMEs); and upgrade national infrastructure.

23. **Public sector and judicial reform**. The government seeks to reduce corruption, improve efficiency in the use of public resources, attract qualified and competent civil servants, and initiate reforms of the judiciary and the public administration. Tangible outcomes that the Bank would support include subordination of revenue agencies to the Ministry of Finance; improved operations and accountability in key revenue agencies (including full data exchange, regularized internal and external audits, and better performance and client orientation of customs and tax officials); and improved efficiency in the use of public resources through better and more transparent procurement practices, and standardized internal and external audits. The program aims to reform the civil service system through adoption of EU compatible legislation, moving towards a competitive pay and hiring system and

practices, to advance administrative reform through a more efficient organization of the state bodies of executive power, and to initiate legal and judicial reform.

24. **Social service provision and inclusion.** The government is committed to raise awareness of the TB/AIDS threat and mobilize resources to address the epidemics. It aims to improve the use of limited social expenditures, and enhance human development through deep reforms of the health and education systems. Specific outcomes the Bank program supports include broader political and social ownership of the strategy to fight HIV/AIDS and TB and the start of coordinated implementation; and an integrated social assistance-social insurance system designed to improve targeting, reduce cost and streamline the entitlement framework. The Bank's program will also support reform of the education system to upgrade and modernize the curricula, introduce and improve universal testing, and the development of a comprehensive health sector strategy to streamline the service network, improve primary health care and facilitate private participation.

C. THE BANK PROGRAM

25. **The existing lending envelope remains appropriate.** Within the base case, the lending envelope will remain in the range of US$1.8 to US$2.4 billion, with development policy lending accounting for up to 50 percent of the total. Under the high case scenario, additional lending of up to US$600 million would become available. Box 3 assesses the status of the base- and high-case triggers. As noted in the assessment of the trigger concerning the macroeconomic framework, while overall macroeconomic outcomes are sound and the new government has taken steps towards enhancing economic stability and sustainability, it needs additional time to address the economic and policy disruption surrounding the 2004 election and to develop a fully consistent and sustainable policy framework. Meanwhile, the Bank proposes to remain in the base case and to calibrate its support to the pace of reform. The Bank's program, in particular the first development policy loan, includes several measures to help further improve macroeconomic management.

26. **Development policy lending will continue at the center of the program, and focus on key policy and institutional reforms.** After concluding the second PAL, the program is planned to evolve into a new series of three single-tranche development policy loans (DPLs) anchored in the government's recently announced program. The main goal is to translate the government's ambitious objectives into results through a prioritized and sequenced course of policy actions and reforms over a three year period. The program would be designed to be consistent with the EU-Ukraine Action Plan, and the Bank and European Commission are coordinating arrangements for monitoring results. The first operation is planned for mid-2005.

27. **Investment lending will continue to support the sectors set out in the CAS, adapted to respond to emerging priorities of the government and new opportunities.** Greater flexibility will be introduced in selecting interventions to respond to evolving opportunities and sometimes uncertain readiness for implementation. The Bank is likely to increase investment lending in infrastructure, reflecting both strong demand in Ukraine and the Bank's Infrastructure Action Plan, which was prepared after the CAS was formulated. Opportunities will be reviewed in water and transport, in addition to the long-standing engagement in the energy sector. The Bank will also assist the government to exploit the significant potential benefits of the Kyoto Protocol, which came into force in February 2005. This includes reviewing Green Investment Scheme opportunities. Finally, the Bank will review how it can expand support for governance issues, responding to the new government's plans for administrative and territorial reform (including decentralization), civil service reform, improved public financial management, and improvements to the legal and judicial system.

28. **There is a strong pipeline of investment lending opportunities.** In mid-2005, it is planned to present for Board approval investment operations in the education, energy, and financial sectors. Operations being considered for FY06 include a second export development project, municipal water and sanitation, social protection and pensions, public financial management/treasury, forestry, and energy. Operations for FY07 are necessarily more tentative, but include possible interventions in health, infrastructure, public administration/governance, and environmental protection. A number of GEF and BioCarbon Fund interventions are also planned.

BOX 3: STATUS OF BASE CASE AND HIGH CASE TRIGGERS

Base Case.

1. *Consistent and sustainable macroeconomic framework in place.* Macroeconomic fundamentals have improved significantly over the CAS period. Growth continues to be strong, debt is low and falling, and reserves are at record levels and rising. Ratings agencies have again upgraded Ukraine's debt, with a stable outlook. Inflation and fiscal loosening emerged as significant concerns in the second half of 2004. The new government has introduced measures to deal with each. With the possible exception of inflation, key economic indicators at the end of 2005 are expected to be better than at the end of 2004. Staff estimate that the 2005 budget amendment will reduce the fiscal deficit inherited by the new government by up to half as a proportion of GDP. Fiscal performance through the first four months of 2005 is ahead of ambitious projections. While overall macroeconomic outcomes are sound, the economic and political dislocation associated with the 2004 election have been such that a fully consistent and sustainable macroeconomic framework will take some more time to develop. The Bank's program, in particular the first DPL, includes several measures to help further improve macroeconomic management.

2. *Satisfactory implementation of the MoU for rehabilitation of the Savings Bank, the implementation of the Action Plan to impose financial discipline, and to bring energy companies to financial solvency and the implementation of the government's White Paper on internal financial control.* Ukraine has satisfactorily implemented the Memorandum of Understanding for the Savings Bank. The Cabinet of Ministers approved a plan to address the solvency of energy companies, including authorizing cost-recovery tariffs. The White Paper on internal financial control has been adopted and implementation has commenced. This trigger has been met.

3. *Continued satisfactory progress in implementation of the agreed World Bank portfolio improvement plan.* The new administration and the Bank have started to implement a series of actions to improve portfolio performance. FY05 disbursements are significantly ahead of those in FY04. This trigger has been met.

4. *Strict adherence to financial and fiduciary obligations.* This trigger has been met.

High Case. Same as Base Case, plus

1. *Substantial restructuring of Naftogaz, and accelerated implementation of reforms in transparency and management.* Improved management, better accounting transparency, and significant steps toward restructuring of NaftoGaz have been implemented. This trigger has been partially met.

2. *Accelerated implementation of measures to facilitate WTO entry and new partnerships with the enlarged EU.* The EU-Ukraine Action Plan was signed in February 2005. Ukraine is seeking to complete WTO accession by end-2005. This trigger has been partially met.

3. *Accelerated reforms of Savings Bank under its strategic development plan.* Savings Bank is performing within the parameters of the signed MoU and now poses significantly less risk to the state budget and the financial system. This trigger has been substantially met. Further reforms will be supported by the DPL program.

4. *Accelerated implementation of the White Paper on public sector accountability.* Implementation of the White Paper has commenced, and will be supported by the DPL program and likely also by an investment project. This trigger has been partially met.

29. **Significant changes are planned to investment lending to respond to persistent portfolio implementation problems.** The Bank has agreed with the government on the need for radical changes to how investment operations are prepared, approved, and implemented. The technical work needed to support these changes is now underway. On the Bank's side, it will involve more rapid internalization of the recommendations of the MIC task force and the more flexible operational policies of recent years. On the government's side, it is expected to lead to a simplification and reduction in duplicative processes as part of a broader program to align project implementation arrangements with the government's normal institutional processes. Among the initial steps that have been taken are the introduction of country financing parameters for Ukraine, providing more flexibility on expenditures eligible for Bank financing

and simpler administrative arrangements; proposed closure and restructuring of several projects, including cancellation of loan amounts; and the provision of additional supervision budgets to projects expected to have impact, but are currently struggling.

30. **Non-lending work.** The Bank will maintain an active program of analytic and advisory services. Around one-third of resources for AAA work would be reserved to allow fast response to requests from the government for policy advice. Among the areas presently envisaged are governance and public administration (PER, updated CFAA and CPAR, advice on debt management, and legal and judicial reform), investment climate (FSAP update, investment climate, and ongoing advice on financial sector and money laundering issues); infrastructure (transport study; updated coal sector note; advice on implementing Kyoto Protocol); and the social sectors (health and education notes, as well as maintaining updated poverty assessments).

D. IFC AND MIGA

31. **IFC.** Over the last two years, IFC has expanded its activities and increased its portfolio. It supported SME financing leasing and credit lines through banks. New investments during this period are distributed in agro-industry, commerce and trade, and banking. It expects to complete four more projects in FY05: a private equity fund, a chain of petrol stations, Kyiv and Rivne Power Distribution Companies, and a hotel chain. IFC is considering future investments in construction materials, agribusiness, retail trade and services, machinery and transport equipment, metal goods, infrastructure (especially ports and municipal infrastructure), IT and telecom, and possibly municipal finance. In the financial sector, insurance, pension funds, housing finance, retail banking, and leasing companies are areas of focus. IFC will continue its extensive on-going donor-funded advisory program. Current activities offer advice on leasing development; governance, financial and asset management, and strategies to attract outside investors; and agribusiness development, which supports local farms, building supply chains and facilitating investment. IFC also conducts annual surveys to assist the legislative and administrative branches and other interested stakeholders identify actions needed to improve the business environment.

32. **MIGA.** MIGA's outstanding guarantee portfolio in Ukraine consists of six contracts with a total gross and net exposure of US$180.8 million and US$115.8 million, respectively. This corresponds to 3.3 percent and 3.6 percent of MIGA's total gross and net exposure, respectively. Three of MIGA's outstanding contracts are in the general banking sector and three in the manufacturing sector. All contracts were signed after September 2003, with the exception of one in the financial sector with a gross exposure of US$19 million. MIGA has an expression of interest for a potential investment in the financial sector in excess of US$100 million. It was also approached by the newly established investment promotion agency of Ukraine - the Agency for Foreign Investments - to assist in the area of investment facilitation. It is looking into the possibility of offering technical assistance services tailored to the needs of increasing FDI into Ukraine.

E. THE IMF AND OTHER DONORS

33. **IMF.** The IMF's precautionary standby arrangement program expired in March without being completed. Ukraine has not requested a new program but has asked the Fund to provide technical assistance in the areas of exchange rate policy, inflation targeting, banking supervision, tax policy, and customs administration. The IMF will continue surveillance activities (next Article IV consultations mission is tentatively planned for October 2005) and will have an active dialogue on fiscal and monetary issues.

34. **Donor activity.** There has been a marked increase in donor interest in Ukraine since the beginning of 2005. This interest has prompted a discussion on how best to coordinate donor assistance. A recent donor meeting identified the following issues: how to help the government coordinate and manage 3,600 donor funded activities; how to effectively respond to the growing TB/AIDS problem in which many donors are involved; the need to avoid conflicting and overloading policy advice from donors; and the development of effective mechanisms to increase absorptive capacity of the government. The government has recently asked the Bank to take a leading role in helping with the coordination of donor activities, and this will form part of the program for the remainder of the CAS period. A donor conference for mid-2005 is under consideration.

35. The **EU** is likely to increase significantly its support for Ukraine from the current EUR 90 million per year. These resources will assist with implementation of the EU-Ukraine Action Plan signed in February 2005 covering the period 2005 to 2007. **EBRD** has prepared a new country strategy, which foresees an increase from the US$350 million invested in 2004. It will focus on infrastructure, financial sector, corporates, and SMEs. **EIB** has extended its activities to include Ukraine, with an initial two-year facility of EUR 250 million to be approved in association with EBRD projects. **UNDP** will continue an active role within the new UNDAF in the amount of US$280 million for all UN agencies over next 5 years. **Japan** made Ukraine ODA eligible, and has announced a substantial US$1 billion program of low cost financing for infrastructure. Other donors that will remain active in Ukraine include USAID, the Netherlands, SIDA, DFID, and CIDA.

F. CREDITWORTHINESS AND RISKS

36. **Ukraine's creditworthiness continues to improve**. Ratings agencies have upgraded Ukraine steadily over the last few years, and spreads have fallen. Negative net IBRD transfers in each fiscal year from FY03 have reduced amounts due from Ukraine to the Bank by almost seven percent. Planned new lending remains within the parameters foreseen in the original CAS.

37. **Risks.** The CAS identified four main risks—political, in the run-up to the presidential election; external, such as a weakening of Russia's economy through lower oil prices; a weakening of European interest in closer collaboration with Ukraine; and adverse macroeconomic developments. The presidential election saw Ukraine's evolution as a modern democratic state tested and re-affirmed. It was followed by a strengthening of links with the EU, reflected in the signing of the EU-Ukraine Action Plan. Russia's economy has remained strong, and the principal external risk now appears to be a global slowdown in demand and weakening prices for Ukraine's main export products.

The main risks going forward are political and macroeconomic. A number of the most significant reforms are unlikely to be adopted before parliamentary elections in March 2006, which will assume more prominence over the coming months. It is not yet clear how the new constitutional changes approved during the political crisis in late 2004 will be implemented. At the same time, the strong majorities in Parliament for the constitutional changes, the appointment of the government, and the amended 2005 budget, as well as the continuity provided by the five year presidential term that has just begun, provide signs of stability. The principal macroeconomic risks are the recent sharp increase in inflation, a higher fiscal deficit, and reduced fiscal space for investment in physical and human capital needed to sustain medium-term growth. The government's efforts to address these issues will be supported by the Bank's proposed DPL program and the IMF's surveillance and technical assistance. The recently amended budget for 2005 is expected to significantly reduce the inherited budget deficit, and there are recent signs of more flexibility in the management of the exchange rate. Ukraine's vulnerability to an external shock has declined, with a much stronger external position and lower levels of debt. Nevertheless, such a shock would have an impact on growth through lower domestic consumption and investment. Growth remains vulnerable to a slow down from external shocks and inadequate diversification beyond those industries that have driven growth in recent years. The banking sector withstood pressures during the political crisis, but remains vulnerable to weak banking supervision, non-transparent ownership and leading practices, severe external shocks and rapid deterioration of the macroeconomic situation. The Bank will continue to provide support to the financial sector through the DPL, investment lending, and advisory services. An FSAP update is planned for later this year.

38. Finally, domestic capacity to implement an ambitious and challenging program is a risk. A significant proportion of the Bank's program, working closely with other donors, will be dedicated to supporting this capacity.

III. THE NEXT PARTNERSHIP STRATEGY

39. This CAS Progress Report provides a basis to reorient Bank support for the remainder of the CAS period. It lays the ground for a new Country Partnership Agreement to be prepared in the spring of 2007.

APPENDIX A

TAKING STOCK: CAS IMPACT THUS FAR AND THE REMAINING AGENDA

1. This appendix takes stock of the CAS impact thus far and assesses if the program is moving towards meeting the long-term goals as spelled out in the CAS. The review that follows is based on the results matrix (see Annex B9) and focuses primarily on the column of outcomes and intermediate indicators. It also includes a discussion of key priorities for the remaining of the CAS period. The current CAS, presented to the Board in October 2003, covered four fiscal years FY04-FY07. It supported the Government program titled ***European Choice*** approved by the Parliament in April 2003**.** That program targeted seven long-term objectives, as described below.

Objective 1: Supporting Macroeconomic and Financial Sustainability for Economic Growth.

2. **Macroeconomic Fundamentals**. Strong progress has been made in creating a sustainable macroeconomic environment, and is reflected in the improved ratings by commercial rating agencies. The PAL program has been the main vehicle to support the government on macroeconomic issues. The attention given to financial discipline has been successful in improving the trust of economic agents on the certainty of economic transactions with beneficial effects in all sectors of the economy – contributing, for instance, to the remarkable growth of the financial sector. There has been also a growing awareness of the advantages of prudent fiscal management in spite of political pressures for populist expenditure. Having reduced significantly the level of public indebtedness, the current challenge is to improve strategic debt management to lock in a maturity structure consistent with the long-term perspectives of the country and reduce the risks from adverse developments in exchange and interest rates. At the same time, the pre-election period in 2004 saw a considerable loosening of fiscal policy, which contributed to a significant increase in inflation. These issues, and the need to restore fiscal space for capital investment, dominate the macroeconomic agenda going forward.

3. **Financial Sector.** A substantial and sustained growth in demand for financial assets denominated in domestic currency has deepened financial markets, improving Ukraine's indicators when compared to other countries in the region. Progress has also been made in tightening regulatory practices in the banking sector. Areas of systemic risk have been addressed, including containment of potential negative impact from the Savings Bank.

4. The Bank supported financial sector development through the PAL program, technical assistance and analytical and advisory work, including FSAP and a subsequent update. Financial sector deepening and modernization are being supported through a proposed credit line aimed at improving access to financial services for the agriculture sector and SMEs in rural areas based on the implementation of the secured transactions law. The scope of the project was expanded to include financing for municipalities for basic infrastructure projects.

5. The financial sector continues to require attention as it goes through consolidation of banks and development of the non-banking financial sector, as detailed in Bank's recent NBFI report. Incomplete institutions and weak governance in the real sector are limiting the ability of the banking sector to openly and effectively intermediate financial services. As noted in the Country Economic Memorandum (FY05), the rise of integrated Financial and Industrial Groups (FIGs) as a driver of growth in response to the existing institutional weaknesses and high transactions costs is at best a temporary fix. A long term solution requires improved legislation on joint stock companies and connected lending, adoption of international accounting and audit standards, and the introduction of credit and asset registries.

6. **Business Environment.** The quality of the business environment improved from 1998 to 2002 mainly through reforms on business registration and government inspections. Introduction of a simplified tax for small business led to rapid incorporation of new entities and the reduction of the shadow economy. PAL support has been instrumental to these achievements. However, capture of the state by special business interests has slowed further improvements in the quality of the business environment. As a consequence, Ukraine has been losing ground to Central European countries (e.g. Slovakia) where rapid improvements in regulatory frameworks are taking place. The attempt to induce improvements in the business environment through providing incentives to regional governments has not been implemented.

7. Actual practice in the areas of customs and tax administration had worsened over the years, especially in the light of fast growing foreign trade. The new government has identified overhaul of tax and customs administrations as one of its top priorities. The Bank provides support under the Tax Administration Modernization Project. Ukraine needs a thorough and rapid assessment of the investment climate to plot a strategy to bring the country to Central European standards rapidly and to eliminate wide regional differences in the quality of business environment. It also needs restructuring and investment in its knowledge institutions if it is to effectively use its highly qualified human resources.

8. **Agriculture.** Agriculture has expanded rapidly as a result of land privatization and capital inflows into the sector, while agro-industry is one of the fastest growing sectors in the economy. The Bank (in cooperation with the OECD) recently reviewed the development of the agriculture sector and outlined a strategy for future action. Concerted government and Bank action is needed to deliver impact through the existing land titling and registration project, which has yet to deliver concrete results.

9. Based on limited reforms implemented thus far, Ukraine has acquired a more significant presence in international markets, despite basic productivity indicators lagging behind other countries in the region and persistent poverty in rural areas. Renewed effort is needed to take full advantage of the endowment in agriculture. The Bank can support movement in this direction by facilitating better access to credit for farmers and SMEs in rural areas and providing knowledge base for an increasing share of quality agricultural goods potentially exportable to the EU.

10. **Energy and Infrastructure.** Given that Ukraine has inherited sufficient infrastructure from the Soviet era, the CAS focus in the energy sector aimed to improve its financial viability, and the quality of the regulatory and governance framework. Financial discipline improved with collections close to 100 percent of billing for electricity and gas. Less progress has been made in resolving the stock of old debts that require an adequate legislative base and a comprehensive workout scheme. The government has consolidated power sector assets in the hands of a single public company whose governance status is yet undefined. Overall, the environment is still not ready to further expand the productive involvement of the private sector.

11. The PAL program focused attention on institutional issues in the energy sector ranging from improved financial discipline to better governance and defined ownership, while investment projects focused on operational and energy saving aspects in power generation and district heating systems. The Bank has also undertaken extensive analytical work with reviews of the coal, electricity and gas markets. With cumulative economic growth in excess of 50 percent of GDP cinse 1999, energy and infrastructure issues are becoming an urgent priority. Likely areas of attention include hydropower generation and power transmission, transport (roads), water, and telecommunications.

12. **Technology.** Notwithstanding a strong technology tradition, little has been done to position Ukraine globally. Internet penetration has increased, but it remains low at 8.4 percent at the end of 2004. This is partly a result of the slow progress in the telecommunications sector. Moreover, the education sector is not in a position to respond to higher demand for educated and highly qualified personnel in

technology. Bank support has centered through the PAL program (including dialogue on the development of the basic telecommunications regulation). The E-development project has not performed as expected due to delays in effectiveness, unclear ownership and, by now, outdated design. With renewed government interest and quality redesign this (pilot) project could pave the way for a further intervention.

Objective 2: Poverty Reduction, mitigation of social risks, and Strengthening of the Middle Class.

13. The fall in poverty incidence resulted from high economic growth, and rapid increases in salaries and pensions. These factors also contributed to an expanded middle class and growing domestic demand. However, the demand for labor has not picked up substantially, and little has been done to understand and reform the labor markets. The Bank is presently conducting a labor study.

14. Poverty reduction responded slower in rural areas, and among vulnerable social groups and regions. The previous government advanced towards targeting social benefits, but political concerns often led to a stop-and-go process. Ukraine still has a social assistance system that is expensive, although it certainly contributes to poverty reduction. The Bank supported improved social assistance through analytical work, technical assistance and lending. The PAL program emphasized the need to rationalize social benefits, while the social investment fund project helped directly target the most needy social groups in least developed oblasts. Planned investment lending focuses on administrative reform of social assistance and social insurance systems and on institution building (including simplified collection procedures and improved information management).

15. Pension reform has been at the center of policy dialogue, especially recently following a rapid increase in benefits. Bank support in the future will be to reexamine the system of entitlements, reduce collection and administrative costs and strategically separate social assistance and social, insurance functions. The Bank is exploring alternative options of assisting the government in unblocking policy reform and institution building in this area, including also possible use of a SWAp.

Objective 3: Comprehensive and Harmonized Human Development.

16. **The threat of a TB / AIDS epidemic.** In spite of fast growing rates of infection in HIV and TB, these diseases continue to have weak ownership within Ukraine. There are encouraging signs that the new government is ready to accord it a higher priority. The government failed thus far to effectively coordinate activities funded by the Bank and Global Fund, and other donors. The leading development partners (World Bank, International HIV Alliance from its current GFATM grants and UNAIDS) have taken an initiative to improve national awareness through a study focusing on the social and economic impact of the HIV/AIDS epidemic in Ukraine. A separate effort has been directed at implementing strategies to fight TB based on best international practice. In this environment the Bank financed TB/AIDS project could not achieve sufficient traction and only now is it likely to commence effective implementation.

17. **In the wider health sector, there is a growing need for thorough reform and modernization.** The World Bank, jointly with the government and other donor agencies (EC and SIDA) supported a Strategic Review of the Health Sector. The resulting policy dialogue among all stakeholders will likely lead to a long-overdue reform of the health sector which the Bank can support through an investment operation envisaged in the current CAS.

18. **Provision of Equal Access to Quality Education.** The Bank supported the development of an education strategy (National Education Doctrine) under the PAL program and will continue to support its

implementation through an Equal Access to Quality Education project. This project focuses on aligning curricula and teaching methods with the European standards, providing better access to education services and on the introduction of universal testing for the entire country

Objective 4: Environmental Sustainability.

19. The government initiated an update of its environmental strategy by preparing a concept document which awaits review and approval by the new government. Ukraine made progress towards achieving environmental MDGs by adopting a national program on safe drinking water in March 2005.

20. PAL supported indexation of pollution fees and fines to protect the real value of resources devoted to addressing environmental issues. In a related effort, the alignment of the national pollution permit system with the EU IPP Directive has been piloted and the results will inform the preparation of a proposed Bank financed project on industrial pollution abatement. A GEF project aimed at supporting biodiversity in the Azov/Black Sea area is facing serious implementation problems due to inadequate arrangements and weak ownership at the national level despite strong interest at the local level. Two GEF projects under preparation (on the methyl-bromide phase-out and on the protection of coastal zones in Crimea) should internalize past implementation lessons and create more effective delivery mechanisms.

21. The Kyoto Protocol offers an exceptional opportunity for Ukraine to address its environmental issues and the potential to profit from funding arrangements that would come into effect between 2008 and 2012. Ukraine has relatively limited time to develop adequate institutional capacity to effectively benefit from the Kyoto protocol in the forestry, industry and energy sectors, utilizing the forthcoming Bank financed projects.

Objective 5: Gradual Integration into the World Economic and Financial Systems.

22. Over the last two years Ukraine has invested much effort to join the WTO. The effort has been supported by the PAL program and a related Dutch grant, as well as by the Bank's Trade Study. The study identified areas where Ukraine can benefit from more transparent and competitive trade regime, and utilize the WTO accession process to harmonize laws that advance market institutions.

23. The new government signed the EU-Ukraine Action Plan in February 2005. While not providing perspective for membership, it sets out a range of steps designed to promote closer integration with the EU. The Bank has agreed to adapt its own programs to be consistent with the Action Plan.

24. The new government is likely to accelerate work on WTO membership, aiming to join in 2005. A possible free trade agreement with EU countries, and market economy status granted by the US and the EU, would help the country diversify trade and sources of economic growth. Important actions in the area of lowering tariffs, modernizing customs and fostering compliance with AML-CFT standards have already been done.

Objective 6: Reduction of Regional Imbalances.

25. Limited progress has been made in regional policy due to a combination of political, economic and fiscal factors. The formula-based system of fiscal transfers supported under the current and previous CAS has been internalized as an important component of IGF transfer system, albeit it had to be temporarily suspended last year due to unpredictable impact PIT rate changes have had on local revenues and at the empirical base of the formula.

26. Ukraine lacks a comprehensive vision of regional development. A new regional development strategy, currently under preparation, will review the impact of the current system of transfers, and, provide a framework to develop local self-governance system and a viable business environment at the local/regional level. Issues of territorial and administrative organization of the country are likely to be on government reform agenda.

Objective 7: Improved Transparency, Accountability, and Integrity of Government.

27. The Bank and the government maintained an extensive governance agenda covering issues of taxation, public expenditure management, inter-governmental transfers, oversight and accountability, management of SOEs, public administration and civil service reform, and improvements PFM (including fiduciary and procurement practices).

28. In the area of taxation, the Bank undertook a review of both policy and administrative issues. This study pointed out the importance of reducing tax exemptions. PIT and CIT rates have been lowered and the number of tax exemptions reduced bringing Ukraine in line with international standards. The reform of tax administration (supported through a Bank loan) has been progressing towards longer-term goals, although public perception has not been turned around yet owing to the prevalence of some controversial practices. The new government has shown resolve to achieve both short run and long-run improvements in tax administration, customs and other key public governance areas. It is committed to introduce a simpler and more transparent policy framework and put in place a greater degree of oversight and accountability.

29. The CAS program also supported: (i) better accountability of public funds through establishment of Single Treasury Account; (ii) improved legal and institutional framework for efficient public procurement; (iii) greater transparency in budget preparation and (formula-based) fiscal transfers to sub-national levels of government; (iv) more efficient operation of the government and the public sector through public administration and civil service reform; and (v) improved diagnostic work and policy making based on modernized, timely and more efficient economic and social data collection and processing following SDDS standards (through statistical development project). In addition there a clear commitment of the new government to gradually develop and implement a comprehensive Medium-Term Expenditure Framework.

APPENDIX B

THE GOVERNMENT'S ACTION PROGRAM "MEETING THE PEOPLE"

1. "Meeting the People" lays out an ambitious vision of a Ukraine with equitable job creation, strong family values, low levels of corruption, and strong social service provision. This vision is supported by a program of actions which would generate inclusive growth, including further integration into the global economy through WTO membership and a closer relationship with the EU.

2. The longer-term objectives of the program include: (a) improved wellbeing through new jobs, higher incomes and available housing; (b) poverty alleviation and protection of vulnerable social groups; (c) the rule of law and fighting against crime and corruption; and (d) implementation of the European choice as a set of guiding principles and values that would drive future institutional reform. The program is organized into six chapters: Faith, Justice, Harmony, Life, Security, and the World.

3. The first chapter of the program aims to restore **faith in human development** based on renewed commitment to better access to quality education for all and improved health care services. It also contains a pledge to develop science, culture, spirituality, freedom of expression, and access to public information. The second identifies **justice** as a key pillar of a modern democracy. It prioritizes modernization of the legal system inspired by EU harmonization, launch of a through overhaul of judicial practices, and an assault on crime and corruption. The broader rule of law agenda advances human political rights and freedoms, protects intellectual property rights, and prevents drug and human trafficking. The third seeks to build **harmony between the state and the people** by balancing the various roles of the state ranging from redistributing income, fighting poverty, and providing social services, on the one hand, to securing a favorable and fair environment for private entrepreneurship on the other. To do this successfully, the program recognizes the need to improve the budget process, better manage state property and reform the state itself though administrative and civil service reform. The fourth addresses a set of **real life priorities,** including **factor markets** (financial markets, stock markets, labor markets and social policy), **markets for goods and services** (industry, agriculture, energy, hi-tech, housing, communal services), as well as **taxation**. Finally, separate chapters are devoted to various aspects of **security** and **integration into the world economy**.

Improved Investment Climate

4. **The government's program to improve the investment climate is designed to attract investment, create jobs and provide an environment for new market entry and competition.** The program calls for establishing a competitive market climate that reduces special privileges and opportunities of state capture by large financial industrial groups. The program's anti-corruption emphasis is largely focused on this issue through better operations of public institutions in support of market economic activity, such as establishing an efficient, just and fair court system, independent and efficient regulation of natural monopolies, and installation of modern tax collection procedures. The program puts emphasis on "radical simplification of the procedure of commencing entrepreneurial activity". This specifically targets reducing the number of activities that require state authorization and/or licenses, limiting the number of control bodies while precisely defining their functions to eliminate abuse, and elimination of duplication of control functions by various inspection bodies. The program focuses on increasing labor market participation through a significant reduction of payroll taxes, which now are high and discourage official economic activity.

5. **The government plans to address problems that are of concern to domestic and international investors.** Efforts are planned to reinforce financial discipline and to undertake far-

reaching energy sector reforms that have stalled. In support of this process, the government program calls for cooperation within the Kyoto Treaty on Greenhouse Gas Reduction. This provides special opportunities for Ukraine to attract investments for energy efficiency and to green Ukraine through reforestation. The program would also abolish the investment tax, as well as quasi-investment taxes such as deductions existing now for various special purpose funds that have troubled investors. The near term expected result is increased SME growth and international investment.

6. **Trade policy issues have taken center-stage in the government's economic strategy.** Completion of the WTO accession process is the government's top trade priority, followed by market economy status recognition by the US and the EU.

7. **The government aims to develop reliable and transparent financial services markets as a key source of internal investment**. Broad themes running throughout the government's program are guaranteeing protection of ownership rights of all participants in financial markets, establishment of transparent rules and procedures on the basis of European legislative norms, and creation of a competitive environment. Specific legislation envisaged includes establishing a single state authority to regulate the markets of non-banking financial services and stock markets based upon European Union standards, keeping separate government bodies that regulate the functioning of banking and non-banking financial sectors, and providing incentives for prudential development of a life insurance industry.

8. **The government's program would open formerly non-competitive segments such as mining operations, housing construction, and road repair**. To diversify the economic base, the government plans to open up formerly protected sectors to market competition leading to freer mobility and more efficient allocation of resources. In parallel, it plans to increase vocational and other training to support workers displaced by market forces, and to improve higher education and support academic institutes in an effort to develop Ukraine's potential in high technology industries.

Public Sector Reform

9. **The government commits to continued political, tax, and regulatory reforms necessary to improve public governance.** The program identifies reform of the civil service system as a first step to ensure political neutrality of public servants, including through application of transparent civil service recruitment conditions and remuneration policies. It also aims to improve public finance management during the process of budget formulation and execution, at both the state and local levels.

10. **The program calls for establishment of a medium term expenditure framework, transparent data flows between core ministries, improved automation and objectivity in budget execution, and development of an EU compatible system of internal financial audit and control**. There is a strong focus on fiscal decentralization which can make local government revenue more stable and locally raised. The program supports an objective fiscal subvention formula for local governments, with a higher share of tax revenues assigned locally in a way that aligns local incentives with national objectives. This effort is to be complimented by giving more attention to civil society outreach and monitoring of the budget and government programs within it.

11. **The program would end illegal requisition of state property, prevent "laundering" of state shares in companies, ensure the state sale of property at a market price, and improve the system of state corporate management**. Expected legislation would address a new state privatization program to maximize transparency, define distinct well-grounded criteria of categorizing enterprises not subject to privatization, and greatly increase the responsibility of enterprise directors to meet financial targets pre-agreed with their majority (state) shareholder. The program envisages an immediate analysis of

unprofitable state enterprises and joint-stock companies where the state share is more then 50 percent as a step toward rationalizing management and/or ownership.

Social services provision and inclusion

12. **A key theme throughout the program is "freedom of the individual in an equitable state"**. The government has committed to strong anti-poverty measures including steadily increasing the amount of material support to raise children. It endeavors to monitor discrimination against women in the labor market and take action to reduce it. The program calls for expanding access and quality of education and healthcare for all Ukrainians, while increasing targeted social safety nets and alleviating poverty country-wide. An important sub-goal is to enhance programs that protect national health by addressing the incidence of communicable diseases such as tuberculosis and HIV-AIDS. These reforms are expected to result in significant improvements in citizen health and well-being, participation in government, increased power and rights of individuals, and a significant reduction of social risks.

13. **The program calls for creating equal opportunities across regions.** The government's regional policy focuses on redistributing resources to support depressed territories and solve nationwide problems (e.g., coal mines and polluted areas). The goal of the program is to guarantee a standard quality of life for every citizen. Key government strategies to accomplish these objectives include improving state transport and telecommunications infrastructure, public-private partnerships on large investment projects, attracting credits international financial organizations, and enhancing labor force mobility through vocational and other forms of training.

APPENDIX C

RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM PROSPECTS

1. The Ukrainian economy has performed well since the Russian crisis in 1998. In 2004 it achieved the highest growth rate in Europe. It has enjoyed a substantial current account surplus and has consequently accumulated a large pool of international reserves. Under these favorable circumstances, households and businesses have gained confidence in the banking system resulting in accelerating monetization of the economy. However, these successes have been achieved under an economic and legal structure that has not been sufficiently transformed to give investors strong confidence that the economy is on a sustainable growth path. Recent political events have highlighted tensions in the system, which, if not addressed, could impede further economic progress. This section describes the economic progress since the Russian crisis and explains the basis for this progress. It examines the government's response to emerging macro-economic imbalances and provides a mid-term forecast.

2. The starting point of this forecast – the year of 2005 – is in many regards the turning point for the development of the Ukrainian economy. Economic performance is expected to be affected by closing stages of the sources of recent rapid growth, combined with a transition from the previous insider economy to greater openness and transparency. Recent economic growth in Ukraine was based on undiversified, but strong export growth, from sectors controlled by financial industrial groups which operated through informal relations and special privileges. Utilization of excess capacity in traditional industrial sectors, and external factors, particularly, high world commodity prices in the goods Ukraine exports, helped drive growth over the past four years. In the context of the reform program of the new Government, the economy is expected to diversify through creation of better investment and continued strong business entry. Key factors toward this objective include further tax reform, better public administration, deregulation, delineation and protection of property rights, better corporate governance, and improved financial sector regulation. This should result in further reduction of quasi-fiscal activity and more investment, both foreign and domestic. The structural reforms to be implemented, such as creation of more fiscal space for infrastructural development, are expected to help facilitate the consumer and business services consistent with more moderate, but continued strong economic growth.

3. **Real sector.** Over the medium term, Bank Staff expects that after the peak of the cyclical growth in 2004, the economy will grow at a slower pace, at around 5.5 percent per year. Investment growth is expected to decline considerably in 2005, and be strong at an average annual rate of growth higher than 10 percent by at least 2007, based increasingly on FDI inflows. The agricultural sector will grow at about 6 percent per year in 2005-2008, with upward potential depending on the pace of further market liberalization and land reform. Industrial growth is forecast to continue and diversify as a result of a better investment climate, and deceleration of world commodity prices pace of growth. On the demand side, the key factors underlying these assumptions are the following:

- The terms of trade will grow less favorably over time, as international prices for key Ukrainian exports (metals and chemicals) will not keep the pace of growth in 2003-2004;
- Inflationary pressures are expected to lead to a more restrictive monetary policy, and more prudent exchange rate policy. After the hryvnia appreciation in April 2005, as a reaction to large current account surplus, inflationary pressures are expected to lessen gradually, and get back to single digits by 2007;
- Fiscal policy is expected to tighten after the parliamentary election in 2006, and potentially earlier should revenue performance be weaker than expected and/or should the authorities perceive inflationary pressures demand a fiscal policy downward adjustment.

4. **Growth.** Growth will be largely consumption driven in 2005-2006 due to the social orientation of fiscal policy, expected in the context of the upcoming parliamentary election. Fiscal policy is expected to substantially adjust by 2007, including a relative public investment increase in the composition of expenditures. Positive signals from the IFIs, continued macro-growth, and a better investment climate are expected to encourage foreign and domestic investors alike.

5. **External position**. The current account surplus reached a record of 10.4 percent of GDP in 2004. It is expected to decline significantly over coming years, as the country purchases more capital goods and financial services, and as the commodity prices of Ukraine's exports level off. Resource balance will decline considerably, due to slow down in export growth through 2007, followed by a more diversified come-back starting in 2008. The forecast current account balance will decline to 5.4 percent of GDP in 2005, and then gradually go into small deficit by 2008. Capital inflows are expected to remain relatively strong. National Bank foreign exchange reserves are expected to continue to increase to 5 months of merchandise imports in 2005, and 6.5 in 2008. However, this projection is especially tentative, depending on monetary policy steps necessary to control inflation, and the pace of change of Ukraine's resource balance. FDI is expected to pick up reaching USD 3.2 billion in 2007.

6. **External creditworthiness**. From 2000 to 2004 Moody's steadily upgraded Ukraine's Sovereign Domestic currency rating from Caa3 to B1. Eurobond spreads are now around 237 basis points above LIBOR as of April 2005. Over the past year, Standard and Poor's has consistently ranked Ukraine-focused emerging market funds in the top quartile of performance.

7. **Debt.** Given the estimated 5.5 percent average real GDP growth, slow real appreciation of the currency, and a few more years of current account surpluses, the total debt to GDP ratio is projected to decline to 19.3 and debt service to GDP to 5.7 percent of GDP by 2008. With regard to the IFI's share of the debt portfolio, preferred creditor debt to total debt is expected to gradually decline to 19.2 percent in 2008. The share of IBRD debt in the total debt is expected to increase over time, but not excessively. The Government is expected to continue follow a strategy of decreasing the share of external debt in total debt.

8. **Fiscal position**. Though the budget execution in the first quarter of 2005 is promising, the fiscal situation for 2005 still raises concerns and subsequently public wage. Large pension increases associated with the 2004 election led to a deterioration in fiscal performance and contributed to a rise in inflation. The fiscal deficit is expected to reach 3.8 percent of GDP in 2005, and decline only modestly in the budget of 2006, primarily due to pressures preceding the parliamentary elections of 2006. Starting 2007, fiscal policy is expected to become tighter, decreasing the fiscal deficit to slightly higher than 2 percent of GDP in 2008. After the boost in pension spending to just under 15 percent of GDP in 2005, the share of pension spending in GDP is projected to decrease by 1 percent per year through 2007. Public wages and salaries are expected to stay constant as a ratio to GDP. While the share of Government revenues are expected to increase significantly in 2005, the Government's medium term program calls for a broader tax base and lower tax rates, along with a downsizing of the public sector. Thus, revenues are expected to fall by at least 2 percent of GDP by 2008. Also, after the year 2006, it is expected that there will be a shift in the structure of the budget towards public investment to better address infrastructure needs. Along with that, infrastructure investments are expected to be helped by increased public-private partnership.

9. **Money and inflation**. After nominal appreciation of the Ukrainian currency from UAH/USD 5.25 to 5.05 in April 2005, we expect the National Bank of Ukraine to maintain a relatively stable, slightly appreciating, real exchange rate, gradually switching to inflation targeting. However, some further revaluation may be necessary in 2005. The considerable budget deficit in 2004, the consumption oriented budget of 2005, and limited prospects for drastic improvements in 2006, along with the emerging bottlenecks in some sectors as the economy continues to rapidly growth, will create inflationary pressures

which need to be watched closely. The National Bank of Ukraine has started to cut the rate of real money growth. Real money growth is expected however as long as money demand remains strong. Growth of the GDP deflator is expected to exceed 16 percent in 2005, but then is projected to slow down, coming back to single digits in 2007. The NBU will continue to focus on lowering real interest rates while strengthening the banking system through better bank and non-bank financial regulation, and continued improvements in auditing and accounting practices.

10. Ukraine's main economic indicators are included in CAS Annex B6.