

which prices of other energy sources prices rise in response to oil and gas prices increase. These factors are implicitly included in our analysis above with respect to GDP estimates.

40. The duration and strength of the inflation increase depends on the economic policy response. Subsidies to producers and consumers can mitigate shocks of oil and gas prices increases. However, attempts to keep energy prices stable at the internal market would lead to an increase in the fiscal burden and make such practice unsustainable in the long run. Moreover, such policy may lead to accumulation of inflationary pressures and worsen the impact of higher prices in the long run, while blocking adjustment of the economy that otherwise would be the upside of the energy price pressures. Price controls have already proved unsustainable in Ukraine. In April-May 2005, the government attempted to fix gasoline prices, but this policy lead to deficit of gasoline supply and the government had to abolish price controls.

6. POLICY RECOMMENDATIONS

41. It is clear that Ukraine is both vulnerable to oil and natural gas price increases, and that upward price pressures are going to be a fact of life for the coming few years. Oil price pressures are driven by World market trends that are essentially beyond the influence of policy makers in Ukraine. With regard to natural gas prices, the pace and magnitude of increases will be affected by Ukraine's use of diplomacy and finesse in its international negotiations. At the same time, moving to a cash basis will be an important step toward governance improvements in Ukraine while helping to bring transparency to the sector. Beyond prices and transparency, Ukraine has in its hands the task of reducing its vulnerability. The following recommendations provide a broad roadmap for policy makers in Ukraine in this regard. More detailed recommendations can be found in a number of studies produced by the World Bank and other organizations over the past few years. The bibliography below is intended as a resource for policy makers who would focus on this issue in more depth. "Taking the Next Steps in Energy Sector Reform" (WB Jan. 2005) and "Ukraine: Challenges Facing the Gas Sector" (Sept. 2003) are good starting places for such analysis.

- Seek a step by step and gradual reduction of gas price increases from main suppliers, in return for a credible commitment by Ukraine as a high quality and dependable manager of the transit system.
- Maintain hard budget constraints on energy producers, intermediate energy suppliers and consumers to encourage them to improve efficiency, modernize capital, and reduce energy dependency. This will be particularly important as Naftogaz and GazProm enter into a cash-only arrangement.
- Eliminate cross subsidization of energy tariffs and bring them to full cost recovery, including needed investment costs.
- Implement the Law on Debt Restructuring of the Energy Sector and adopt a strategic plan for further restructuring, ownership transformation and private sector participation in the energy sector.

- Improve corporate governance and foster commercialization of majority state-owned energy companies based on transparent performance targets contracted with the corporate management and supervised by independent Boards.
- Foster competition in coal and electricity supply through further market opening and gradual liberalization of the wholesale electricity trade.
- Strengthen financial and administrative independence of the energy regulator (NERC) and gradually introduce main regulatory principals governing the EU gas and electricity markets.

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