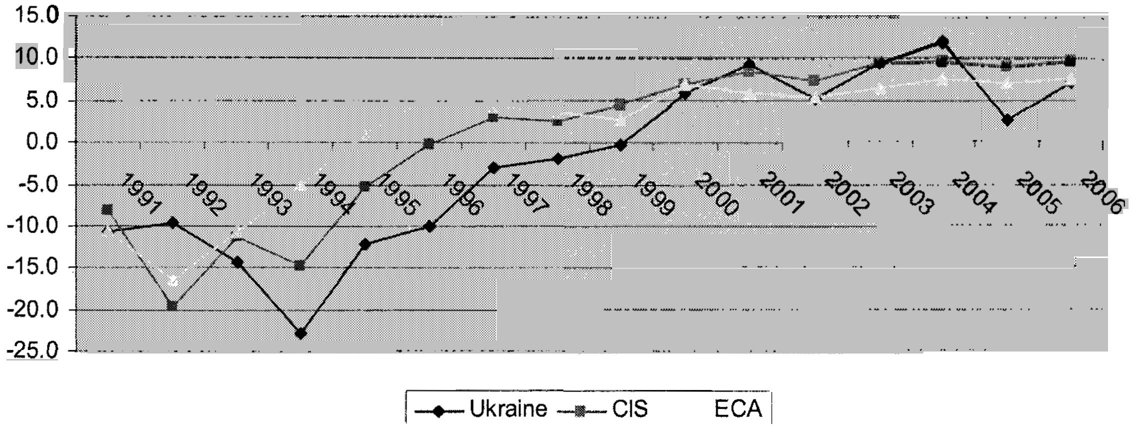
I. COUNTRY CONTEXT

A. ECONOMIC CONTEXT

1. **Ukraine is a lower middle income country, with a GDP per capita of US$1940 in 2006.** It is the second largest country of the former Soviet Union with a population of 46 million.

2. **Ukraine suffered one of the steepest declines of any of the successor states of the former Soviet Union, with GDP falling to 45 percent of the 1991 level by 1998** (Figure 1). Structural reforms were initially hesitant with Ukraine lagging considerably behind Russia in the liberalization of markets, privatization of state assets and the foundation of market-based institutions.

Figure 1: GDP Growth Rate, 1991-2006



3. **Since 2000, however, Ukraine has enjoyed a strong economic recovery, with growth at around 7.5 percent per year on average** (Table 1). The period of recovery was initiated by a sustained reform effort that began during the government of Prime Minister Yushchenko, now Ukraine's President, and continued under subsequent governments. Macroeconomic stability was established, key industries were privatized and the process of legislative and institutional reform was begun. Economic recovery has benefited from the significant excess capacity in industry, as well as from a favorable external environment, and an initially strongly undervalued currency. Trade expanded rapidly, while at the same time, its geographical orientation changed gradually towards Europe and other markets outside the former Soviet Union. Russia remains Ukraine's largest single trading partner, however.

4. **Structural change has started but remains incomplete.** The services sector has become more important, while agriculture has declined as a share of GDP and employment. The industrial sector remains large and dominated by capital-intensive branches such as iron and steel and industrial chemicals. However, catalyzed by the steep rise in the price of imported energy from Russia since 2005, Ukrainian manufacturing is undergoing a process of investment-led modernization. A particular

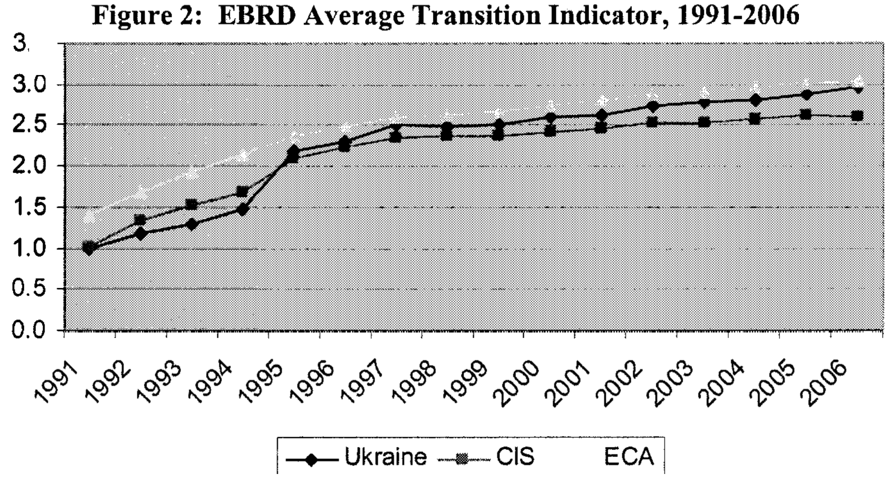
feature of Ukraine is the size of its government sector. At over 40 percent of GDP, it is uncharacteristically large for a lower middle income country. Over half of total employment remained in the public sector as of 2004[1].

Table 1: Main Macroeconomic Indicators, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
Real GDP (change in percent)	5.9	9.2	5.2	9.6	12.1	2.7	7.1
Real Industrial Production (change in percent)	13.2	14.2	7.0	15.8	12.5	3.1	6.2
CPI, a.o.p. (change in percent)	28.2	12.0	0.8	5.2	9.0	13.5	9.1
CPI, e.o.p. (change in percent)	25.8	6.1	-0.6	8.2	12.3	10.3	11.6
Real Exchange Rate, a.o.p. (change in percent, a decline means depreciation)	-1.4	11.2	-3.7	-8.2	-2.1	10.2	4.6
Current Account Balance (percent of GDP)	4.6	3.7	7.5	5.8	10.6	2.9	-1.5
Foreign Exchange Reserves (USD billions)	1.5	3.1	4.4	6.9	9.5	19.4	22.3
Fiscal Balance (percent of GDP)	-1.3	-1.6	0.5	-0.9	-4.4	-2.3	-1.3
PPG Debt (percent of GDP)	47	38.6	36.5	29.0	24.7	17.7	15.0
Memo:							
Nominal GDP (in billions of USD)	31.3	38.0	42.4	50.1	64.9	86.1	106.5
GNI per capita (USD, Atlas method)	690	720	780	970	1260	1520	1940

5. **Ukraine continues to lag behind the EU accession in terms of economic reform,** although it has caught up with the ECA average (Figure 2). Since 2000, steady but gradual reform progress has been made, but frequent government changes, and the lack of a strong external anchor have been important constraints. An important benchmark may be reached in 2007 with WTO accession.

Figure 2: EBRD Average Transition Indicator, 1991-2006



Source: EBRD

6. **Ukraine has one of the largest informal sectors among the transition economies.** The shadow economy is estimated at around 50 percent of official GDP[2]. This has

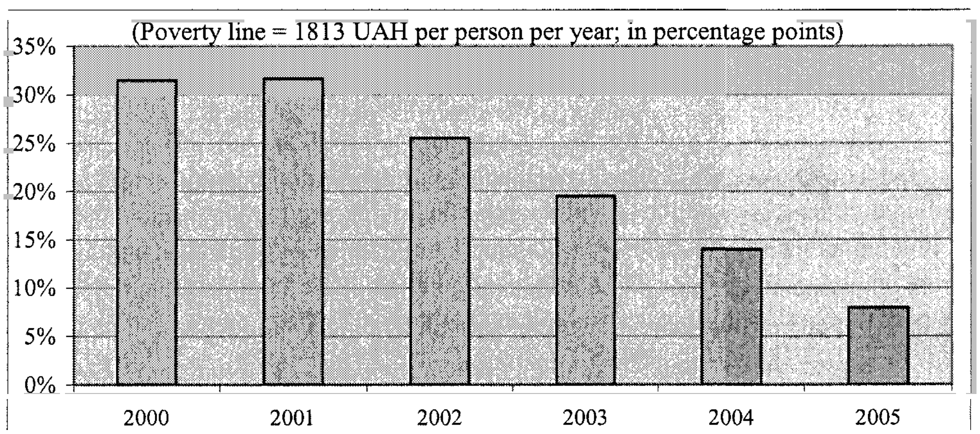
[1] Ukraine Jobs Study. Fostering Productivity and Job Creation, World Bank Report No.32721-UA, February 2006.

significant implications for economic diagnostics. For instance, ratios of key variables to GDP, such as government spending, or the size of the financial sector, would tend to be over-estimated. By the same token, trade data tends to suffer from under-reporting, due to transfer pricing (for exports) and customs evasion (for imports). If the underlying trade dynamics are different than officially reported, this would affect underlying GDP growth rates as well. Furthermore, if the dynamics of the informal sector are different than those in the formal sector, real incomes may follow a different pattern than suggested by official statistics. Aside from affecting the reliability of economic diagnostics, the large informal sector is a symptom of pervasive governance problems and reflects the significant obstacles businesses and individuals face if they seek to operate according to the existing formal rules.

B. Recent Social Developments

7. **Rapid economic growth has facilitated a sharp decline in poverty in recent years. Poverty has fallen sharply from 31 percent in 2001 to 8 percent in 2005**[3] (Figure 3). Ukraine has enjoyed one of the fastest rates of poverty reduction in ECA since the onset of economic recovery in 2000. However, in spite of this achievement, the public's satisfaction with their material well-being remains low (Box 1).

Figure 3: Poverty Rate in Ukraine, 2000 - 2005



Source: Ukraine Household Budget Survey, World Bank

8. **Generous increases in social transfers have significantly contributed to reducing poverty.** Real average pensions increased by 34.8 percent in 2004 and another 28.9 percent in 2005. Pension increases, and to a much smaller extent a rise in child benefits, explain around one-third of the decline in poverty over the 2004-2005 period. However, these measures have pushed the size of the Pay As You Go (PAYG) pension system to 14 percent of GDP in 2005, one of the highest ratios in the world. Generous social transfers are financed by high payroll taxes of about 35 percent which burden businesses, stimulate under-reporting of wage income, and hurt Ukraine's long-term competitiveness.

[2] Schneider and Enste, 2004. According to estimates of the Ministry of Economy the informal sector was 39 percent of GDP as of 2006.

[3] Ukraine: Poverty Update, World Bank Report No. 39887 - UA, June 2007.

Reforming Ukraine's social insurance and assistance system is therefore a reform priority.

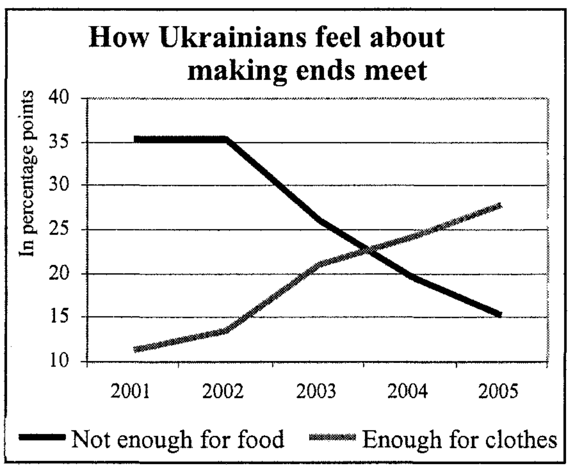
Box 1: Poverty in Ukraine: Concepts vs. Perception

Poverty is conventionally defined as those individuals whose consumption falls below a certain level called the poverty line. However, poverty lines differ – some lines are defined in absolute terms, others are defined relative to average income.

The Bank's poverty analysis is based on an *absolute* poverty line, a threshold below which individuals would not satisfy their basic needs. The line constructed for Ukraine reflects the country's official calorie requirements (2,508 calories per day per person), aligned with the consumption patterns and the demographic composition of the populations, plus an allowance for non-food goods and services.

This method differs significantly from the one applied in Ukraine to measure poverty. Thus, the Bank aggregate consumption estimate excludes consumer durables and health expenditures, adjusts for the rural population consumption patterns through imputing regional price indices for food, and, finally, applies different equivalence factors to account for economies of scale. As a result, the average consumption per capita equivalent to the absolute poverty line used by the World Bank is substantially lower than the official Subsistence Minimum – the money equivalent of an administratively defined consumption basket to ensure a minimum living standard in Ukraine. This basket contains a number of items that are not typically considered to be part of the *basic* consumption pattern of the poor, such as weekly rations of meat and fruit. In addition, the subsistence minimum is not constant in real terms complicating comparisons over time. Indeed according to the Government's estimates relative poverty has remained constant at around 27 percent of the population, measured against a poverty line of UAH 365 in 2005, up from UAH 175 in 2001.

The poverty rate of 7.9 percent computed for 2005, based on the World Bank methodology, therefore does not seem to correspond to public perceptions of the underlying poverty situation in Ukraine. However, although the majority of the population remains dissatisfied with their current standard of living, a public opinion poll conducted by the Kyiv International Institute of Sociology, also suggests that households are more able to buy enough food to eat (see figure). Individual perceptions of well-being would seem to lag behind falls in the poverty rate. Nevertheless, the dynamics shown in the chart are consistent with the Bank's findings that over recent years, Ukraine made huge progress in poverty alleviation.



Source: KIIS

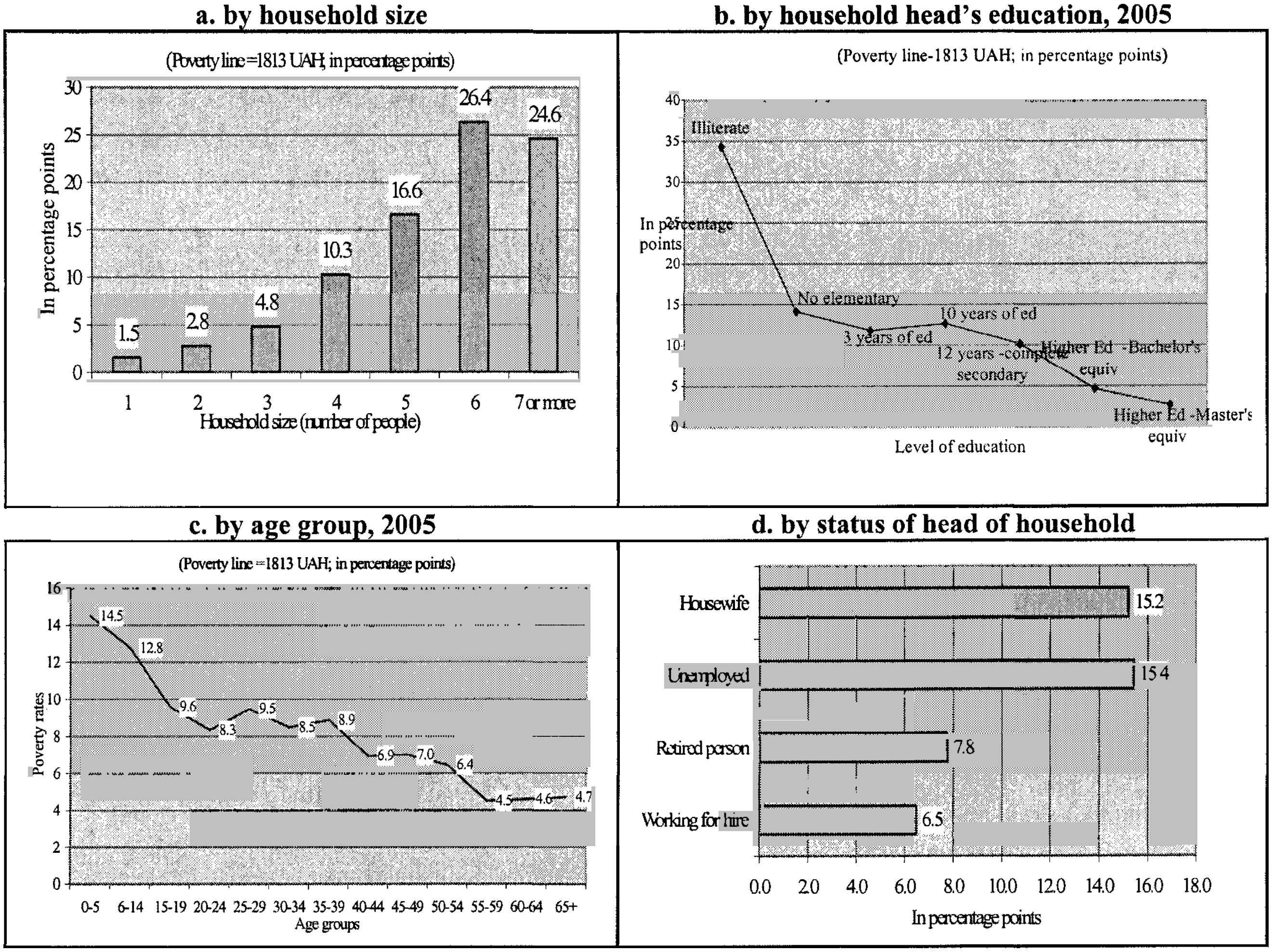
World Bank (2005). *Ukraine Poverty Assessment: Poverty and Inequality in a Growing Economy.* Report no. 34631-UA, World Bank: Washington, DC, December.

9. **Households with many children are particularly vulnerable to poverty** (Figure 4). The incidence of poverty is close to 30 percent in households with six or more members, more than three times the national average. In contrast, the incidence of poverty is not higher than average among pensioners, confirming the positive effect that the recent increases in pension payments have had. The numbers presented here differ from Government estimates, according to which, overall poverty remained constant during 2001-2005, and poverty in families with many children, as well as among pensioners, fell

by 3.6 percentage points and 4 percentage points, respectively. Although the unemployed have a higher incidence of poverty, in absolute terms, the majority of the poor live in households headed by the employed or by pensioners. Returns to education have been increasing in Ukraine, and so the incidence of poverty is declining in more educated households, an effect that has become steeper over time.

Figure 4a-d: Ukraine Poverty Rates

a. by household size **b. by household head's education, 2005**

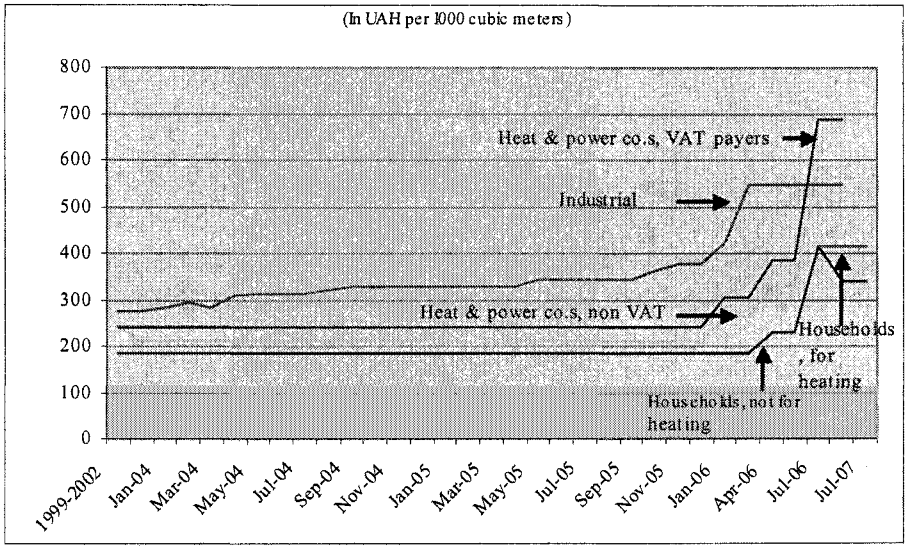


Sources: Ukraine Household budget survey, World Bank

10. **The doubling of household energy tariffs between 2005 and 2007 has created a significant social challenge.** From January 2006, import prices for Russian gas increased by 53 percent and by another 35 percent in January 2007. Consequently, household tariffs for gas and power were also raised substantially (Figure 5). The size of the increase has raised concern about its potentially negative social impact. However, calculations carried out by the World Bank suggest that because even the poor do not spend a very large proportion of their income on energy, a doubling of energy prices from the levels at the end of 2005 would raise poverty by only 1.7 percentage points. Moreover, it would cost only US$63 million to restore all those that had become poor as

a result of energy price increases to a spending level just above the poverty line, provided social assistance was perfectly targeted.[4].

Figure 5: Natural Gas Prices by Type of User



Sources: Ukraine Household budget survey, World Bank

11. **Ukraine spends a high proportion of GDP on health and education and this is reflected in universal access to primary and lower secondary education and to basic healthcare** (Table 2). However, quality is variable, and spending patterns are highly inefficient. In education, inequality of access widens significantly at the upper secondary level, and is also prevalent in pre-school education, which negatively affects poor children's educational outcomes. In health care, inequalities in access are determined both by significant variations in the quality of service between rural and urban locations, and by the prevalence of significant informal payments, which may reach a level similar to total public spending on healthcare. Moreover, public health is underdeveloped and health risks from lifestyles, environmental hazards and communicable diseases are high. Consequently, Ukraine scores low for its level of income on key demographic indicators, such as life expectancy and male mortality rates.

[4] Ukraine: Poverty Update, World Bank Report No. 39887 - UA, June 2007.

Table 2: Key Social Indicators, 2005

	Ukraine	Russia	Kazakhstan	ECA	High income: OECD
Health expenditure, total (% of GDP)	6.50	6.00	3.80	6.58	11.31
Out-of-pocket health expenditure (% of private expenditure on health)	90.50	76.70	100.00	82.08	37.52
Public spending on education, total (% of GDP)	6.39	..	2.31	..	..
Fertility rate, total (births per woman)	1.2	1.29	1.75	1.57	1.66
Life expectancy at birth, female (years)	73.97	72.4	71.85	74.02	82.29
Life expectancy at birth, male (years)	62.23	58.87	60.91	64.67	76.41
Mortality rate, adult, female (per 1,000 female adults)	150.23	173.33	151.57	135.7	..
Population growth (annual %)	-0.77	-0.51	0.88	0.06	0.64

Source: WDI

* Data on total health expenditures and out of pocket payments are for 2004.

12. **A particular social challenge is Ukraine's demographic profile.** Ukraine is forecast to lose around 25 percent of its population by 2025 as a result of still relatively high mortality rates and very low birth rates[5]. Moreover, because of low retirement age, employment rates are low in spite of recent improvements in the labor market. As a result, Ukraine's dependency ratio (i.e., the ratio of Ukraine's non-working to its working population) was already high at 44.6 percent in 2005. As Ukraine's population ages, the overall costs of providing care to the elderly will also increase, perhaps by as much as 5.2 percent of GDP by 2020. Ukraine will need to increase its retirement age, improve employment prospects for those workers that have been discouraged from looking for work through training and re-training, and potentially open its labor market to migrants if it is to stem the increase in the dependency ratio. Reforms of the pension system, professional training and old-age care, are also urgent to handle the rising costs of an aging society.

C. Recent Political Developments

13. **Ukrainian politics in the recent past has been quite volatile.** During the period of implementation of the previous CAS from 2003 to 2007, Ukraine had no fewer than four different Governments. Presidential elections in 2004 led to a political shift, as the chosen successor to former President Kuchma and current Prime Minister, Mr. Yanukovych, lost against Mr. Yushchenko, who retains the Presidency to date. The shift in power, often referred to as the "Orange Revolution", was associated with a significant increase in political freedom, reduced state control over the media and the emergence of a vigorous national political debate (see Section III and Annex 2 on the governance agenda).

14. **Important constitutional issues remain unresolved, which has given rise to additional political tension.** Part of the political compromise that facilitated a re-run of the 2004 presidential elections and the victory of Mr. Yushchenko, were amendments to the constitution that transfer significant powers to the Parliament. However, the amendments leave considerable ambiguity on respective roles of the Government, the

[5] World Bank. From Red to Gray, 2007

Presidency and the degree of independence of the Judiciary. These ambiguities have been a source of tension between the Presidency and the Government, in particular, following the return to power of Mr. Yanukovych as Prime Minister, after his Regions Party emerged as the largest party from the parliamentary elections of March 2006.

15. **Tensions came to a head in April 2007, with the President dissolving parliament, leading to early parliamentary elections on September 30, 2007.** The ruling coalition of the Party of the Regions, the Communists and the Socialists was unable to retain its majority. As of mid-October 2007, no decision had been taken on the formation of a new governing coalition, with many possible combinations actively discussed. Among the more plausible options is the return to power of former Prime Minister Yulia Timoshenko, backed by a coalition of her party with the pro-presidential faction Our Ukraine – National Self-Defense. Another government change would fit into the pattern of frequent government turnover observed in other Eastern European countries, where incumbent governments have found it characteristically difficult to stay in power.

16. **Despite the continuous power struggles, the basic vision of economic development for the country is broadly shared between all main political forces.** The development vision includes a commitment to closer integration with Europe and with the world economy at large, exemplified by the progress made in the WTO accession, and to the further deepening of structural reforms as the key to sustained economic growth. This basic vision has survived the frequent changes in government since the turn of the millennium and is reflected in the sequence of government programs adopted since the European Choice agenda launched by former President Kuchma in 2003.

17. **Despite significant political risks going forward, a compromise remains more likely than a protracted political stand-off.** The economy has taken the recent political uncertainty in its stride and the major business interests which are strongly represented in all branches of executive and legislative power have little interest in a drawn-out political conflict. While it would be desirable for Ukraine to re-establish constitutional clarity and work to strengthen the rule of law and the trust in state institutions, the base case assumption for the current strategy is a continued muddle-through scenario, in which the political system generates enough compromise to move forward gradually and sometimes inconsistently, whilst avoiding reform reversals or a protracted crisis. The nature of political risks and mitigation measures is discussed further in Section VI of this document.

18. **Ukraine is receiving increased attention from international partners, in particular from Europe.** The EU launched a new framework agreement with Ukraine in late 2006, a key provision of which is the negotiation of a "deep" Free Trade Agreement following WTO accession. This goal is supported by all the dominant political forces in Ukraine and is likely to provide the strongest anchor to economic policy during the period of implementation of this CPS. In the political arena, the EU Ukraine Action Plan foresees the further strengthening of the rule of law, political and

media freedoms. The EU has evaluated progress on all dimensions positively at the end of the first year of the Action Plan in late 2006. Taken together, the European institutions, comprising the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the European Commission (EC) is by far the largest donor to Ukraine. Ukraine has also qualified for assistance from the Millennium Challenge Corporation, although the size and timing of support remains somewhat uncertain. Russian commercial interests are developing strongly. Overall, the international environment is expected to remain supportive to greater economic integration.

II. RECENT ECONOMIC DEVELOPMENTS AND RISKS

A. RECENT ECONOMIC GROWTH – DRIVERS AND PROSPECTS FOR SUSTAINABILITY

27. **Ukraine has consistently exceeded expectations of economic growth over the period 2000-2007.** Growth averaged 7.5 percent, and per capita incomes in US$, according to the Atlas method, increased from US$700 in 2000 to US$1940 in 2006.

28. **Two factors contributed to this phase of economic "recovery".** First, the financial stabilization and introduction of economic reforms in 2000 effectively hardened budget constraints, bolstered confidence in the Government's macroeconomic management and in the country's fledgling financial sector, and created the legal and institutional basis for market-based exchange.

29. **Second, the real exchange rate depreciation, following the 1998 financial crisis in Russia and the availability of ample spare capacity in Ukrainian industry, created conditions where the returns on investment and entrepreneurial initiative were unusually high.** Both factors together shifted the incentive structure towards formal economic relations and away from the rent-seeking predominant in the 1990s. The result was the emergence of Ukraine's particular brand of capitalism built on strong domestic financial industrial groups, which originated thanks to close and often non-transparent links to political power brokers, but which were increasingly acting as the motors of economic recovery and growth.

30. **Ukraine's transition path to date has two weaknesses:** First, the sources of recovery and export revenues are highly concentrated in heavy industry, in particular ferrous metallurgy. Ukraine's economic performance is thus vulnerable to a shift in terms of trade against the metals sector in particular. Ukraine's high degree of energy inefficiency is also a main source of vulnerability. Unlike other Eastern European countries, Ukraine's trading patterns were still heavily oriented towards Russia and commodity-based, whereas Ukraine's peers are increasingly developing intra-industry trade links with Europe and the Organisation for Economic Co-operation and Development (OECD) countries, thereby gradually managing to move up the value chain[6].

[6] Ukraine's Trade Policy, World Bank Country Study, November 2005.