

## EXECUTIVE SUMMARY

- i. Ukraine is a lower middle income country, with a Gross Domestic Product (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.
- ii. Since 2000, Ukraine has enjoyed a strong economic recovery, with growth at around 7.5 percent per year on average. Structural change has started but remains incomplete. Ukraine continues to lag behind the European Union (EU) accession in terms of economic reform. An important benchmark may be reached soon with the World Trade Organization (WTO) accession.
- iii. 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. Ukraine has enjoyed one of the fastest rates of poverty reduction in the Europe and Central Asia Region (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.
- iv. Ukraine's macroeconomic framework on the whole remains adequate, but the authorities will need to be vigilant in the face of potential external shocks or political spending pressures. Under the Bank's base-case medium-term macroeconomic forecast, growth is maintained at around 5-6 percent per annum, with moderate inflation and external as well as fiscal imbalances. External shocks would require policy adjustment to safeguard Ukraine's improvements in external creditworthiness.
- v. Despite frequent government changes and significant political volatility, 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.
- vi. Ukraine is receiving increased attention from international partners, in particular from Europe. The EU has started negotiating a deep Free Trade Agreement with Ukraine, and collectively the European institutions are now by far the largest provider of financial assistance.
- vii. This Country Partnership Strategy (CPS) builds on an analysis of Ukraine's key development challenges. To sustain growth into the future, specifically, Ukraine will need to address three key challenges: (i) the improvement in competitiveness, (ii) the reform of public finance and the public sector to improve service delivery and make growth socially inclusive, and (iii) tackling weaknesses in governance.
- viii. In response to these challenges, the CPS proposes a two-pillar framework of support. The first pillar will aim to improve Ukraine's competitiveness through investments in public sector infrastructure (in particular transport and energy efficiency), advisory services and advocacy work to improve the business climate, technical

assistance and access to credit lines to strengthen the financial sector, and global knowledge sharing to promote innovation and technology adoption, as well as to ensure that Ukraine benefits from the framework for international carbon trading and makes a contribution to emission reductions. The second pillar will seek to improve public services by targeting greater efficiency in spending, and using improvements in public sector financial management as an entry point into public sector reforms more generally.

ix. Governance and Anti-Corruption efforts will cut across both pillars of the CPS. A key problem for Ukraine is the lack of trust in public sector institutions, and the resulting low expectations trap: the public expects little from the state, but is in turn not willing to make much of an effort to advocate for improvements either. The Bank's approach will concentrate on building demand for better governance, whilst continuing to seek opportunities to strengthen public sector institutions where sufficient client ownership and policy consensus exists.

x. The International Finance Corporation's (IFC) activities will be a key element of the Bank Group's strategy. The IFC will support the achievement of target outcomes in the first pillar through investments to support modernization of the private sector, and through selected investments in municipal and public infrastructure. The IFC will also look for opportunities to help mobilize private funding for the modernization of public services. The IFC's expanded advisory services will be a key component of the Bank Group's non-lending interventions.

xi. Three principles underlie the operational approach in this CPS: (i) selectivity, (ii) flexibility and (iii) partnerships. These principles are directly derived from the lessons of experience in the previous CAS. The Bank will adopt a programmatic approach, choosing a selected number of areas for support, with the range of instruments adapted to the degree of client ownership, development urgency and the Bank's own comparative advantage in relation to other donors. A selection of programs across the two main pillars has been identified for the first two years of the CPS. Beyond this, the CPS retains the flexibility to adjust both the selection of program and the range of instruments to changing client demand, development needs and evolving development partnerships.

xii. The CPS lays particular emphasis on non-lending activities. Recognizing that in several critical reform areas, there is not yet a national consensus around reform priorities or a well-defined reform roadmap, the Bank will invest in advocating for and building capacity to implement policy changes through non-lending activities and advisory services. To make room for this enhanced non-lending focus, the Bank will target improvements in the performance of the investment lending portfolio, aiming at fewer, larger and more effective interventions.

xiii. The CPS proposes a lending range of US\$2-6 billion over four years, with annual lending levels modulated by a series of performance benchmarks. Specifically, the Bank will monitor the maintenance of an appropriate macroeconomic framework, overall progress in structural reform, and progress in improving the implementation of the

existing portfolio as key performance benchmarks determining the size of financial allocations. The maintenance of an appropriate macroeconomic framework will be a precondition for access to Development Policy Lending (DPL). Consequently, the share of DPL in the total allocation would increase from zero at the bottom of the lending range towards 40 percent in the middle of the range and potentially higher at the top of the range.

xiv. The Bank Group is strongly committed to harmonizing its assistance with country systems and coordinating its activities with other development partners. Although collectively the donor community contributes only marginally to Ukraine's own investments, the transactions costs for Ukraine of dealing with external donors remain high. The CPS proposes to address this issue by continuing to work towards the greater use of country systems, where appropriate, and by advocating for policy change and building capacity, where country systems fall short of acceptable standards (e.g., in public procurement). Over time, the Bank aims at channeling an increasing share of its resources through the Ukrainian budget, potentially against agreed performance targets, and together with other donors (e.g. through Sector Wide Approaches – SWAs).

xv. The CPS is tied into a results framework which will serve as the main tool for joint accountability during implementation. Annual Country Portfolio Performance Reviews (CPPRs) are planned at which an annual results report will be jointly reviewed and discussed. The Country Team is investing considerable resources into strengthening capacity for results, in particular to address the challenge of how to adjust the results framework to the principles of flexibility, as well as how to reflect the role of advocacy work.

xvi. The Bank would appreciate guidance from the Executive Directors on the following questions:

- Are Ukraine's development challenges appropriately identified in the CPS and does the two-pillar structure of support provide an adequate response?
- Are the principles of the CPS of selectivity, flexibility and partnership and the resulting selection of programs appropriate?
- Is the lending range acceptable and are the benchmarks modulating between the levels of lending adequately defined?
- Is the results framework realistic and provide for sufficient accountability?