

civil society raised concern about governance and corruption in Ukraine and highlighted that there was some disillusionment with the reform process, which they felt had not translated into sufficient improvements in living standards and in the quality of service delivery. Civil society representatives strongly endorsed the emphasis in the CPS on stimulating demand for improved governance and urged the Bank to establish a forum and a platform for greater national debate on reform priorities. NGOs expressed great interest to widen their collaboration with the Bank in the implementation of the CPS and some expressed a view that the CPS should adopt the strengthening of civil society as a key objective in its own right. The independent political analysts cautioned that improvements in governance may continue to be slow given strong vested interests, and argued for a pragmatic approach that failed to raise unrealistic expectations. There was general agreement that financial support to the government, through lending operations, was most effective in areas where a national consensus on the need for reform had been reached.

125. Consultations with representatives from different political parties confirmed that there is no fundamental difference in economic vision and the commitment to reform. All those consulted welcomed the Bank's continued engagement to support economic reform in Ukraine and felt the principles established by the CPS were adequate. A review of sectoral priorities also did not reveal major differences of opinion in relation to areas of focus for the Bank. A detailed summary of the consultation process held to date is in Annex 8.

VI. RISKS AND RISK MITIGATION

A. IMPLEMENTATION RISKS

126. Implementation risks in Ukraine are considerable. The track record of implementation, particularly in the investment lending portfolio, is poor. Ukraine has the lowest disbursement rates among any IBRD borrower, although there have been some significant recent improvements.

127. The main sources of implementation risk fall into three categories: (i) lack of ownership, (ii) cumbersome internal procedures which are inconsistent with World Bank procedures, and (iii) policy delays or reversals.

128. Ownership: The capacity of Ukraine's government for strategic planning remains relatively weak. The authorities have been making efforts to improve internal coordination, but strategic prioritization remains a challenge. In this environment, it is sometimes difficult to ascertain the extent of client ownership for a particular intervention. Yet, the Bank has in the past also been culpable of preparing lending operations at the request of line ministries, without verifying the extent of support (and or political resistance) by power brokers in the central government agencies (Cabinet of Ministers, MoF, Ministry of Economy).

129. The current CPS imposes greater limits on the number of new projects being prepared, thereby forcing the authorities to coordinate more effectively. This has already been in evidence in preparation of the CPS, when the Government internally agreed to a clear sequence for the preparation and approval of three institutional reform projects in the lending pipeline: Court Modernization, PFM Reform and Social Insurance Administration Modernization. In addition, the Government clarified that they would not consider asking for support for civil service reform until 2010, which is consistent with Bank staff evaluation that the political consensus to push forward civil service reform does not yet exist. The recent improvements in coordination with World Bank assistance by the authorities are part of a general effort, as reflected in the elaboration of a Government Strategy for Cooperation with IFIs, adopted in 2006.

130. The CPS also aims for greater ownership of the AAA work and the planned Innovation Fund would be the strongest expression of a new partnership where client co-determination of the focus areas for Bank advisory services would result in greater impact.

131. **Cumbersome procedures:** Ukraine has a bewildering array of internal procedures and every step in project preparation requires a consultative inter-ministerial process that can last several months. Moreover, IFI projects with the exception of the DPL, are not included in the annual budget and hence each project requires ratification by the Rada, which again delays project effectiveness by several months.

132. The Bank and the government have started a dialogue on simplifying national procedures and moving towards the use of country systems on a selected basis, where fiduciary risks are thought to be manageable. As an initial success of this dialogue, the government recently passed a resolution mandating the disbursement of World Bank funds through the National Treasury. Moreover, the 2007 CPPR has committed both sides to clear service standards in portfolio monitoring and implementation (Box 7). An improvement in the disbursement rate to 12 percent and general portfolio performance standards are base case conditions of the CPS.

133. **Policy delays or reversals:** The pace of policy reform in Ukraine has by and large fallen short of expectations. This has affected the sequence of DPLs, which have tended to take at least two years to prepare. The annual disbursement schedule foreseen in the CPS may thus be regarded as ambitious.

134. The risk is mitigated at least in part by a recalibration of the DPL program. Compared to close to 100 benchmarks and over 20 triggers in the PAL 2 program, DPL II contains only 8 prior actions and six triggers. Moreover, the DPL framework is flexible; triggers can be waived if reform progress is delayed in one area, but this is compensated by greater progress in another area. The recalibration of the DPL program is reflected in the smaller share that adjustment lending takes in the overall CPS envelope, and in the smaller size of each DPL relative to the size of the budget or the economy. Thus while the economy has tripled in size in US dollar terms since 2000, the average DPL size of

US\$300-400 million is not much higher than the average size of previous adjustment operations.

135. Delays in the implementation of key legislation can also affect the preparation schedule of investment lending operations. To the extent possible, the DPL should shoulder this risk by taking on policy conditionality important to deliver investment lending results. However, in some cases, a legislative change is a pre-condition for an investment operation to be feasible. In such cases, a careful political economy analysis will need to be conducted to understand the risks associated with this policy conditionality and the preparation schedule may have to be adjusted or the project abandoned.

Box 7: Portfolio Monitoring and Implementation: Agreed Services Standards

On March 30, 2007, the representatives of the Ukraine central government agencies and the World Bank discussed the proposed new draft CPS for FY2008-2011 that will be based on new principles and approaches in cooperation as well as the World Bank project portfolio in Ukraine.

The meeting reviewed the status of the lending portfolio and agreed on the need to improve its performance. In order to achieve greater results of the Bank-financed Investment projects, the parties will make every effort to apply to the investment projects the following performance standards:

- From commencement of work (decision of the Government on the expediency of a project) to signing the minutes of formal negotiations - 1 year; If there is a delay in such Government's decision, the two sides should discuss and decide whether there is a necessity in project preparation;
- The Ukrainian side will facilitate the international project agreements to become effective within 6 months after their signing;
- Projects under implementation but with insufficient implementation progress, and whose objectives are at risk of not being met, will be subject to consideration with regard to their restructuring, extension and/or closure by mutual agreement, without prejudice to the rights of either side to make decisions individually within the framework of respective international project agreements.

Quarterly portfolio performance review meetings will be convened by the Ukrainian side and the Bank which will allow all project implementing entities and project implementing units involved in World Bank programs to discuss project implementation. The Government and Bank management will meet at more senior levels as appropriate to discuss systemic or urgent matters.

A review of progress in the Bank's CPS and the overall performance of the Bank's programs will be held during an annual Country Program Review. The World Bank, working closely with the Cabinet of Ministers and relevant ministries, will develop program- and project-level results indicators that will be monitored and assessed as part of the Country Program Review.

The parties will apply a systems approach to the country project portfolio, starting with the use of the State Treasury to service all investment projects executed by the central governmental bodies and other budgetary agencies, which are approved by the World Bank after July 1, 2007 (World Bank's fiscal year 2008). In those cases when Special Accounts are still needed, such accounts will be opened exclusively in the local commercial banks or NBU.

The parties will continue to optimize the procedures and shorten the period of processing documents by both the World Bank and corresponding central government agencies.

136. **Fiduciary risks are another important source of risk for the CPS.** However, several recent diagnostic pieces allow the conclusion that these risks are manageable and the standard assistance mode through the central government remains a viable model for

Ukraine. An internal review of corruption risks was carried out in 2006 to analyze governance problems in Ukraine and how they affected fiduciary risks in the portfolio. This analysis came to the conclusion that although fiduciary risks in Ukraine were recognized to be higher on all important dimensions than in the EU accession countries or other large middle income borrowers, in practice, fiduciary controls in investment lending operations worked to acceptable standards. The Governance Annex (Annex 2) of the CPS explains how the Bank intends to go beyond standard fiduciary controls in addressing governance risks, although it should be acknowledged that additional demand side measures are likely to take some time to take effect and will be applied initially on a selected basis. Stronger fiduciary controls, as developed in the context of the Bank's GAC, will additionally be required.

137. The PEFA assessment revealed significant strengths in budget execution, credibility and transparency. These achievements are encouraging and suggest that the Bank should over time move to disbursing financial assistance through the government budget. However, the PEFA assessment also highlights weaknesses in the capital budget and in the state procurement system. These two weaknesses should therefore be at the center of the Bank's efforts to move towards a greater reliance on country systems as an explicit risk mitigation strategy.

B. CREDIT RISKS

138. Ukraine's public sector debt levels are low and the country's macro economy at present is reasonably balanced. Section II provided an analysis of Ukraine's recent growth and macroeconomic performance and highlighted Ukraine's considerable macroeconomic strengths and good fundamentals.

139. Nonetheless, several important macroeconomic risks exist, which will need to be carefully monitored in terms of their implications for Ukraine's overall creditworthiness. The main risks from a macroeconomic perspective include:

- **Adverse terms of trade shock:** With metal prices at record highs, the impact of rising energy import costs has been muted. Should this change, Ukraine would face widening current account deficit, reduced corporate profitability, and at least temporarily lower growth.
- **Reduced access to international financing:** Ukraine has benefited from a benign external environment in terms of both export prices and access to financing. Should portfolio preferences shift against emerging markets, Ukraine would be vulnerable both because of the reliance on external financing of its current account deficit, and perhaps more importantly, because of potential impacts on domestic financial sector liquidity. Liquid domestic assets are well in excess of scheduled private debt repayments, but a sharp curtailment of liquidity could expose underlying credit risks in the financial sector.
- **Rapid financial sector expansion and remaining weaknesses in regulation.** While banking sector supervision has improved, there is still need for further

capacity building and greater transparency in the management of banking sector risks. In the non-banking sector, which has experienced fast growth from a low base, regulation remains very weak. This could exacerbate risks should a tightening of liquidity or an unexpected sharp exchange rate devaluation expose underlying credit quality issues.

- **Fiscal expansion driven by populist politics:** Fiscal management to date has been conservative, but political instability has led to election promises that if fulfilled could be fiscally costly. Fiscal expansion would risk overheating the economy, with further rises in inflation, growing external imbalances and the potential risk of a hard landing.

140. **The above macroeconomic risks are mitigated by Ukraine's past record of macro-management, which suggests policy will adjust in the face of negative shocks.** Specifically, it is likely that in the face of strong negative terms of trade shock, the exchange rate would adjust, and fiscal policy would support the economic rebalancing. Should external conditions deteriorate more gradually, the NBU would have time to move towards a more flexible exchange rate regime, which it has indicated it will do over the medium-term. Ukraine's experience at the end of the 1990s has moreover engrained a strong commitment to fiscal stability and aversion to too much dependence on external financing. Nonetheless, continued vigilance will be required to monitor Ukraine's macroeconomic balance and any possible impact on creditworthiness of large adverse external shocks.