INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/69

UKRAINE

March 2015

REQUEST FOR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND CANCELLATION OF STAND-BY ARRANGEMENT—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR UKRAINE

In the context of the Request for Extended Arrangement Under the Extended Fund Facility and Cancellation of Stand-By Arrangement, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 11, 2015, following discussions that ended on February 11, 2015, with the officials of Ukraine on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on February 27, 2015.
- A **Supplement** of March 6, 2015 on the Assessment of the Risks to the Fund and the Fund's Liquidity Position
- **Staff Supplements** of March 9 and 10, 2015 updating information on recent developments.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Ukraine.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Ukraine*
Memorandum of Economic and Financial Policies by the authorities of Ukraine*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UKRAINE

February 27, 2015

REQUEST FOR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND CANCELLATION OF STAND-BY ARRANGEMENT

EXECUTIVE SUMMARY

Ukraine needs a new economic reform program to restore stability and lay the basis for robust growth over the medium term. The conflict in the East has pushed Ukraine's balance of payments and adjustment needs beyond what can be achieved under the current two-year SBA-supported program. The economy has been hit hard by the disruption in trade and industrial production, and the subsequent loss of confidence, which fueled capital outflows and led to a sharp exchange rate depreciation. Banks have come under increasing stress, public debt dynamics have worsened, and international reserves have fallen to critically low levels. New financing needs have emerged. Addressing these challenges now requires broader and deeper reforms over a longer horizon, as well as significant new international assistance.

The authorities have requested support under a four-year Extended Arrangement (SDR 12.348 billion; 900 percent of quota; about US$17.5 billion). In the attached letter, they describe their economic and financial policies to support economic recovery and return to external sustainability, building on the existing macroeconomic program while extending the structural reform agenda. Specifically, policies would aim at:

- **Securing financial stability**. This includes (i) a strong monetary policy framework to restore price stability; (ii) exchange rate flexibility to cushion the economy against external shocks; and (iii) a comprehensive strategy to strengthen banks' financial health, through bank recapitalization, reduction of related party lending, and resolution of impaired assets, which are critical to regain public confidence and support economic recovery.

- **Strengthening public finances**. An expenditure-led adjustment will support fiscal consolidation in the coming years. Together with energy sector reforms and the announced debt operation, this would reduce fiscal imbalances and achieve public debt sustainability with high probability. Social protection schemes would be revamped to protect the poorest and alleviate social costs.

- **Advancing structural reforms**. Decisive efforts will help revitalize the business climate, attract investment, and enhance Ukraine's growth potential. This includes

governance reforms, including anti-corruption and judicial measures, deregulation and tax administration reforms, and reforms of state-owned enterprises to improve corporate governance and reduce fiscal risks. Broader energy sector reforms, including Naftogaz's restructuring, would increase energy efficiency and foster energy independence.

This program will be supported by significant financial assistance from the international community. Risks to the program are exceptionally high due to the weak state of the Ukrainian economy, the presence of vested interests opposed to reforms, and the ongoing conflict. These risks are mitigated by strong policies, including bold and frontloaded actions, and significant external financial support. This includes new multilateral and official bilateral financing, as well as a debt operation to improve debt sustainability. The authorities' steadfast policy implementation, including their ability to overcome entrenched resistance to reforms, will be critical for the program to succeed. The resolution of the conflict in the East, so critical for the region, would also strengthen and speed up prospects for macroeconomic stabilization and growth.

In many respects, the program provides Ukraine with a unique opportunity to fundamentally reform its economy. The authorities have shown strong resolve in this regard as evidenced by their performance under the SBA. They recognize that an ambitious program is needed both to stabilize the economy and enable its structural overhaul to resume sustainable growth and make a clear break with the past. As Prime Minister Yatsenyuk has noted, "*Throughout these four years Ukraine will be carrying out the reforms vital to ensure the economic and financial stability of the state. This reform program is not for the IMF, it is a program for reforms in Ukraine. The program is aimed to restore economic growth.*" (February 12, 2015, Kyiv)

Approved By
Thanos Arvanitis and Mark Flanagan

Discussions were held in Kyiv during January 8–February 11, 2015. The IMF team comprised Nikolay Gueorguiev (head), Anita Tuladhar, Peter Dohlman, Etienne Yehoue, Pamela Madrid, Beata Jajko, Linda Kaltani, Almira Buzaushina, Dustin Smith (EUR); Olga Stankova (COM); David Amaglobeli (FAD); Emmanuel Mathias and Sebastiaan Pompe (LEG); Luis Cortavarría-Checkley, Annamaria Kokenyne Ivanics, Johannes Forss Sandahl (MCM); Cesar Serra (SPR); Jerome Vacher and Wim Fonteyne (Resident Representative office). Poul M. Thomsen (Director, EUR), Thanos Arvanitis (Deputy Director, EUR), Ceda Ogada (Deputy General Counsel, LEG) and Oleksandr Petryk (Alternate ED) participated in discussions. Nikita Kannekanti and Christine Rubio (both EUR) provided support from headquarters.

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INTRODUCTION

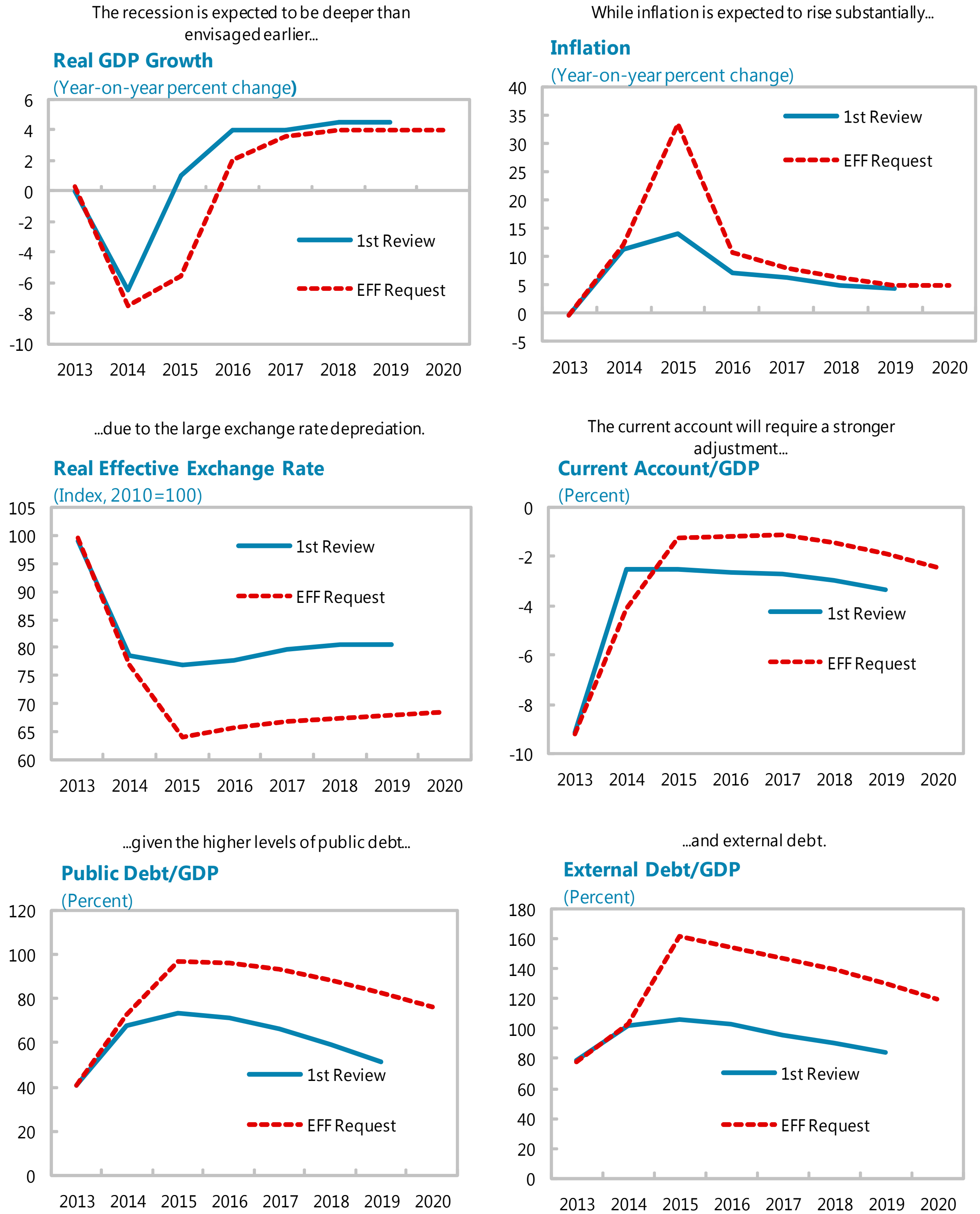
1. **Ukraine initiated ambitious reforms under the SBA, but recent developments have weakened the economy and opened up a larger financing gap, requiring an adjustment of policies and financing to restore growth and external viability**. In a very difficult environment, the authorities took decisive measures aimed at introducing a flexible exchange rate regime, stabilizing the financial system, securing fiscal sustainability, restructuring the energy sector, and setting the stage for sustainable growth through comprehensive governance and structural reforms. However, geopolitical and economic shocks since the first SBA review have increased Ukraine's balance of payments (BOP) and adjustment needs (text charts). The escalation of the conflict in August 2014, as well as more recently, led to a significant loss of confidence and disrupted industrial production and exports. BOP outflows and FX interventions depleted official reserves and opened up a large financing gap.

2. **Ukraine's BOP and adjustment needs have increased to levels beyond what can be achieved under the current two-year SBA-supported program**. International donor commitments over the next year, although sizable, would not suffice to restore the SBA program reserve targets, and low market confidence prevents quick resumption of growth and market financing. As a result, closing the larger financing gap within the period of the SBA now appears out of reach.

3. **To address Ukraine's more protracted BOP needs and deeper structural problems, the authorities have requested a new four-year program under the Extended Fund Facility (EFF) with exceptional access of 900 percent of quota (SDR 12.348 billion; about US$17.5 billion)**. The extended arrangement will provide more financing and more time to Ukraine to implement its reform program, including SDR 5.7 billion (US$8.1 billion) of additional net disbursements over 2015–18 (given the longer repayment terms under the extended arrangement). This reflects both the sizeable financing needs and the expected time needed to restore full market access at longer maturities and sustainable rates. The program will build on the reform momentum that began under the SBA while allowing broader and deeper reforms to spread over a longer period to correct structural imbalances.

4. **Significant financial support from the international community will supplement Fund financing**. The extended arrangement will provide a strong policy framework to catalyze further external financing from multilateral and official bilateral creditors. In addition, the Ukrainian government has announced its intention to hold consultations with public sector debt holders with a view to improving medium-term debt sustainability and addressing financing needs over the program period. As a result, a total financing package of around US$40 billion will support the program over the four-year period, helping to mitigate financial risks. The peaceful resolution of the conflict in the East would be a welcome development reducing political risk and uncertainty, and speeding up prospects for macroeconomic stabilization and growth.

Ukraine: Revised Macro Projections



Source: IMF staff calculations.

RECENT ECONOMIC DEVELOPMENTS

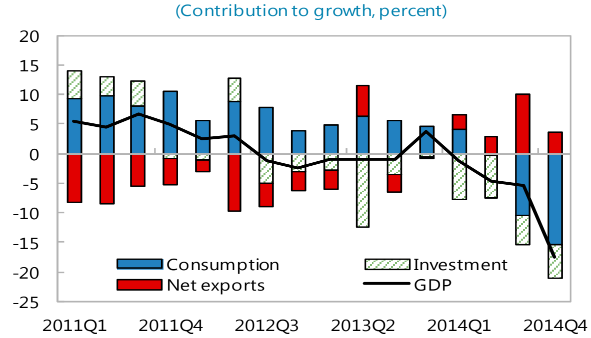
5. **Ukraine experienced a sharp output fall in 2014, driven by a deep decline in the East and a more moderate recession in the rest of the country** (Figure 1 and Annex I). The escalation of the conflict in August–September 2014 took a significant toll on the real and financial sectors. GDP contracted by 5.3 percent in 2014:Q3, as lower real household income weighed down on consumption, heightened economic uncertainty deterred investment, and the disruption of trade with Russia held back exports, notwithstanding a good agricultural harvest. From the production side, the output decline was broad-based in 2014. Retail sales, industrial production and construction all contributed to the output loss. For the year as a whole, GDP contraction is estimated at 6.9 percent (compared with 6.5 percent at the first SBA review), reflecting a big fourth quarter output drop in Donbass, an important exporting area directly affected by the conflict. However, there was a considerable differentiation in economic performance across regions. Indicators suggest a more moderate decline in Eastern regions outside the conflict areas and a relatively mild output drop in the rest of the country, reflecting a different trade orientation and limited non-energy interlinkages across regions (Annex I: Regional Developments).[1] Nonetheless, reflecting the broader decline in economic activity, unemployment is on the rise, reaching 8.9 percent as of end-September, up from 7 percent a year ago.

High Frequency Indicators Ukraine and the Eastern Regions
(Cumulative Y-o-Y Growth Rates) 1/

	Jan–Mar 2014	Jan–Jun 2014	Jan-Sep 2014	Jan-Dec 2014
Industrial Production				
Donetsk	-13.0	-12.3	-24.3	-31.5
Luhansk	-1.6	-5.0	-30.0	-42.0
Rest of Ukraine	-3.5	-2.9	-3.3	-4.6
Ukraine, total	-5.0	-4.7	-8.0	-10.1
Agriculture				
Donetsk	0.4	-11.4	11.7	-3.8
Luhansk	1.2	-11.3	-7.1	-17.7
Rest of Ukraine	6.3	-3.3	16.9	3.7
Ukraine, total	5.9	-3.9	16.0	2.8
Construction				
Donetsk	-7.3	-19.1	-37.5	-49.9
Luhansk	5.9	-16.9	-42.4	-54.1
Rest of Ukraine	-6.8	-7.3	-14.4	-18.5
Ukraine, total	-6.4	-8.9	-17.2	-21.7
Retail Trade				
Donetsk	6.8	-2.5	-19.9	-37.0
Luhansk	7.0	-7.7	-35.0	-49.0
Rest of Ukraine	7.8	1.6	-2.8	-5.2
Ukraine. total	7.7	0.8	-5.3	-8.6
Exports of goods				
Donetsk	-19.2	-14.4	-21.6	-32.2
Luhansk	-14.9	-19.0	-34.5	-46.2
Rest of Ukraine	-3.5	-2.0	-3.1	-8.5
Ukraine. total	-6.9	-5.2	-7.7	-13.5
Imports of goods				
Donetsk	-28.8	-34.4	-41.5	-47.7
Luhansk	-28.0	-25.1	-34.0	-45.1
Rest of Ukraine	-19.9	-16.9	-24.4	-27.2
Ukraine. total	-20.5	-17.9	-25.4	-28.3
Unemployment				
Donetsk	9.1	9.6	10.2	
Luhansk	8.4	8.9	10.4	
Rest of Ukraine	8.8	8.5	8.7	
Ukraine. total	8.8	8.6	8.9	

Sources: National authorities; and IMF staff calculations and estimates.
1/ Data from April exclude Crimea and Sevastopol.

Gross Domestic Product and Components
(Contribution to growth, percent)



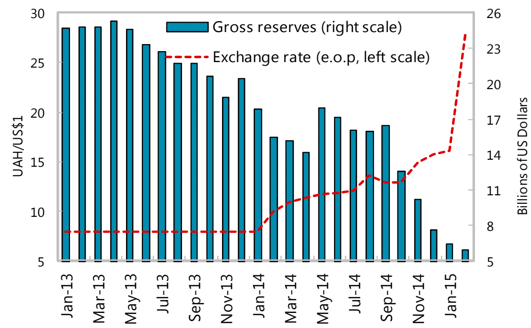
Sources: Ukrainian authorities; and IMF staff calculations.

[1] National accounts data exclude Crimea and Sevastopol from 2014. The authorities continue to publish data for the conflict-affected regions of Luhansk and Donetsk, but data coverage, collection, and processing from the areas not directly controlled by the authorities are challenging. Statistical information is largely based on reports from some large companies which continue to work in the region, albeit at lower capacity. Most small and medium-size companies do not report data.

6. **Inflation reached 24.9 percent at end-2014, driven mostly by the sharp exchange rate depreciation and energy price increases** (Figure 2). By end-December, the hryvnia has lost nearly half of its value relative to a year ago, driven by political instability, conflict in the East, and weakening confidence. The depreciation together with hikes in administrative prices, including gas and heating tariffs, caused CPI inflation to accelerate from close to zero at end-2013 to levels not seen since Ukraine's 2008–09 crisis.

7. **Official reserves fell to US$6.4 billion at end-January 2015 and the exchange rate depreciated sharply in recent weeks**. This was in part due to resources provided for debt service payments and to clear gas arrears and import gas in December, but also to earlier intervention to slow hryvnia depreciation. After allowing the exchange rate to adjust in November, the NBU modified the rules for its daily FX selling auction in an effort to dampen exchange rate movements. This, together with the existing capital controls, led to a widening parallel market, with the parallel rate being 30–40 percent more depreciated than the official rate in late January. On February 5, in an effort to eliminate the parallel market, the NBU halted its FX auctions allowing the interbank exchange rate to converge to the parallel market rate. As a result, the hryvnia fell immediately to around UAH 24–25/US$1. Depreciation pressures continued in recent days following recent conflict-related shocks and lack of external financing, with the hryvnia reaching about UAH 29/US$1 on February 23. Staff estimates that the exchange rate has significantly overshot, and the current real exchange rate is significantly undervalued based on macroeconomic fundamentals.

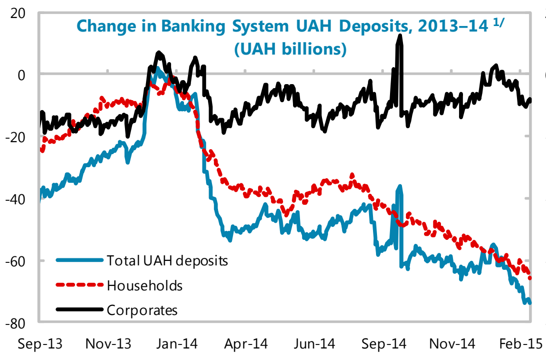
International Reserves and Exchange Rate

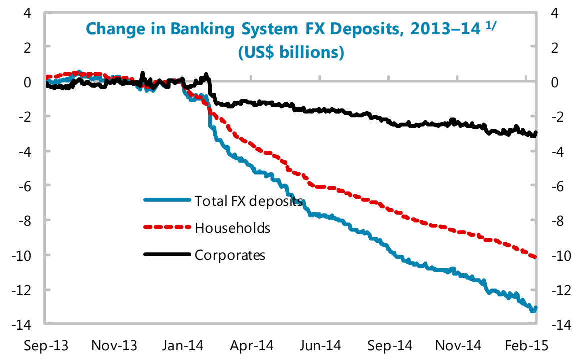


Source: National authorities.

8. **The current account deficit declined substantially in 2014**. Weak domestic demand, including from the ongoing fiscal consolidation, as well as the exchange rate depreciation have reduced imports and the current account deficit substantially (Figure 3). At the same time, exports declined by about 14½ percent, as exports to Russia dropped by some 34 percent in 2014. However, some redirection of exports toward the EU has started mainly in sectors such as metals, mineral products and agriculture. Still, Russia remains an important export market for Ukrainian goods, accounting for about 18 percent of exports (while the EU is now at 31½ percent).

9. **Banks have come under considerable stress, with worsening asset quality, profitability, and liquidity**. By mid-February 2015, the banking system had lost about 27 percent of deposits since their peak in January 2014, or more than 12 percent of GDP. NPLs rose from 12.9 percent of total loans at end-December 2013 to 19 percent at end-December 2014, and are expected to worsen further given recognition lags. These factors, together with losses associated with the holding of negative foreign exchange positions in a context of persistent hryvnia depreciation have brought return on assets to -4.1 percent at end-2014. Banks' liquidity positions have worsened on account of economic distress and deposit outflows. Large NBU liquidity support has helped banks, reaching about 9 percent of the total system liabilities as of mid-February 2015.





Source: National authorities.
1/ Change since January 22, 2014.

10. **Despite the difficult economic situation, recent developments give rise to cautious optimism for the near term**:

- **In December, a five-party coalition government including both the president's and the prime minister's parties was formed, strongly boosting the political influence of reformist forces**. Political leaders have made repeated public commitments to deep reforms and the new parliament has approved the government's program on reforms to address deep-rooted governance challenges and improve the business climate.

- **The trilateral agreement on a "winter package" for gas supply is being implemented as planned**. Naftogaz cleared US$3.1 billion of arrears to Gazprom as agreed and gas import flows have resumed. The arbitration case in Stockholm is ongoing, with decisions now expected in the second half of 2016.

- **Efforts by the international community are underway to find a sustainable solution to the conflict in the East.**

PROGRAM OBJECTIVES AND STRATEGIES

11. **The proposed four-year EFF-supported program builds on reforms that started under the SBA, while taking into account Ukraine's more protracted balance of payments and adjustment needs**. It aims at:

- **Restoring confidence and economic and financial stability through strong adjustment policies**. These are oriented toward stabilizing the foreign exchange market, rebuilding official reserves, repairing bank balance sheets, strengthening public finances, and reforming the energy sector. More specifically, Ukraine will pursue: (i) an appropriately tight monetary policy to anchor expectations and a sustainable exchange rate policy that fosters steady reserve accumulation; (ii) bank recapitalization and resolution measures to strengthen banking system soundness, including measures to reduce related-party lending; (iii) fiscal adjustment consistent with a sustainable debt path; (iv) measures to keep Naftogaz's deficit on course to be eliminated by 2017, and to restructure Naftogaz to increase efficiency and improve governance.

- **Lifting medium-term growth through deep structural reforms**. These will be oriented toward improving competitiveness and enhancing investment and growth potential by strengthening economic governance, transparency, and capacity building. More specifically, Ukraine will pursue: (i) governance reforms, including anti-corruption and judicial reform measures; (ii) deregulation and tax administration reforms to improve business climate; and (iii) a comprehensive reform of state owned enterprises (SOEs) to enhance their financial viability, reduce their fiscal burden, and strengthen corporate governance.

12. **The program's success hinges crucially on three main assumptions**: (i) the full and timely implementation of policies under the program; (ii) adequate and timely external financing from the official sector and, via a debt operation, the private sector; and (iii) the non-intensification of the conflict in the East. These assumptions are incorporated in, and are critical for the program. The program includes some buffers in terms of (i) conservative near term projections; (ii) careful attention to the pace of adjustment, including social policies; and (iii) increased economic flexibility, including a floating exchange rate. However, if any of the key assumptions fail to materialize, the macroeconomic outcomes would be at risk (see ¶17 for a detailed discussion of risks).

FINANCING

A. Financing Gap

13. **Ukraine faces an exceptionally large financing gap of about US$40 billion over the program period (2015–18), equivalent to 31¼ percent of the estimated 2014 GDP**. About three-quarters of the gap results from the need to gradually strengthen official reserves to adequate levels, in particular, to around US$18.3 billion (66 percent of the IMF composite reserve metric) at end-2015 and US$35.2 billion (about 113 percent of the metric) at end-2018. In 2015 alone, the financing gap is projected at US$21.4 billion, consisting of a reserve build-up of US$10.8 billion and an underlying BOP gap of US$10.6 billion.

- **The US$10.6 billion underlying BOP gap in 2015 is split roughly 4:1 between the financial and current account of the BOP**. This projection reflects continuing low confidence and moderate capital outflows, as well as lack of external market access, low FDI, and conservative rollover rates for banks and firms. The current account contribution comes from reduced exports, especially of services, only partly offset by falling imports.

B. Financing Strategy

14. **Ukraine's financing gap will be filled by a combination of official and private funds, in the context of a comprehensive adjustment program**. The proposed financing provides for

appropriate burden sharing, with just under one-half of the financing gap filled by Fund purchases. With these commitments, financing assurances are in place.

Ukraine: Program Financing

(US$ billion)

	2015	2016	2017	2018	Total
Financing Gap 1/	21.4	6.8	6.9	4.8	40.0
Reserve accumulation	10.8	3.9	6.3	6.7	27.7
Underlying BOP gap 1/	10.6	2.9	0.7	-1.9	12.3
Identified Financing 2/	21.4	6.8	6.9	4.8	40.0
Bilateral and multilateral	16.3	3.5	2.5	2.5	24.7
IMF	10.0	2.5	2.5	2.5	17.5
Other multilateral/bilateral	6.3	1.0	0.0	0.0	7.2
Multilateral	1.8	0.0	0.0	0.0	1.8
European Union	1.8	0.7	0.0	0.0	2.5
United States	2.0	0.0	0.0	0.0	2.0
Other bilateral	0.7	0.2	0.0	0.0	0.9
Debt operation	5.2	3.4	4.4	2.3	15.3
Memorandum items:					
Project loans 3/	2.0	2.6	2.7	2.2	9.5
Multilateral	2.0	2.2	2.4	1.8	8.4
Bilateral	0.0	0.4	0.4	0.4	1.1
Gross international reserves	**18.3**	**22.3**	**28.5**	**35.2**	
% of composite metric	66	79	96	113	

1/ Excludes the effect of spending reflected on the current account generated by project loans.

2/ Excludes project loans.

3/ Project financing to the public and private sector.

- **The Fund will provide SDR 7.092 billion (about US$10 billion) towards the 2015 gap, and an additional SDR 5.256 billion (about US$7.5 billion) over the remainder of the program, subject to the successful implementation of the program**. About SDR 1.915 billion (about US$2.7 billion) of the first disbursement will be used for budget support to help cover fiscal financing needs in an environment of restricted market access.

- **International donors have committed US$7.2 billion in financing so far**. This includes US$1.5 billion of budget support commitments under the SBA, US$5.1 billion of new budget support commitments, and US$0.6 billion of other multilateral support for financing gas payments.[2] New commitments include Macro-Financial Assistance of over US$2 billion from EU, guarantees of US$2 billion from the U.S., and other bilateral support that has been assured in

[2] The Ukrainian authorities are in the process of activating a swap agreement with the People's Bank of China in the amount of CNY 15 billion (about US$2.4 billion). Discussions are ongoing on the use of the swap to support Ukraine's balance of payments, as well as on its possible extension beyond its current expiration in June 2015.

the context of the G7 discussions. Additional bilateral support, including for reconstruction purposes, may be forthcoming in future years.

- **Given Ukraine's high debt levels, resolving its balance of payments problem also calls for private sector involvement through a debt operation**. The authorities have announced their intention to hold consultations with holders of public debt with a view to improving medium-term debt sustainability. They have hired financial and legal advisors to help them with this process. While the specific terms of the debt operation would be determined following consultations with creditors, the debt operation would be guided by the following program objectives: (i) generate about US$15 billion in financing during the program period; (ii) bring the public and publicly guaranteed debt/GDP ratio below 71 percent of GDP by 2020; and (iii) keep the budget's gross financing needs at an average of 10 percent of GDP (maximum of 12 percent of GDP annually) in 2019–2025. The restructuring discussions are expected to begin on the basis of the program's baseline macro framework. However, the continued applicability of the macro framework informing the operation would be reviewed before the discussions are finalized. The debt operation is expected to be concluded by the time of the first review.

MACROECONOMIC FRAMEWORK AND RISKS

15. **The economy is expected to slowly return to growth on the back of strong policies and the unlocking of external financial support.** Macroeconomic stabilization, underpinned by a strong monetary anchor, fiscal adjustment, financial sector recovery, and external official financing is expected to take hold in late 2015 and become more entrenched in 2016. This, combined with structural reforms, is expected to attract investment and private capital, and lift economic growth to its potential in 2018.

- ***Growth***. Strong policies and frontloaded financing in the first half of the year are expected to arrest excessive imbalances in the foreign exchange market and restore quickly a measure of financial stability (see ¶19). Nonetheless, baseline growth projections have been downgraded relative to the first SBA review. Growth is now expected to bottom out in 2015:H1, with GDP contracting by about 5½ percent in 2015 (versus -3.4 percent in the January *Consensus Forecasts*). This reflects the full year economic impact of the conflict in the East, the expected drag from fiscal adjustment, and the process of bank restructuring underway that leads to bank deleveraging.[3] A moderate recovery would emerge in 2016, with GDP projected to rise by 2 percent (versus +2.2 percent in the January *Consensus Forecasts*). This will be a modest bounce back following a deep recession in 2014–15 (of more than 12 percent) and will be driven by a rising industrial production—after a steady decline for four consecutive years—on the back of a slow recovery of steel production, and manufacturing of chemicals, pharmaceuticals, and

[3] Projections for 2015 continue to assume loss of economic capacity for an extended period in parts of the Eastern regions which are outside the control of the government. The contribution of this loss to the 2015 GDP decline is estimated at over 2 percentage points.

machinery and equipment. Domestic trade and agricultural production will also increase moderately, while exports of food and consumer products to the EU will continue to grow, benefiting from the asymmetric treatment of the Ukrainian agricultural exports. While growth will gradually become more broad based and pick up speed over time, real GDP will surpass its pre-crisis level only by 2019, reflecting the depth and scope of the ongoing crises. Overall, growth projections remain conservative by the standards of past crises, falling near or below the bottom quartile compared to historical episodes of post-crisis recovery (text chart on p. 16).

- ***Inflation***. Inflation is projected to rise to about 27 percent in 2015 due to the pass-through effects of the large exchange rate depreciation, energy price hikes and base effects. Given the large and widening negative output gap, demands for higher wages are expected to be limited. Inflation is projected to recede in 2016 as these one-off effects subside and stabilize to around 5 percent over the medium term as economic and monetary stabilization takes hold and the NBU shifts to an inflation targeting framework.

- ***External account***. The current account deficit is expected to narrow significantly to 1.4 percent of GDP, from 4.8 percent of GDP as the REER depreciates cumulatively by 35 percent in 2014–15. This decline also reflects lower energy imports, which are expected to continue over time and lower dividend payments, reflecting shrinking corporate profitability and administrative measures. These effects are offset in part by the adverse terms of trade, and conflict-induced decline in transportation and tourism services. Over the medium term, the REER dynamics are expected to reverse some of the recent overshooting on the back of gradual returning capital inflows and rising reserves. Nonetheless, the real exchange rate level is expected to remain significantly below its pre-crisis level, allowing permanent competitiveness gains, with its projected trajectory well below the median of past emerging market crises. This would be necessary to generate small and sustainable current account deficits over the medium term and reduce the high external debt (text chart on p. 16).

- ***Financial account***. Sovereign market re-access is delayed to late 2017 and expected to be moderate over the medium term. Rollover rates for corporate and bank debt are expected to be around 95–100 percent in 2016–17. The effect of bank restructuring is also factored in via the outflow of bank deposits owing to the negative confidence effect of bank closures. A number of large private companies have initiated restructuring of their external debt on a voluntary basis and the envisaged debt operation would also help reduce pressures over the program period. Under these assumptions, reserves would gradually strengthen reaching almost 100 percent of the Fund's composite metric by end-2017. Specifically, the reserve target for the end of the SBA (US$26.7 billion in 2016:Q1) is now expected to be reached by 2017:Q3.

- ***Debt***. Public and publicly guaranteed debt is projected to peak at 94 percent of GDP in 2015, but it is expected to be on a steady downward trajectory afterwards, falling below 71 percent of GDP in 2020. This would be supported by the announced debt operation which is expected to reduce debt service significantly during and after the program period, mitigating debt-related risks (Annex II). With the fiscal adjustment complete and growth restored, the public debt ratio would continue to decline beyond 2020. Private external debt will be reduced by the moderate current account deficits, coupled with the ongoing private debt restructuring as noted above.

16. **While the macroeconomic outlook has been revised to reflect recent adverse developments, the uncertainty around these projections remains exceptionally high**. While the area where the conflict takes place is relatively limited, its impact on confidence and thereby on financial stability, the balance of payments, and growth prospects is very large. As such, an escalation of the ongoing conflict is a major risk to the program. As noted earlier, the macroeconomic framework incorporates conservative assumptions to buffer the impact of the current conflict on the baseline for 2015 by assuming loss of economic capacity in the conflict regions for an extended period and continued decline in the rest of the Eastern regions. A flexible exchange rate will help absorb moderate shocks. From 2016 on, the authorities' policies and reforms would start having a positive impact, at least on the part of the country not directly affected by the conflict. Growth is projected to pick up in 2017–18, on the back of stronger investment and consumption, while the negative contribution of net exports will remain moderate relative to historical averages.

17. **Risks to the outlook are exceptionally high and predominantly on the downside**.

- **Fighting in the East may resume and spread**. This would unravel confidence, increase the direct loss of economic and export capacity while military spending may rise sharply.

- **If not smooth, the proposed debt operation could disrupt the fragile equilibrium in the balance of payments of the private sector**. In particular, the debt operation, especially if the process turns disorderly, could disrupt the voluntary private debt roll over that is under way (some US$40 billion of short and medium-term private debt service payments are assumed to be rolled-over in 2015).

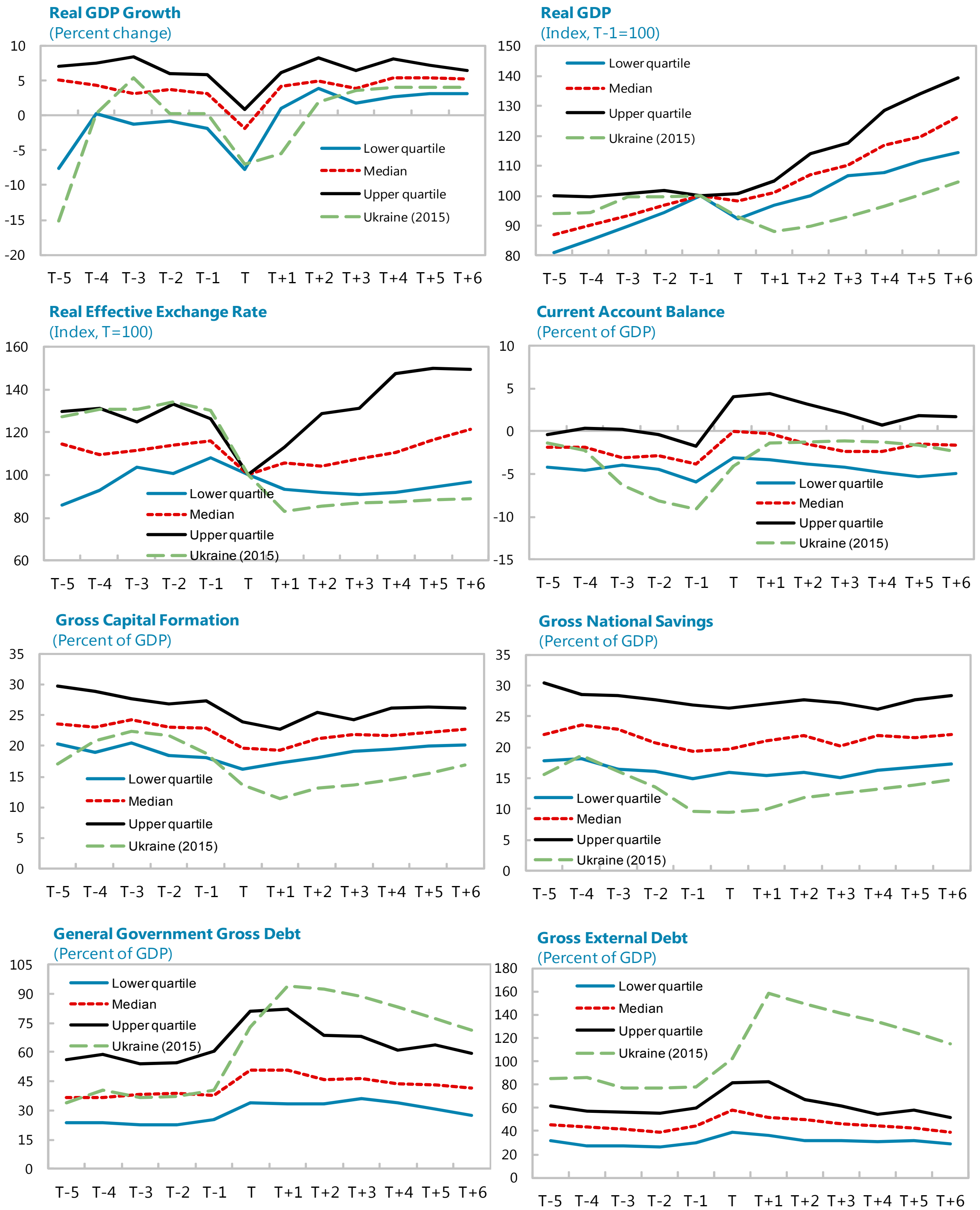
- **Furthermore, creditor participation in the debt operation may fall short of expectations**. Creditors may balk at the terms being offered in the debt operation and holdouts may try to free ride. The negotiations may be protracted, particularly as some creditors have large positions in specific bond issues. At the same time, Ukraine's continued capacity to service its debts would be contingent on a successful debt operation that ensured sufficient program financing and restored debt sustainability with high probability, and this should help encourage participation.

- **Slippages in program implementation would negatively affect stabilization and growth prospects**. Incomplete fiscal and financial sector reforms or delays in implementation of structural measures would undermine public support for reforms, affect growth, and see debt remain at high and likely unsustainable levels.

- **On the positive side, an early resolution of the geopolitical crisis would boost confidence**. Also, a faster than envisaged adaptation of production and exports to the new macroeconomic and external environment would support growth.

Economic Indicators during Past Emerging Market Currency Crises, 1990–2014

(T indicates a crisis year)



Source: INS; WEO; and IMF staff estimates.

MONETARY AND EXCHANGE RATE POLICY

A. Background

18. **Amidst a challenging environment, the NBU has taken several measures in recent months to contain inflation and pressures on the hryvnia**. In August, it tightened monetary policy by increasing its overnight refinancing and deposit certificate rates by 250 basis points. In November, the NBU increased its main policy rate by 150 basis points and its longer-maturity deposit rates by 50–100 basis points. It also tightened administrative restrictions and capital controls.[4] In early February, the NBU increased its main policy rate by 550 basis points to 19.5 percent. However, against weak confidence, limited external financing, and no buffers for FX intervention, the exchange rate came under significant depreciation pressures in recent weeks.

B. Policies

19. **A first priority is to stabilize the foreign exchange market and reduce the pass through to inflation.** The program will be anchored initially by very tight monetary policy targets, which together with administrative measures will reduce steadily the demand for foreign currency. In line with this, base and broad money growth will be negative in real terms. In addition, following approval of the program, frontloaded external disbursements in excess of US$10 billion in the first half of year will shore up international reserves and help calm the foreign exchange market. In the first two months, with the Fund and other international partner's disbursements, gross international reserves are programmed to nearly double. With the exchange rate stabilizing and confidence returning, the supply of foreign exchange will gradually increase, including from seasonal export proceeds. As the situation normalizes, the burden on monetary policy will gradually ease.

- **Monetary policy will continue to be geared toward bringing inflation back to single digits by late 2016**. Following an initial spike in inflation in mid-2015, inflation is expected to decelerate rapidly on the back of prudent monetary policy and tight incomes policies which would limit the pass through of the recent depreciation. To this end, the NBU will set its main policy rate (the discount rate) positive in real terms on a 12–18 month forward-looking basis. This should strengthen the signaling role of the discount rate and help anchor inflation expectations. During this period, and in light of the segmented nature of Ukraine's money market, NBU monetary operations will also play an intermediary role by reallocating surplus liquidity to banks in need through performing weekly two-sided tenders.

- **The authorities will maintain a flexible exchange rate regime to cope with external shocks, while aiming for a gradual rebuilding of FX reserve buffers**. The NBU will not sell FX, except

[4] In particular, the NBU increased the export surrender requirement to 75 percent, reduced the limit for individuals' FX purchases, banned transfers abroad of proceeds from over the counter sales of securities and dividend repatriation for such securities, and tightened verification procedures for compliance with its regulations.

for central government needs and critical energy imports in amounts factored into the program. From 2015:Q2, NBU sales to Naftogaz will be phased out. New financing and improving market conditions are expected to allow a gradual build-up in reserves over the medium term. In order to eliminate distortive administrative measures, the authorities will prepare by May 15, 2015 a plan for the gradual removal of the exchange restrictions and capital controls that will be conditioned on sufficient improvement in financial and exchange rate stability and accumulation of international reserves as projected under the program.[5]

- **The NBU's institutional foundations will be strengthened, aiming to improve governance, autonomy, and effectiveness**. Legislative amendments to the NBU Law will be approved by end-April 2015 **(structural benchmark)**. The reform, being designed in consultation with IMF staff, will focus on modifications to the governance structure of the NBU and strengthening its autonomy, including modalities to safeguard its balance sheet.[6] The legislation will also address other concerns raised in the context of the 2014 Safeguards Assessment. The NBU's organizational structure and communications strategy will also be revamped to further enhance its effectiveness.

20. **Efforts toward future adoption of inflation targeting will continue**. The NBU will continue strengthening its technical and operational capacity. It will continue to refine its own inflation projection capacity, and has discontinued past practice of using projections developed by the Cabinet of Ministers. Once appropriate macro-financial conditions have taken hold and institutional pre-requisites are in place, the NBU will adopt inflation targeting.

RESTORING BANKING SYSTEM SOUNDNESS

A. Background

21. **Banking soundness has significantly weakened**. As of end-January 2015, the banking system's capital adequacy ratio (CAR) stood at 13.8 percent, down from 15.9 percent at end-June. However, NPLs have not yet peaked, and the recent large exchange rate depreciation is likely to reduce bank profits further. Also, aggregate ratios mask vulnerabilities in individual banks, as evidenced by reported bank losses and confirmed by recent bank diagnostics.

22. **Progress was made regarding the recapitalization and restructuring of banks on the basis of the 2014 diagnostic results** (MEFP ¶17).

[5] The authorities have introduced a temporary surcharge on imports (with exemptions for energy and pharmaceuticals) based on Article XII of the GATT (1994) agreements that aims to contain BOP pressures. The authorities have indicated their intention to remove this measure by end-2015. The WTO will consider the case in April.

[6] The authorities planned to restructure the government debt held by the NBU at a 15–30 year maturity and a low interest rate. As this would have opened a large hole in the NBU balance sheet, an agreement was reached to abandon this plan.

- **Group 1 banks**: For the nine large banks that needed a capital increase, and for which: (i) credible recapitalization plans were approved, and (ii) capital shortages were reduced by 25 percent, the recapitalization deadline has been set for end-June 2015. Banks that did not reduce the capital shortage by 25 percent will be put under regulatory constraints, including on asset growth, and will be subject to higher degree of on-site monitoring. One out of the nine large banks, accounting for about 2½ percent of the system assets, failed to submit a credible plan and was resolved.

- **Group 2 banks**: All banks in this group of the second largest 20 banks remain on track to complete their recapitalization plans by end-February 2015.

- **Other banks**: The NBU has stepped up the resolution of smaller banks. As of end-February 2015, 41 banks were resolved through the Deposit Guarantee Fund.

23. **The NBU has also strengthened surveillance and crisis management measures**. Parliament recently passed an anti-crisis law that, inter alia, facilitates the use of public funds for bank recapitalization and grants powers to NBU to adopt extraordinary measures to ensure financial stability. A Financial Stability Board has been established to ensure timely identification of systemic risks and recommend measures to minimize their impact on the financial system and the economy.

24. **Preliminary information suggests that several institutions intervened by the Deposit Guarantee Fund (DGF) had breached credit limits to insiders**. Opaque ownership structures and lending schemes have made it difficult for the NBU to limit effectively banks' exposures to insiders. This highlights the need to strengthen the supervisory framework to better address related lending. International experience shows that excessive lending to insiders raises the banks' likelihood of failure and reduces expected recovery in cases where banks turn insolvent and need to be resolved.

B. Policies

Updating the banking recapitalization, restructuring, and resolution strategy

25. **The authorities agreed on the need for an updated bank recapitalization strategy** (MEFP ¶15). This will take into account updated diagnostic exercises based on a more adverse macroeconomic scenario, as well as the need to gradually unwind related party loans. In particular, the NBU has required revised recapitalization plans that credibly identify the sources of funds to be used for capital injection and specific plans for asset deleveraging. In view of the large shocks buffeting the economy, staff and the authorities agreed that some forbearance on capital indicators was appropriate. To this end, an agreement was reached to allow banks that were solvent to meet a minimum capital adequacy ratio of 5 percent as of end-January 2016 and gradually reach 10 percent no later than end-December 2018.[7]

[7] A similar approach was adopted in Indonesia, Korea and Japan in the late 1990s.

26. **Taking these factors into account, the cost of bank restructuring in 2014–15 is estimated at 9¼ percent of GDP**. This represents an upward revision from the SBA estimate, which reflects the incorporation of potential additional losses associated with the conflict in the East and the higher than expected FX depreciation. Overall, staff believes that capital injections by the private owners remain the best option for bank recapitalization and restructuring. However, given the uncertainties and risks associated with this strategy, the program contains a buffer of nearly 4 percent of GDP in public funds that could be used for bank recapitalization and restructuring. Costs are also estimated conservatively before asset recovery from failed banks.

Enhancing asset recovery and launching forensic audits

27. **The management of assets from resolved banks is being strengthened** (MEFP ¶18). The authorities stressed that as the balance sheets of intervened banks turned out worse than the books indicated, little value has, so far, been recovered from the assets of failed banks.[8] The authorities and staff agreed that to maximize recovery values, more time is needed to dispose assets of failed banks than the 3 years foreseen in existing legislation. The recovery process would also be further strengthened by introducing unlimited liability for related party loans (¶28). Furthermore, with the assistance of World Bank staff, the DGF will create a specialized unit to consolidate the management of assets from resolved banks and prepare their disposition in a timely and efficient manner. In addition, two pilot forensic audits of failed banks are set to be launched. These would aim to identify bad banking practices (including outright fraud) and draw lessons for bank regulation and supervision and the functioning of the DGF.

Enhancing the regulatory and supervisory framework

28. **The authorities have taken decisive steps to bring rules and supervision on related party lending in line with international best practice** (MEFP ¶13). As intervened and resolved banks have revealed above-limit credit to insiders, existing legislation and regulation on related parties will be strengthened to: (i) minimize the risk that excessive lending to insiders could undermine the proper functioning of banks in the future; (ii) prevent related party borrowers from receiving better credit conditions than non-related bank customers; and (iii) enhance supervisory surveillance over banks. To this end, the authorities will:

- ***Enact key legal amendments***. These would include two key elements. First, they would introduce unlimited liability on losses arising from loans granted directly or indirectly to shareholders holding 10 percent or more of total voting shares (**prior action**). This would create incentives to bank owners to avoid failure and hold capital, reducing moral hazard on related party loans. Second, the amendments will grant legal powers to NBU to presume the existence of economic relationship between banks and borrowers on the basis of objective criteria, unless the banks are able to prove otherwise.

[8] Most of the intervened banks have been small banks that were not subject to diagnostics and had issues with high levels of related loans.

- ***Revise the existing related party lending framework***. The authorities will analyze the current legal and regulatory framework on related parties and identify loopholes that need to be fixed in the near future with IMF and WB technical support.

- ***Allow bank self-assessment***. The aim would be to identify exposures that are above limits according to the revised regulatory framework.

- **Conduct a supervisory review of bank reporting and preparation of unwinding plans**. The NBU will verify proper reporting with the participation of accounting firms. Banks will be given prudent time to orderly reduce such exposures with the view to smoothly adapt to the new regulatory environment, on the basis of well-structured and credible unwinding plans.

- ***Undertake prudential monitoring***. The NBU has announced the establishment of a specialized unit to follow up on credit exposures with the banking industry of economically related groups and individuals (financial and non-financial groups).

Schedule for Unwinding Related Party Lending in 10 Largest Banks

2015	Schedule
February-March	• Legislative amendments introducing unlimited liability of bank owners on losses arising from related party lending • Tightening of NBU regulations on lending limits to insiders
May	• Banks report to NBU on related party exposure according to new legal and regulatory framework
July	• NBU notifies banks on discrepancies
August	• Banks responds on discrepancies
September	• NBU completes prudential review and issues final report
October	• Banks submit reduction plans to unwind related party exposure
November	• NBU approves reduction plans

Strengthening bank capacity to resolve bad loans

29. **The framework for addressing NPLs will be enhanced (**MEFP ¶19). The authorities remain committed to supporting a voluntary negotiation process between borrowers and banks for the restructuring of foreign currency denominated mortgage loans serviced by struggling borrowers. By end-March 2015, the NBU will issue a Code of Conduct to guide negotiations between borrowers in difficulty and banks, establish debt restructuring guidelines, and put in place an appeal process to

induce fair and balanced negotiations. By end-June 2015, the authorities will establish a coordinated out-of-court restructuring system, in line with international best practice. By end-July, legislation will be submitted to strengthen the framework related to private debt restructuring, on the basis of international best practice and cross-country experience, covering foreclosure procedures, corporate and personal insolvency and tax incentives.

FISCAL POLICY

A. Background

30. **Despite the deteriorating security situation during 2014, the authorities have met the 2014 general government deficit target with a large margin**. Revenues were in line with projections, reflecting measures introduced in July, while expenditures were curtailed, owing to liquidity constraints and stalled budgetary payments to the conflict areas in the East. The cash budget deficit for 2014 is estimated at 4.6 percent of GDP, lower than the targeted 5.8 percent of GDP.[9] The fiscal saving was nearly sufficient to offset the higher than expected Naftogaz's deficit of 5.7 percent of GDP, bringing the combined general government and Naftogaz deficit to 10.3 percent of GDP, broadly as targeted.

31. **In December 2014, the authorities adopted a 2015 budget targeting a deficit of UAH 65 billion (3½ percent of GDP)**. The tax reform package includes significant permanent revenue-increasing measures as well as measures related to tax simplification and reduction in labor tax wedge (Box 1). On the expenditure side, the 2015 budget aims to reduce the size of government as well as inefficiencies (text table). It eliminates subsidies that supported the inefficient coal-mining industry (equivalent to 0.6 percent of GDP in 2014) and reduces budgetary employment by 3 percent. The budget also includes significant pension savings, achieved by effectively freezing pensions during most of 2015, reducing the replacement rate from 70 percent to 60 percent for special pensions, and tightening eligibility for early retirement. The budget continues to provide pensions to all pensioners who relocate from the ATO regions, but does not assume any fiscal revenue from or spending to the areas of active conflict in the East, except military spending which has been increased. The budget also increases outlays on capital investment to fund Ukraine's immediate reconstruction needs. A more significant scaling up of reconstruction spending will be contingent on additional concessional donor support.

[9] Adjusted for the unpaid bills to the East (mainly pensions), the general government budget deficit would amount to about 5 percent of GDP.

Box 1. Authorities' Tax Policy Changes

Parliament has approved a package of significant tax policy reforms. The package is revenue-enhancing, although some key measures are temporary. The main proposed changes could be grouped into three broad categories:

- **Simplification, reduction of labor tax burden and elimination of a distortive tax**. These measures include abolishment of a few small revenue-yielding taxes, merging of taxes with similar characteristics and simplification of a single tax. In addition, a reduction in the average social security contribution rate conditional on a significant increase in the reported wage bill. Foreign exchange sales tax for the noncash transactions was abolished. The net negative revenue impact is estimated at 0.3 percent of GDP.

- **Permanent revenue-raising measures**. A set of new measures introduced in the tax code are expected to generate additional revenue of 2.3 percent of GDP on a permanent basis. These measures include (i) raising personal income taxation by increasing the progressivity including by taxing high pensions, maintaining the "military tax," and increasing the rate and expanding the base for the capital income tax; (ii) increasing excise taxation by introducing a new retail sales tax and raising tobacco excises; (iii) increasing property taxation; (iv) increasing royalties on natural resources and (v) various other taxes such as tax on lottery and fixed agriculture tax.[1]

Table 1. Revenue Measures Adopted as Part of 2015 Budget

	Revenue impact (Percent of GDP) 1/
Simplification of taxes and elimination of distortive taxes	**-0.5**
Eliminate foreign exchange sales tax for noncash transactions and increase for the cash transactions	-0.3
Eliminate small taxes and reform of the single tax	-0.1
Permanent revenue-raising measures	**2.3**
Extend the personal income tax surcharge (military tax) until the completion of the military reform	0.4
Introduce progressive personal income tax rates, eliminate preferential treatment for miners and expand the tax base to include passive incomes	0.1
Tax pension benefits exceeding three minimum wages	0.1
Increase the tax rate on passive incomes to 20 percent from 15 percent	0.1
Remove nontaxable threshold on lottery wins	0.1
Introduce a new excise tax on retail sales of alcohol, tobacco and fuels	0.4
Equalize excise tax rate for unfiltered and filtered cigarettes	0.1
Introduce a new luxury vehicle tax	0.1
Expand the property tax base	0.0
Increase royalties on natural resources	0.8
Other measures	0.3
Temporary measures	**1.5**
Introduce temporary import duty surcharge	1.0
Extend VAT exemptions on grain exports	0.5

Sources: Ukrainian authorities; and Fund staff estimates.
1/ Revenue impact estimates relative to revenues on current policies.

- **Temporary measures**. The introduction of a temporary import duty surcharge—although aimed at providing balance of payments relief—will have a significant revenue impact with an estimated yield of 1 percent of GDP in 2015. The tax code amendment will also extend VAT exemption on grain exports for agricultural traders and producers (0.5 percent of GDP).

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[1] Although the increase in royalties for gas extraction was made permanent, the tax code requires the government to revisit the tax regime and submit its new draft amendment to parliament by July 1, 2015.

Fiscal Measures in 2015 Approved and Supplementary Budgets

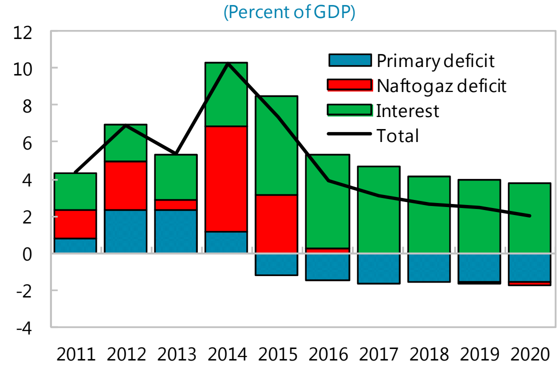
	Revenue/Savings (Percent of GDP)
Revenue measures	**3.3**
Of which	
Simplification of taxes and elimination of distortive taxes (e.g. foreign exchange sales fee for noncash transactions)	-0.5
Increase in personal income tax base and rates	0.7
Introduction of a new excise tax on retail sales and increase in tobacco excise rate	0.5
Expansion of the property tax base and introduction of a new tax on luxury vehicles	0.1
Increase in the royalties on natural resources	0.8
Temporary measures (import duty surcharge, extension of VAT exemption on grain exports)	1.5
Expenditure measures	**-4.1**
Of which	
Maintaining the nominal wage bill at 2014 level (except for military personnel)	-0.8
Delaying the minimum pension indexation until December 2015 and implementation of short-term pension measures including the reduction in replacement rates for special pensions and the reduction in pension benefits to the working pensioners	-2.3
Reduction in subsidies to SOEs, including to the coal industry	-1.1
Elimination of various uninsurable payments and limiting the size of various insurance payments	-0.1
Increasing the energy subsidies to households while improving targeting of social assistance programs	0.3

Sources: Ukrainian authorities; and Fund staff estimates.
Note: (-) sign implies savings.

Consolidation strategy and program targets

32. **The program aims to strengthen fiscal sustainability through expenditure led adjustment and frontloaded price increases to reduce energy subsidies** (MEFP ¶22) (Table 2). The primary balance of the combined general government and Naftogaz, a key fiscal anchor, will improve from a deficit of 6.9 percent of GDP in 2014 to a surplus of 1.6 percent of GDP in 2017, setting debt on a firm downward path. This fiscal path implies a combined deficit of 7.4 percent of GDP (general government deficit of 4¼ percent of GDP and Naftogaz deficit of 3.1 percent of GDP) in 2015. This is higher than the envisaged combined deficit of 5.8 percent of GDP at the time of the first SBA review as it reflects the adverse impact of the exchange rate depreciation on the Naftogaz deficit and the budget's interest bill, as well as the need to provide additional funds for social assistance in view of the higher energy price hikes (see below). The combined deficit will be reduced to 2.6 percent of GDP by 2018 (a general government deficit of 2.6 percent of GDP and a zero Naftogaz deficit already by 2017 (Table 2)). In this regard, the relatively modest headline general government adjustment (2 percentage points of GDP over the program period) masks a very strong effort to reduce the combined fiscal deficit, including a large

Fiscal Deficit
(Percent of GDP)



Sources: Ukrainian authorities and staff calculations.

consolidation in items that expanded fast in 2010–13 (wages, pensions, and subsidies) will make room for necessary increases in social assistance, interest, and capital expenditure (Table 2).

33. **In line with the above, the authorities have agreed to amend the budget to target a deficit of UAH 78 billion** (**prior action**). This was necessary to reflect the updated macroeconomic framework, in particular the lower growth and the sharply depreciated exchange rate as well as to accommodate higher social spending arising from the steep increase in energy prices, net of the partial offset provided by the increased tax revenues from the domestic gas production subsidiary (MEFP ¶23).

34. **Additional measures to support the medium-term structural adjustments include**:

- ***Pensions***. Improve the pension system's long-term fiscal sustainability, while making it more equitable. In particular, tightening early retirement provisions and gradually unifying special pensions' calculation rules with those of the general system are envisaged, starting in 2015. Moreover, with assistance from the Fund, the authorities plan to review the whole pension system with the goal of reducing the pension deficit and adopt the necessary legal amendments by end-2015.

- ***Social Assistance***. Increase utility tariffs as detailed below, while protecting the most vulnerable groups of the population (Box 2). In this regard, the existing social assistance programs (privileged housing utilities; means-tested subsidies for housing utilities; and a tariff compensation scheme introduced in 2014) will be consolidated and used to compensate poor households for higher energy bills. The fiscal cost of the compensating measures will be reduced through greater reliance on the general guaranteed minimum income (GMI) program, as it is better targeted to low-income households.

- ***Public wages and subsidies***. Downsize budgetary employment by 3 percent, including the civil service workforce by 20 percent through closure of redundant regulatory agencies to achieve a smaller but more efficient government. Measures will also include reduced staffing in the SOE through improved budgetary oversight and restructuring of loss-making and inefficient enterprises (¶51).

- ***Education and Health Care***. Healthcare reform will aim to open up the sector to private financing and gradually move to medical insurance system. Education sector reforms will seek to improve the quality and efficiency of education spending, including by streamlining the extensive network of educational institutions and rationalizing employment to bring it in line with international standards. In these reforms, the authorities will draw from advice provided by the World Bank and other specialized institutions in these areas.

- ***Tax policy***. Measures will aim to improve the tax base by bringing the agriculture sector fully under the general VAT regime in 2016, yielding a net gain of about ½-¾ percent of GDP. They will also include improving taxation and compliance of high net wealth individuals, elimination of exemptions, and increases in property tax rates.

Box 2. The Impact of the Crisis on Households

The economic crisis has adversely affected household incomes. The program has sought to help households recover by providing the foundations for economic stabilization, sustainable growth, and job creation. Furthermore, to assist the most vulnerable part of the population, it balances reforms aimed at restoring fiscal sustainability with expanding targeted social programs.

Household real income is expected to deteriorate as the crisis leads to rising inflation, higher unemployment and stagnating incomes. Real wages are declining as inflation is outpacing nominal wage growth in most economic sectors. Growing unemployment, largely reflecting the loss of production capacity, is now projected to increase to 11.5 percent in 2015 from 10.5 percent at end-2014 which will further weigh on household incomes. The economic toll is evident in rising non-performing loans of households, which reached 20 percent at end-2014. These problems are ever more acute in the conflict areas in the East, which has forced many families into displacement both inside and outside Ukraine.

Nevertheless, there are mitigating factors. Wage growth in agriculture, trade and services remains robust. While the nominal wage bill in the budgetary sector will be broadly similar to 2014, it corrects for the rapid growth in previous years. In 2014, the average wage in the budgetary sector exceeded average wage in the economy by 10 percent. Similarly, pension spending has reached unaffordably high levels at over 17 percent of GDP, one of the highest in Europe. Nevertheless, both pensions and budgetary wages are set to increase in December 2015.

The impact of the large depreciation on household balance sheets is also expected to be positive. The household sector has a long foreign exchange position (assets exceeding liabilities by more than twice) and would, on a net basis, benefit from the currency depreciation.

The program seeks to alleviate the negative impact of the crisis on households.

- **In the short-run, compensatory measures to protect the most vulnerable are being stepped up**. Total spending on social assistance programs will reach 4.1 percent of GDP in 2015, an increase of 30 percent compared to 2014. Specifically, social assistance with energy bills would more than double. In addition, unemployment benefit spending will rise by 15 percent. The government is also considering strengthening its recently introduced Internally Displaced Person (IDP) support program to cover IDP housing and utility needs. IDP spending would increase by six-fold in 2015, reaching about 1/4 percent of GDP. Given the low uptake of government assistance by IDPs which currently covers only about 40 percent of IDP families, streamlining of administrative requirements to facilitate access to benefits is also underway.

- **In the medium term, policies seek to restore macroeconomic stability through robust and balanced growth**. By removing the inflation tax, household purchasing power would be strengthened. Reforms to economic governance and business climate would lay the foundation for more investment and job opportunities. Reducing public debt would also lower the fiscal burden for future generations.

Fiscal Institutional Reforms

35. **Fiscal institutions will be strengthened to achieve lasting improvements in revenue collection and expenditure transparency and control** (MEFP ¶24). Widespread tax evasion has eroded the fairness of the tax system. At the same time, budgeting and spending controls remain weak. Addressing these issues requires deep restructuring of the revenue administration and the public financial management system. However, these reforms are complex and can take time to deliver results. Early reform implementation should therefore be a high priority.

36. **Strengthening the efficiency of tax administration operations is a key pillar of the revenue administration reforms** (MEFP ¶25). The authorities intend to prepare, in consultation with Fund staff, a revenue administration reform plan by end-April 2015 to overhaul the state fiscal service (***structural benchmark***). The plan, inter alia, will include measures to implement governance and institutional reforms that remove large numbers of underperforming officials, and encourage an environment free of political interference in operational decision making. The reform will also clarify the revenue authority's reporting responsibilities by subordinating the State Fiscal Service to the Ministry of Finance, which will help the ministry better coordinate tax policy and administration. The plan will seek to:

- **Strengthen the organizational structure of the tax administration** by ensuring that all taxpayers meeting large taxpayer criteria will be transferred to the Large Taxpayer Office (LTO) by end-December 2015 (***structural benchmark***), simplifying the taxation of small business, establishing an office for physical persons, and a transfer pricing department or office.

- **Restructuring and rationalizing the tax offices**. The authorities will seek to consolidate far-flung operations and local offices, based on a number of criteria, which include territories covered, the size of potential taxpayers, and taxpayer services.

- **Compliance**. VAT compliance measures are being implemented such as electronic VAT administration. Moreover, mandatory cash registers in retail establishments will be required starting July 1, 2015.

37. **Public financial management reforms will aim to strengthen budgetary framework and cash management over the medium term**. Specifically, measures will focus on developing a credible medium-term budgetary framework, including expenditure ceilings, strengthening budget execution controls, and developing a cash management strategy to ensure availability of adequate financing.

ENERGY POLICY

A. Background

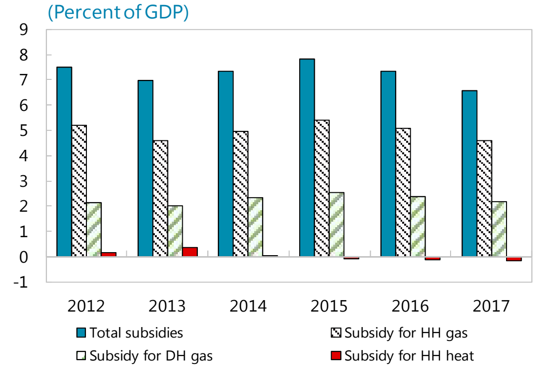
39. **Progress was made during 2014 in tackling Naftogaz's deficit, but these gains have been eroded by unfavorable macroeconomic developments**. Household gas and heating tariffs were raised in May and July, while industrial gas tariffs have generally been raised in line with import price and exchange rate developments. However, the gains made toward cost recovery were rapidly eroded by the exchange rate depreciation. This, combined with reduced transit revenues and gas prepayments for 2015, led to a higher than expected deficit of 5.7 percent of GDP, compared to 4.3 percent of GDP at the time of the first SBA review.

B. Policies

40. **In a decisive effort to break from the past, the Ukrainian authorities have put forward an ambitious and comprehensive reform agenda for the energy sector**. The authorities recognize that the loss-making and opaque gas sector in Ukraine weighs heavily on public finances, the external sector, and the overall economy. The very low prices for residential gas and district heating encourage excessive energy consumption and lead to large losses by Naftogaz, drive gas imports up, discourage investment in domestic production, and breed governance problems. To address these problems, the program aims to:

- bring gas and heating prices to cost recovery based on international gas prices by 2017 and eliminate Naftogaz's deficit. In the process, domestic wholesale gas prices charged by Naftogaz's subsidiaries will be raised to cover operational and investment costs;
- strengthen the social assistance system to assist vulnerable households with energy bills;
- support Naftogaz's restructuring to reduce losses caused by governance issues and raise social acceptance of cost-recovery prices;
- introduce measures to strengthen Naftogaz' collections of both past and future bills, including through smoothing of bill payments to enhance compliance, and
- encourage efforts to improve energy efficiency and raise investments in the sector.

Ukraine: Energy Subsidies, 2012-17
(Percent of GDP)



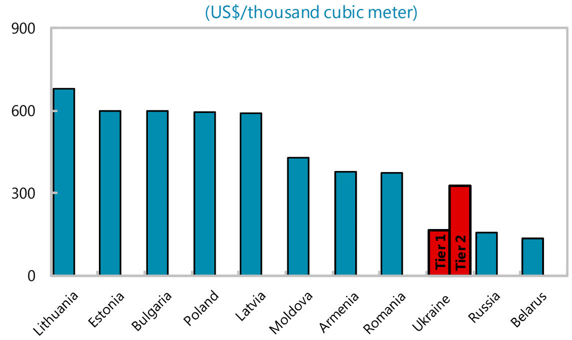
Source: IMF staff estimates.

41. **Restoring the financial health of Naftogaz is an overarching goal of the program**. Under current macroeconomic assumptions and absent further measures, the implicit energy subsidies are projected to rise further in 2015, exceeding their already high 2014 level (text chart). The authorities therefore intend

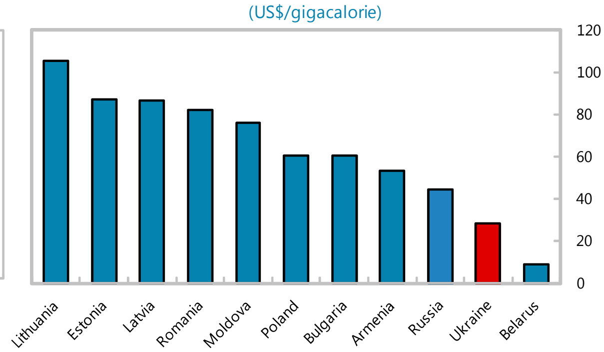
to undertake bold measures with the aim of reducing Naftogaz's deficit to 3.1 percent of GDP in 2015 and eliminate it by 2017.

a. **End-user price hikes**. Given the current low base for gas and heating prices, the authorities agreed that significant increases in end-user prices while protecting the most vulnerable, were necessary to make a decisive first step toward achieving these objectives (MEFP ¶28). To this end, the energy regulator will adopt and officially publish a decision to raise **retail gas prices** to households by 284 percent on average, effective April 1, 2015 (***prior action***). This encompasses a two tier price increase—a smaller increase of 231 percent for the first tier low consumption and a larger increase of 326 percent for the second tier higher consumption, which represent a cost recovery rate of 42 percent and 83 percent, respectively. The first tier price, which remains well below cost recovery, will act as a temporary lifeline tariff to allow households to transition to cost recovery prices. The second tier price will apply to all consumers during the off heating season. The energy regulator will also adopt and officially publish a decision to raise **retail heating prices** to households by 67 percent on average, effective April 1, 2015 (***prior action***). Heating price increases will be accompanied by investment in energy efficiency measures that allow consumers to better manage their consumption through installation of meters, regulators, and insulation. Even with these price increases, the gas and heat retail prices will remain well below most neighboring countries (text chart). Additional price adjustments in April 2016 and April 2017 will be needed to reach import parity for both gas and district heating by April 2017. **Industrial gas prices** will continue to be adjusted to reflect exchange rate and gas import price movements.

Natural Gas Tariffs in Select Transition Economies
(US$/thousand cubic meter)



Heating Tariffs in Select Transition Economies
(US$/gigacalorie)



Source: Ukrainian authorities; Eurostat; WB and IMF staff estimates; www.energy.eu; www.euroheat.org.

b. **Improve collections**. To facilitate **compliance with payments**, the authorities are implementing several measures such as the option of smoothing bill payments, independent audit of Naftogaz receivables and legislative amendments to improve **Naftogaz collections** (***prior action***). These changes are critical to prevent accumulation of new arrears and increase collections of existing receivables (over 2 percent of GDP in 2014).

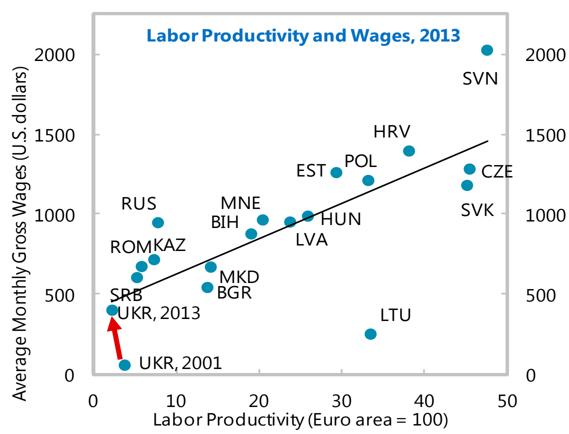
c. **Naftogaz restructuring**. Action will be taken on several fronts to increase Naftogaz efficiency and governance. A new gas market law has been presented to the Cabinet of Ministers and is expected to be enacted by April 2015 (**structural benchmark**). The law will provide an enabling framework for the functioning of the gas market, including issues like Naftogaz unbundling, providing third party access to the gas transmission system, and enhancements of corporate governance in the gas sector. The law will be supported by an implementation plan prepared in collaboration with the World Bank staff. The plan is expected to become effective by end-April 2015.

42. **Eliminating energy subsidies requires an effective strategy for protecting lower-income households from the adverse impact of higher energy prices**. As the gas and heating price increases will be primarily felt in the next heating season in the fall, the authorities plan to use the interim period to prepare their social assistance programs and the population for the impact of upcoming increases. To improve targeting of benefits and expand coverage of low-income households, a consolidation and streamlining of social assistance systems is needed (MEFP ¶29). Specifically, the existing three social assistance systems will be consolidated, and the benefit formula improved to incentivize energy savings. Sufficient fiscal and administrative resources will be allocated to protect the most vulnerable from upcoming energy price increases. These benefits are expected to cover over a quarter of all households. Currently the budget has allocated UAH 24 billion towards energy social assistance programs. Estimated average household budget shares for utilities after social assistance would be 11-13 percent depending on the energy source used, but less than 10 percent of income for households in the bottom quintile. Extensive public information campaigns to explain the necessity of energy price increases and the role of social assistance to shelter the neediest families are also planned.

STRUCTURAL REFORMS

A. Background

43. **Ambitious structural reforms are needed to remove growth bottlenecks that deter investment and productivity growth**. Endemic corruption and a stifling regulatory burden, as well as weak investor protection and contract enforcement have significantly weakened the business climate and deterred foreign and domestic business investment (Figure 7). In addition, lack of technological upgrading of companies has held back productivity and eroded their competitiveness. As a result, growth has been sub-par despite Ukraine's well-educated labor force.



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

44. **The authorities have started to make important steps to address these challenges and improve the investment climate**. In 2014, parliament adopted a more transparent public procurement law and the cabinet imposed a moratorium on inspections of businesses by controlling

agencies (except by fiscal authorities). With the assistance of the EBRD, a business Ombudsman was appointed in December 2014. The government's reform strategy approved in December focuses on:

- **Overhauling governance and anti-corruption**: The government plans to implement the recently adopted anti-corruption legislation and establish the National Agency for Prevention of Corruption and the National Anti-Corruption Bureau (NAB, an investigative agency).

- **Improving business climate**: the government will concentrate on deregulation, decentralization and capacity building in the regions, and downsizing of public sector employment.

- **State-owned enterprise reform**: Measures will be introduced to strengthen corporate governance and management of state property.

45. **The government has also taken a number of steps towards deregulation**. Several laws aiming at improving the business climate have already been adopted and the government is working extensively, including with the civil society, on further legislative changes and their implementation. Selected key deregulation measures already approved by parliament are included in the text table below.

Adopted Legislative Measures on Improving Business Climate

Measure	Entered into force
Permits, business registration and procedures	
Reducing the number of permits (from 143 to 85 documents) and streamlining administrative procedures;	April 26, 2014
Streamlining procedures for termination of business activities of natural persons;	July 7, 2014
Limiting number of inspections; establishing a ban on scheduled state supervision inspections of a single business entity;	August 17, 2014
Streamlining procedures of obtaining permits;	December 7, 2014
Taxation	
Reducing the tax burden; reducing number of taxes and levies, shortening the time needed to complete the compulsory procedures to declare and pay taxes, simplifying procedures for taxpayers which temporarily suspend their business activities to submit their tax reports.	January 1, 2015
Improving the system of State regulation of transfer pricing; bringing provisions on tax control over transfer pricing in line with the OECD Guidelines;	January 1, 2015
Transparency	
Granting public access to information on real estate from the State Register of Proprietary Rights;	February 6, 2015

Source: Ukrainian authorities.

46. **The authorities have already made first steps towards increasing operating efficiency of SOE**. Specifically, they have developed a concept document on the comprehensive reform of SOEs; prepared new transparency and accountability guidelines for SOEs; prepared recommendations for improving financial plans approval procedure, and developed an action plan to audit top 50 SOEs. To improve corporate governance, the authorities have changed the nomination procedure for CEOs of the key SOEs and selected members of an independent Selection Committee. In addition, they have reviewed the privatization process and prepared recommendations for its improvement.

47. **The government recognizes that decisive implementation of reforms is a prerequisite for external financial assistance**. The involvement of the recently established National Reform Council has helped improve coordination of these reforms. While progress has been made with the structural reform agenda, vigilance against vested interests is of the essence, as highlighted by ongoing attempts in parliament to water down the new procurement code.

B. Policies

Strengthening Business Climate and Governance

48. **The authorities are moving ahead with reforms to streamline the regulatory framework to enhance business climate**. In consultation with the civil society, they have identified regulatory and legislative impediments to a growth-conducive business climate. The removal of these impediments have been specified and prioritized in an action plan, which the authorities intend to adopt by early March. In cooperation with the Ministry of Economy, the recently established State Regulatory Service will monitor implementation of the action plan and publish quarterly reports on progress being made. Simultaneously, the authorities have introduced changes to the existing legislation. Specifically, a deregulation law has recently been adopted by the parliament and the law on licensing, which aims among others at substantially reducing the current number of licenses is scheduled to be passed by parliament in early March.

Anti-Corruption

49. **Key elements of a robust anti-corruption legal framework are now in place**. Significant progress has been made towards the establishment of a strong anti-corruption investigative agency. Legislative amendments have been adopted to ensure that the National Anti-corruption Bureau is subject to a robust external oversight process, it can access all relevant information for its investigations, including of high level officials, and is staffed with high integrity officials (**prior action**). Amendments to the Anti-Money Laundering (AML) law, the criminal code, and asset disclosure requirements have strengthened the authorities' tools to fight corruption and related money laundering. Nevertheless, in view of vested interests, strong political commitment will be needed to ensure these measures are not reversed or diluted.

50. **Rapid implementation is now a priority so that the public sees tangible indications that corruption is being reduced or sanctioned**. In this regard, the authorities have committed to establish the anti-corruption investigative agency (***structural benchmark***) and start its investigations. Anti-corruption efforts would be supported by strengthening the implementation of the AML framework to prevent the misuse of the financial sector to launder the proceeds of corruption (***structural benchmark***).

Judicial Reform

51. **The authorities are seeking to strengthen the effectiveness of the judiciary with measures to enhance its independence, integrity and efficiency of legal enforcement**

processes. Following up on the recommendations of the July Diagnostic Report, the reform program encompasses measures on judicial reform and on strengthening court efficiency and procedures for effective enforcement. Specifically, the law on the Judiciary and the Status of Judges will be sent to the Venice Commission which will seek to strengthen judicial independence in line with European standards. To improve efficiency in civil litigation—which is burdened with excessively high caseload—a law will be enacted on a selective increase of court fees (**structural benchmark**). The authorities will seek to strengthen procedures on Order for Payment and Bank Account Seizures (Garnishment) which could potentially cover up to 80 percent of all commercial claims in the country (**structural benchmark**). Additional measures will be taken to improve enforcement, including passage of a law establishing a profession of private enforcement agents and develop a reorganization plan for enforcement agencies. By end-March 2015, a reorganization plan will be submitted for the public prosecution.

SOE Reform

52. **The SOEs sector in Ukraine is very large and fragmented by international standards, resulting in a significant fiscal drain**. The sector comprises 1,833 active entities (out of 3,350 registered public enterprises) with over 1 million employees—about quarter of total public employment. In addition, inefficiencies in the sector are a substantial source of fiscal risks. In 2014, transfers from government to the SOE sector amounted to over 2½ percent of GDP (excluding the large transfers to Naftogaz), while dividends were less than 0.2 percent of GDP. Furthermore, state asset ownership and management arrangements are highly decentralized, fragmented, and characterized by numerous conflicting roles and responsibilities at different levels of government.

53. **To enhance efficiency of the SOEs and reduce fiscal risks, the authorities are working on a broad reform strategy of the sector**. By end-May 2015, the authorities, in consultation with the Fund and the World Bank staff, plan to develop a restructuring strategy laying out a specific timeline for implementation of measures needed to: (i) improve budgetary oversight, (ii) implement a comprehensive ownership policy, (iii) strengthen corporate governance, (iv) prioritize enterprises subject to restructuring, and (v) transparent privatization of identified assets in the medium run (**structural benchmark**). Efforts will also be undertaken to improve corporate governance standards of individual enterprises by adopting international standards and to undertake a fiscal risk assessment of the SOEs (MEFP ¶36).

PROGRAM MODALITIES

A. Access, Phasing, and Conditionality

54. **Staff supports the authorities' request for a new extended arrangement under the EFF with an access level equivalent to SDR 12.348 billion or US$17.5 billion, representing an additional amount of SDR 4.345 billion (about US$5.8 billion) relative to the amounts committed but not purchased under the SBA**. The proposal envisages phasing disbursements over 16 quarterly installments beginning with the Board approval of the arrangement and some

frontloading gross disbursements of SDR 7.092 billion (about US$10 billion) in 2015 to achieve a minimum level of reserves necessary to restore confidence and stabilize market expectations. Of this, SDR 1.915 billion (about US$2.7 billion) will be used for budget support.[10] Together with financing assurances from the other multilateral and bilateral donors over the next 12 months (¶14) and the announced debt operation, this should provide sufficient financing to meet financing needs.

55. **Conditionality is focused on key vulnerabilities and aimed to shore up confidence in the short run and strengthen the policy framework in the medium term**. The authorities have taken upfront actions to reassure their ability to implement the program. They will undertake a number of prior actions for approval of the new arrangement. These are summarized in Table 8 and, in particular, include hiring of financial and legal advisors for debt operation (MEFP ¶26).

56. **The program monitoring will be guided by quarterly reviews, quarterly and continuous performance criteria, and structural benchmarks**.

- **Quarterly reviews**. Program reviews are being proposed on a quarterly basis. The first review will be based on targets for end-March 2015.
- **Quantitative performance criteria (PCs) and phasing** (MEFP Table 1). Performance criteria are set through end-June 2015 and indicative targets through the remainder of the year. The quantitative performance criteria and indicative targets remain the same as in the SBA. Quantitative PCs include a ceiling on the cash deficit of the general government and on the combined deficits of the general government and Naftogaz; a ceiling on publicly guaranteed debt; a floor on NBU's NIR; a ceiling on the NBU's NDA; and non-accumulation of external debt payment arrears by the general government.
- **Structural benchmarks**. Structural benchmarks are well-calibrated and phased in line with the authorities' capacity. Some conditionalities also address outstanding benchmarks under the SBA (Table 7). They are summarized in Table 8.

B. Exceptional Access Criteria

57. **Exceptional access would be required under the program in light of the large projected financing gap**. Staff's assessment is that the new program satisfies the substantive criteria for exceptional access. This assessment is premised on the expectation that the authorities'

[10] Such use of Fund financing is consistent with the Fund's relevant policy framework. Specifically: (i) Ukraine needs financial support under the proposed EFF to address its current account deficit and pressures on the capital account, as well as to build up reserves; (ii) in addition to having an actual and acute balance of payments need, Ukraine has committed to implement policies that will assist in resolving its balance of payments problems and ensure repayment of Fund resources; and (iii) Ukraine's program is designed in a manner that envisages that an amount equivalent to foreign exchange purchases from the Fund will be used to meet a balance of payments deficit or to strengthen reserves.

policy undertakings to launch the new program are implemented in full and the upcoming debt operation is completed successfully.

Criterion 1: *The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account resulting in a need for Fund financing that cannot be met within the normal limits*. Ukraine is experiencing exceptional balance of payments pressures emanating from both the current and capital accounts. Official reserves have fallen to dangerously low levels. In addition, Ukraine faces risks of further economic and trade disruptions from an escalation of geopolitical tensions. Together, these factors are generating actual and potential financing needs beyond what can be financed within normal limits, even taking into account expected financial support from the broader international community.

Criterion 2: *A rigorous and systemic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over the period, exceptional access would be justified if there is a high risk of international systemic spillovers*. Public debt to GDP ratio is projected to decline steadily to around 70 percent of GDP by 2020, and debt service burden indicators would remain significantly below DSA higher risk benchmark. This would be delivered through a combination of fiscal adjustment, additional official financing on adequate terms, and a debt operation that would help restore medium-term debt sustainability with high probability. Sensitivity tests show that debt remains on a non-explosive path after a number of macroeconomic shocks. The fact that the macro parameters informing the debt operation would be reviewed before finalization provides some robustness of the debt trajectory to shocks related to the conflict.

Criterion 3: *The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding*. The policy and financing mix under the proposed program addresses the long-standing domestic and external imbalances needed to stabilize the economy and revive growth in the medium term. As reconstruction and recovery efforts take hold, and given steps the authorities are taking to ensure manageable gross financing needs, confidence in the system would improve helping to bring Ukraine CDS and bond spreads down and ultimately improve the country's prospects of regaining market access. Staff anticipates that with a successful implementation of the program, combined with support from the broader international community, Ukraine has good prospects for regaining greater access to private capital markets before the end of the program period.

Criterion 4: *The policy program provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment*. The authorities have performed reasonably well under the SBA-supported program, notwithstanding the adverse environment. This is shown by strong budget implementation, including in the pre-election period, increases in household gas and heating prices, stepped-up administrative reform in the NBU and decisive resolution of weak banks, and steps to strengthen the anti-corruption and anti-money laundering framework. In addition, they are committed to implement strong prior actions for this program. The escalation of the conflict in the East is certainly a major concern for the authorities. However, their willingness and capacity to implement the program remains strong. The macroframework and the fiscal program have been adjusted to reflect the impact of the recent conflict and the authorities remain committed to adapt policies as necessary. They recognize that a decisive break with the past is needed to achieve program objectives, involving strong ownership and full and sustained implementation of difficult measures. The authorities' reform agenda is ambitious, and would be supported by extensive involvement and financial assistance by the international community. The government's institutional and technical capacity has been, and will continue to be, strengthened by extensive and ongoing technical support from the Fund and other partners, and staff judges it to be sufficient to deliver the core elements of reform with reasonably strong prospect for success.

C. Capacity to Repay the Fund and Risks to the Program

58. **Under the baseline, Ukraine's capacity to repay the Fund remains adequate, albeit subject to exceptional risks** (Table 9). With an extended arrangement under an EFF, the repayment period is extended through 2028 so that total repurchases during 2017–19 are reduced from US$12.2 billion (SBA) to US$4.9 billion (EFF). Repayment to the Fund over the next five years would peak at a manageable 7.6 percent of reserves in 2018. The planned debt operation would also keep gross financing need contained during the period when the first large repayments come due to the Fund in 2018, mitigating risks to the Fund. With the envisaged policies and reforms, the revival of growth, the current account and fiscal adjustment, the reduction in gross financing needs created by the authorities' intention to restructure their debt, and the buildup of reserves, Ukraine should have adequate capacity to repay the Fund. So far all repurchases have been made in full and on schedule, and outstanding Fund credit to Ukraine has dropped below 300 percent of quota as of end-October 2014. By the end of the arrangement in early 2019, outstanding credit to the Fund is expected to peak at about 17.0 percent of GDP, or 54 percent of gross reserves. Debt service to the Fund as a ratio of exports of goods and services would peak at 3.5 percent in 2018.

59. **Notwithstanding these factors, risks remain very high given the large uncertainties surrounding the baseline scenario**. The main risk is related to geopolitical developments. While the program can adapt and withstand moderate domestic and external economic shocks, Ukraine's ability to repay could be adversely affected by a prolonged or intensified conflict that could weigh further on market and investment sentiment, and/or weak program implementation. Failure to allow sufficient exchange rate and fiscal/energy price adjustment could lead to continuing balance of payments problems and raise repayment risks. A four-year arrangement will help support Ukraine undertake deeper reforms, but it also commits Fund resources for a longer period.

60. **A safeguards assessment mission was completed in August 2014 and identified some deficiencies at the NBU**. These include strain on NBU's balance sheet owing to liquidity lending to commercial banks and purchases of domestic government securities; mandated profit distributions from the NBU to the government that were far in excess of permitted distributable amounts under the NBU Law, limited NBU Council mandate to establish sound oversight arrangements of the daily management of the NBU. The authorities are taking actions to strengthen internal controls of the

NBU (MEFP ¶37). The government and NBU signed an agreement in May 2014 on the respective responsibilities for servicing obligations stemming from direct budget support under the SBA. Furthermore, the existing legislative framework also limits the distribution of dividends to a maximum of 25 percent of the projected annual amount before the financial audit is completed.

STAFF APPRAISAL

61. **Despite tangible progress under the SBA, the crisis in Ukraine has increased its BOP and adjustment needs beyond what can be achieved under the current program**. The SBA-supported program initiated ambitious policies and reforms aimed at stabilizing the financial system, strengthening fiscal sustainability, modernizing and restructuring the energy sector, and improving governance. While the authorities made strong efforts in all these areas, the economy and the banking system continue to be affected by the conflict in the East and the subsequent loss of confidence. The deep recession and sharp exchange depreciation aggravated existing vulnerabilities, weakened bank balance sheets, and raised public debt.

62. **The authorities' new four-year Fund-supported program aims to decisively address these challenges**. The program lays out a strategy to restore financial and economic stability and resolve long-standing structural obstacles to growth, including weak corporate governance. The authorities recognize that the resolute and full implementation of the program is critical to restore confidence and growth, bring inflation back to single digits, keep external deficits manageable, and replenish international reserves to adequate levels.

63. **The implementation of a flexible exchange rate regime should help cushion the economy against external shocks, while sizable external financial support would enable the gradual rebuilding of reserve buffers.** The authorities recognize that the best support for the hryvnia is the restoration of confidence through strong policies and reforms. To support this new regime, which is an important departure from the past, appropriate reserve targets are included in the program.

64. **Upgrading NBU's monetary policy toolkit and operational framework is vital for program success**. The recent steps to regain control over monetary aggregates and the tight monetary policy stance are necessary to bring inflation back into single digits. The authorities are committed to maintain policy rates positive in real terms to anchor inflation expectations and eliminate capital controls and restrictions at an appropriately calibrated pace as the balance of payments improves.

65. **Strong actions are needed to rehabilitate the banking system**. Ukraine's weakened banking sector can be returned to health only through a comprehensive strategy and swift actions, which would be a key test of the authorities' determination to overcome vested interests and put in place a modern and sound banking system that is adequately supervised. In this regard, staff welcomes progress in recapitalizing systemic banks and resolving weak non-systemic banks. The

decisive implementation of the banking strategy would be crucial to regain public confidence and lay the foundation for economic recovery.

66. **The program's fiscal adjustment path appropriately balances the need to reduce fiscal imbalances and restore public debt sustainability with high probability while alleviating social costs to the most vulnerable**. While revenue performance will continue to be strengthened, restraining current spending requires expenditure rationalization, including control over wages, pension reforms, and reforms of the large public sector. In this regard, the 2015 budget and the approved supplementary budget are a good start, and the authorities should resist pressures to increase spending as well as to refrain from low-quality ad-hoc policies. At the same time, strengthening the social safety net programs to accompany the fiscal consolidation and energy policies is crucial to alleviate social costs and build support for reforms.

67. **The steadfast implementation of the agreed strategy to strengthen the financial situation and restructure Naftogaz would be key for the program's success**. The reform of the gas sector has been long overdue and necessary to increase energy efficiency, attract investment, promote domestic production, and alleviate governance problems. The authorities' commitment to eliminate Naftogaz's deficit by 2017 by undertaking bold measures to increase tariffs, improve collection rates, and lower costs as well as to fundamentally restructure the company are commendable. However, to break from the weak implementation record in the past, the new government should persevere with the timely implementation of the agreed measures. In this regard, the authorities' plan to increase funding to protect the most vulnerable from the impact of the tariff increases is appropriate to build support for the reforms.

68. **Addressing deep-rooted structural problems would create an enabling environment for investment and private activity**. Tackling weak governance and improving the business climate is critical to achieve higher growth and restore trust in government. Perceived corruption including in the judiciary system reduces investment attractiveness of Ukraine and prevents it from unlocking full growth potential. By addressing the core structural challenges, the expectation is that confidence will gradually return—and place the economy on a more dynamic path with better shock-absorbing capacity.

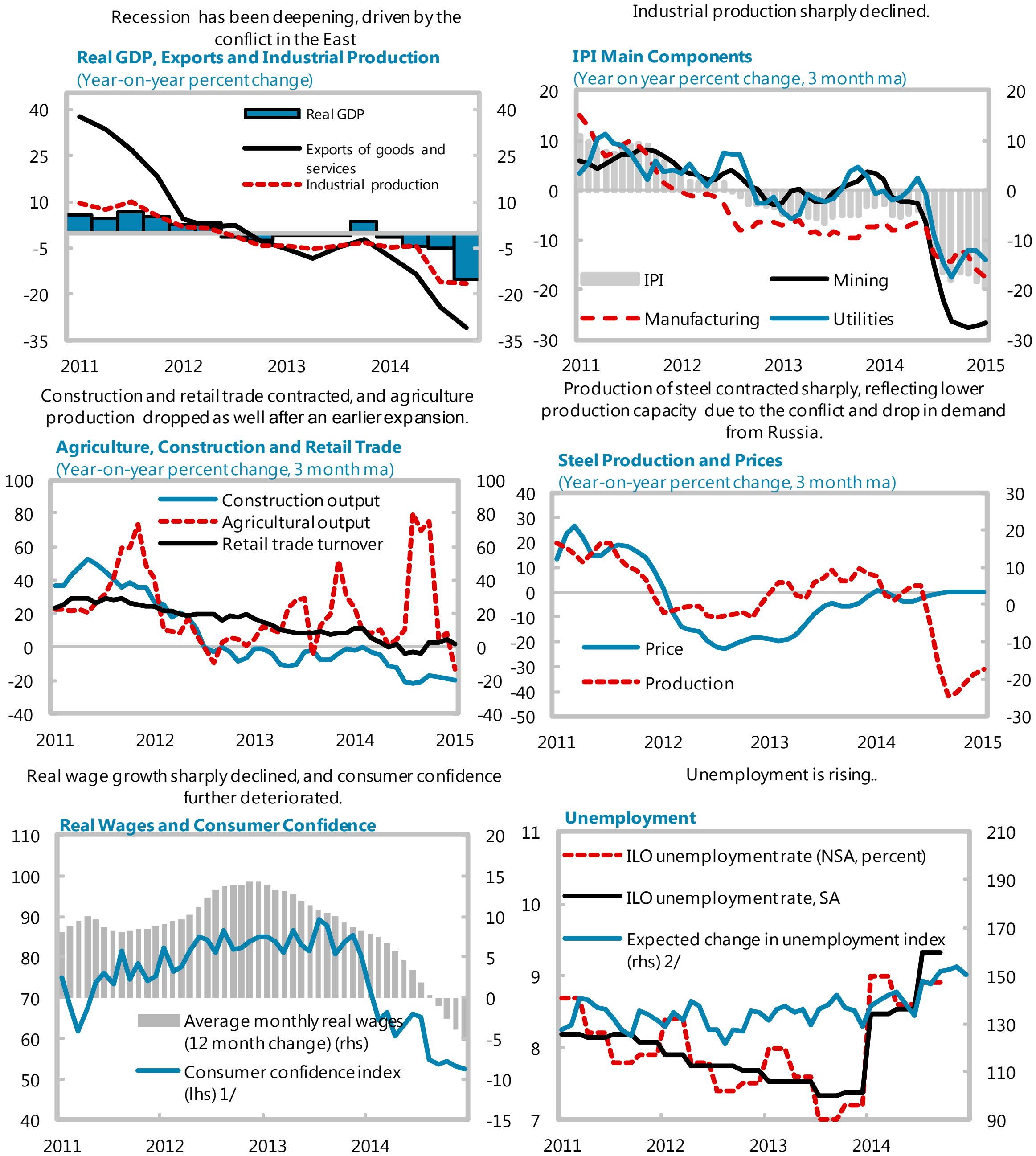
69. **Risks to the program are exceptionally high, but the program offers Ukraine an opportunity to make a clear and decisive break from the unsustainable policies of the past**. The program is subject to exceptional risks, stemming from the conflict in the East that, if it escalates, may affect the country's ability to sustain the stabilization efforts and deliver the structural overhaul needed to resume growth. Also, Ukraine's track record on program implementation is weak and punctuated by repeated false starts. In fact, in key policy areas such as the exchange rate regime, energy sector, anti-corruption, and agricultural VAT, progress was stalled in the past under pressure from vested interests. More recently, however, in a welcome change, the authorities have shown strong resolve to avoid these missteps as evidenced by their performance under the SBA. Going forward, their steadfast commitment for a full and timely program implementation will be critical. International support during these challenging times will hinge crucially on the implementation of these reforms. With strong program implementation, Ukraine's repayment

capacity remains adequate despite the risks. The stabilization and growth-supporting reforms embedded in the program reinforce this assessment.

70. **Staff welcomes the support pledged by Ukraine's international partners, and notes that the authorities' intended debt operation will be critical to program success**. Bilateral financial support is needed to help give the authorities space to successfully implement their adjustment program. Further bilateral support may well be needed to support reconstruction efforts, and more generally to support Ukraine in the event downside risks materialize. The authorities' intention to undertake a debt operation is critical to restoring a high probability of debt sustainability and to providing the financing necessary for program success.

71. **In view of Ukraine's large external financing needs and the authorities' strong policy commitments, including the commitment to a debt operation to secure sustainability with high probability, and with a full appreciation of the risks, staff supports approval of Ukraine's four-year Extended Arrangement under the EFF with access equivalent to SDR 12.348 billion (900 percent of quota)**. Staff also supports the authorities' request for approval, for a period of 12 months, of the retention of the exchange restrictions and multiple currency practices that are inconsistent with their obligations under Article VIII Sections 2 (a) and 3 on the grounds that they are non-discriminatory, imposed for balance of payments reasons, and temporary.

Figure 1. Ukraine: Real Sector Indicators, 2011–14



Sources: State Statistics Committee of Ukraine; Haver; Bloomberg; GFK Ukraine; International Centre for Policy Studies; and IMF staff calculations.

1/ Consumer confidence index is based on survey respondents' answers to questions that relate to personal financial standing, changes in personal financial standing, economic conditions over the next year, economic conditions over the next five years, and propensity to consume. Index values range from 0 to 200. The index equals 200 when all respondents positively assess the economic situation. It totals 100 when the shares of positive and negative assessments are equal. Indices of less than 100 indicate the prevalence of negative assessments.

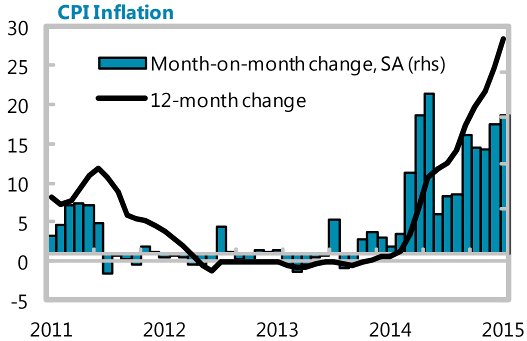
2/ Values above 100 indicate that more respondents expect unemployment to rise than fall over the next one to two months. Values can vary from 0 to 200.

Figure 2. Ukraine: Inflation, Monetary, and Exchange Rate Developments, 2011–15

(Year-on-year percent change, unless otherwise indicated)

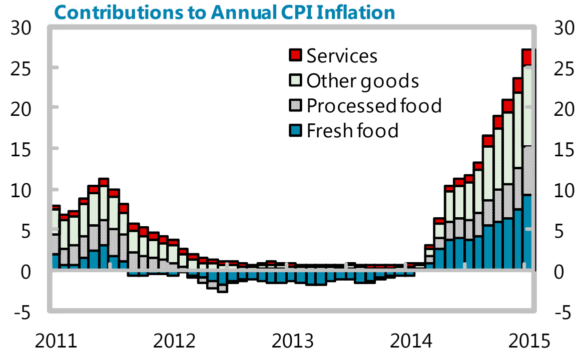
Inflation continued to rise sharply, driven mainly by the depreciation of the hryvnia.

CPI Inflation



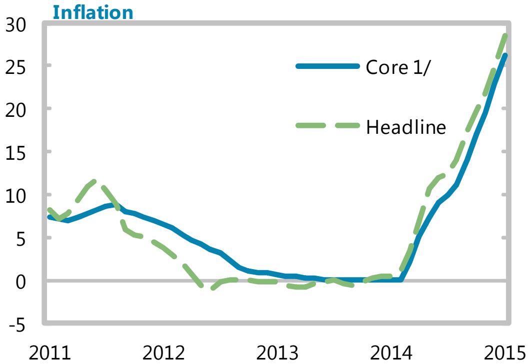
Food, utilities and transport price increases pushed the headline inflation up

Contributions to Annual CPI Inflation



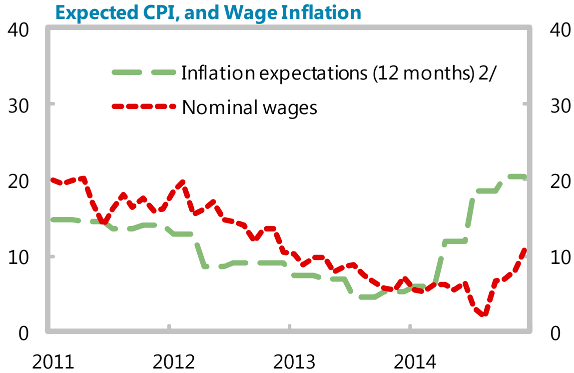
...and core inflation moved up as well, only at a slightly slower pace than headline CPI.

Inflation



Inflation expectations moved up, while nominal wage growth started to pick up gradually.

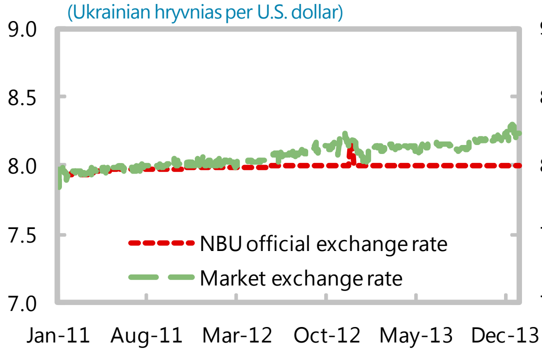
Expected CPI, and Wage Inflation



In 2011–13, NBU fixed the official exchange rate and tightly managed the market rate.

Exchange Rate, 2011–13

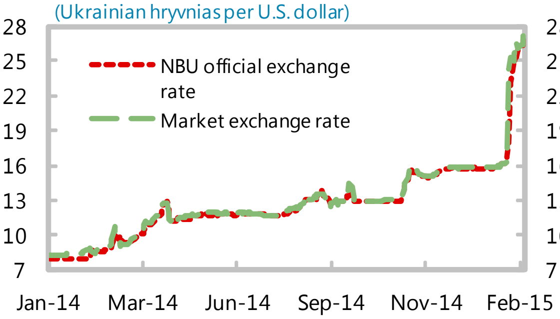
(Ukrainian hryvnias per U.S. dollar)



The hryvnia depreciated rapidly after the NBU discontinued supporting it early November, and abandoned FX auction in early February.

Exchange Rate

(Ukrainian hryvnias per U.S. dollar)



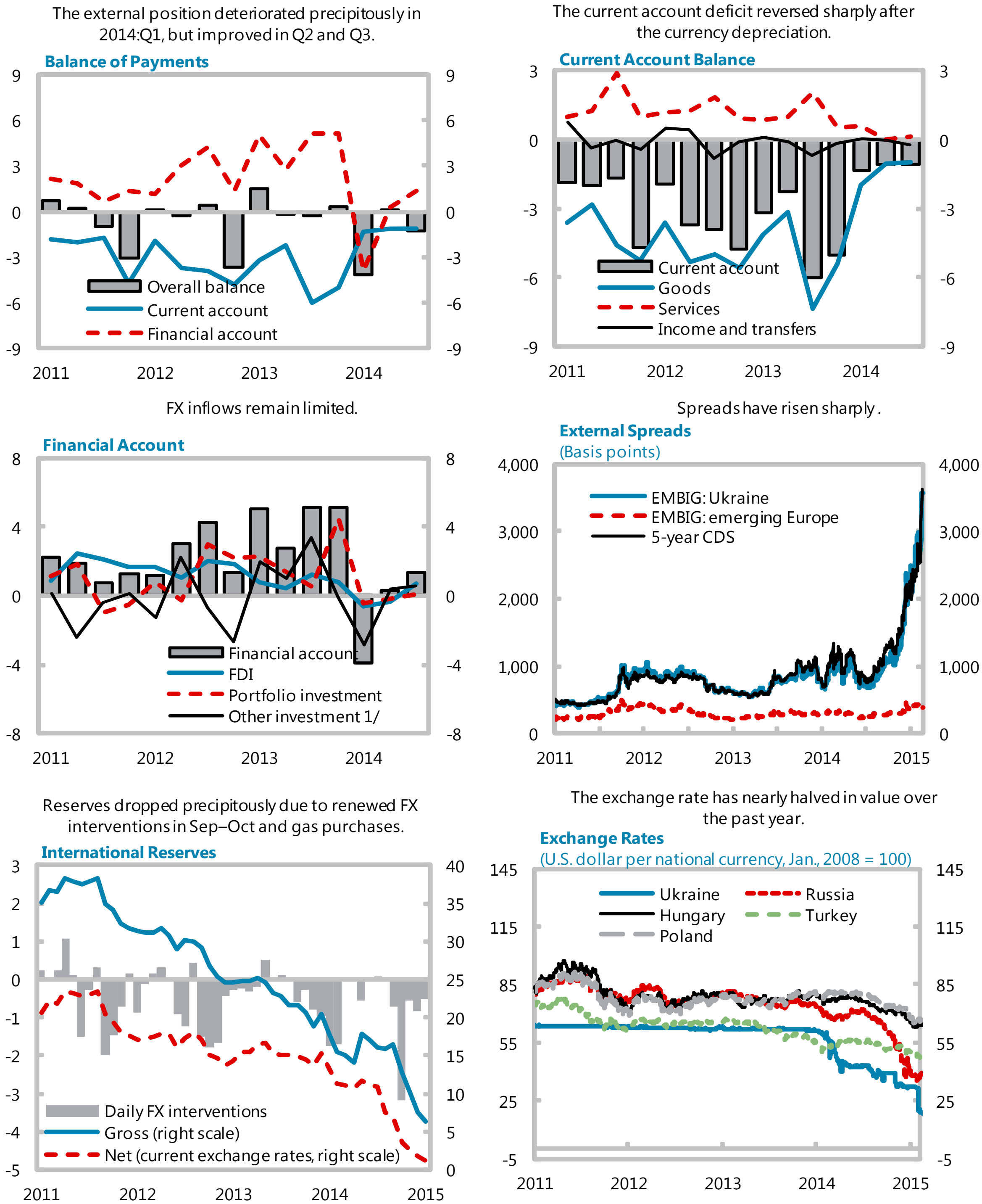
Sources: State Statistics Committee of Ukraine; International Centre for Policy Studies; National Bank of Ukraine; Bloomberg; and IMF staff calculations.

1/ Broad core excludes unprocessed food, fuel, and administrative services.

2/ Inflation expectations are surveyed and compiled by the NBU.

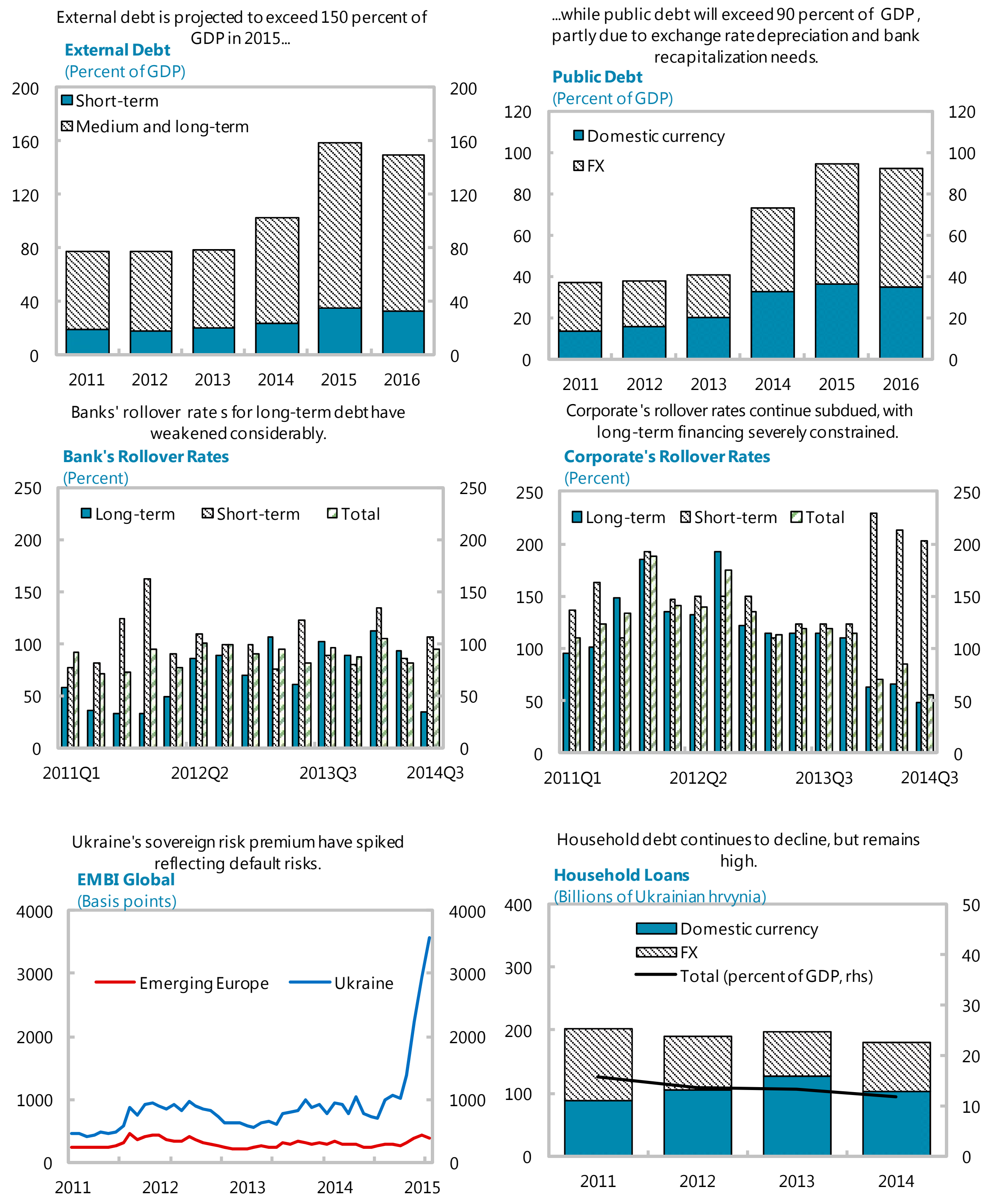
Figure 3. Ukraine: External Sector Developments, 2011–14

(Billions of U.S. dollars, unless otherwise indicated)



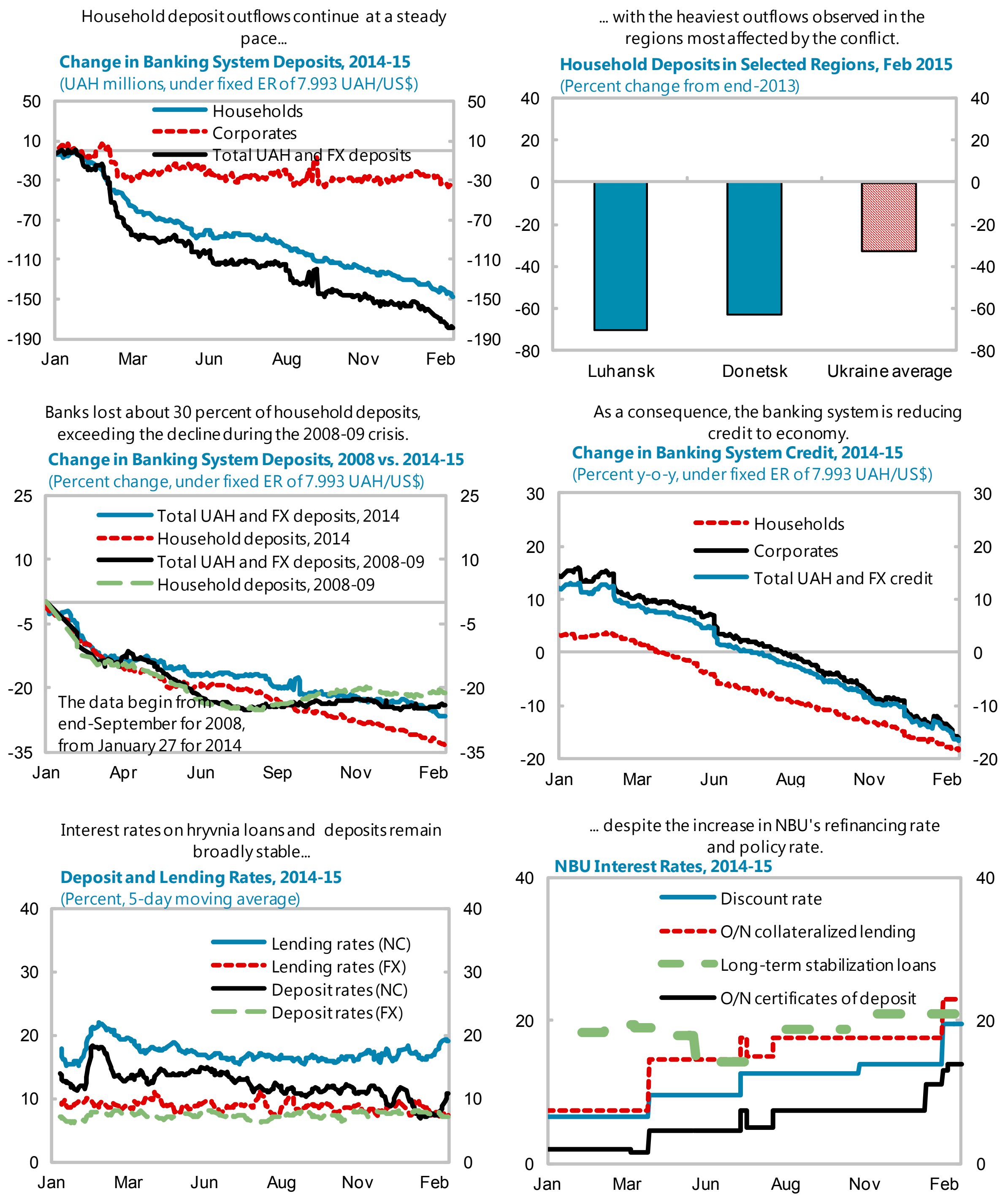
Sources: National Bank of Ukraine; State Committee of Statistics; Bloomberg; and IMF staff estimates and calculations.
1/ Includes residents' conversion of hryvnia cash to foreign currency held outside the banking system.

Figure 4. Ukraine: Debt and Rollover of Debt, 2011–16 1/



Sources: National Bank of Ukraine; Bloomberg; Ministry of Finance; and IMF staff estimates.
1/ 2015–16 are projections.

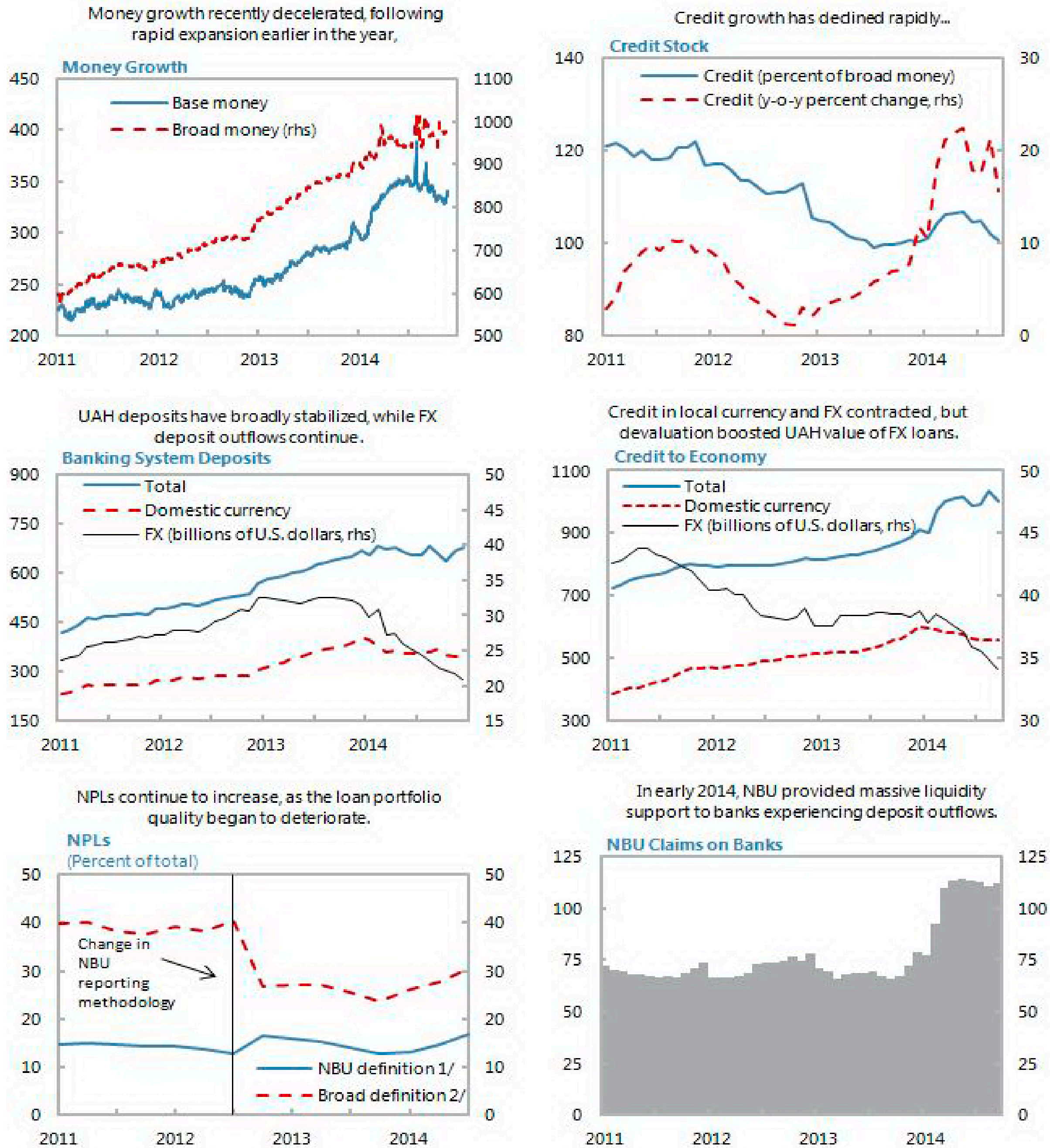
Figure 5. Ukraine: Banking Sector Deposits and Credit, 2014–15



Sources: National authorities; and IMF staff estimates.

Figure 6. Ukraine: Financial Sector Indicators, 2011–14

(Billions of Ukrainian hryvnias, unless otherwise indicated)

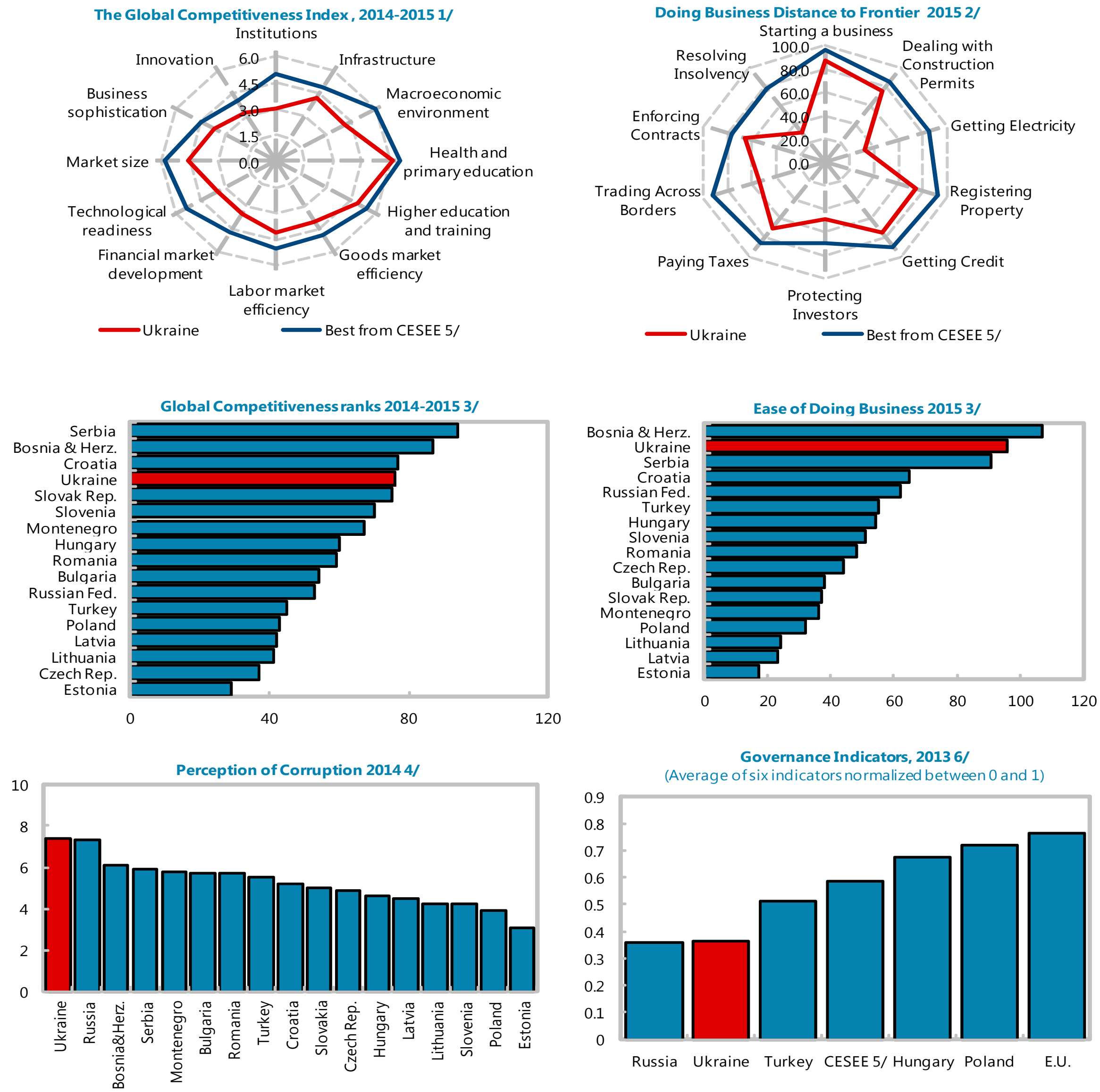


Sources: National Bank of Ukraine; and IMF staff calculations.

1/ Included NPLs that were classified as doubtful and loss until December 2012, when the NBU changed its classification of reported NPLs, which resulted in series break.

2/ Included NPLs that are classified as substandard, doubtful, and loss. From December 2012, estimated by staff using NPL data published by NBU according to new methodology, which resulted in series break.

Figure 7. Ukraine: Structural Reforms



Sources: World Bank, *Doing Business Indicators*; Transparency International, *Corruption Perceptions Index*; Heritage Foundation, *Index of Economic Freedom*; World Bank, *World Governance Indicators,* World Economic Forum *Global Competitiveness*; and IMF staff calculations and estimates.

1/ Index from 1 (the worst) to 7(the best performer).

2/ The "frontier" represents the highest performance observed for each indicator across all economies in Doing Business. Scale from 0 (the lowest performance) to 100 (the frontier).

3/ The higher the rank the worse the score. Rank "1" indicates the best performer.

4/ Score indicates the perceived level of public-sector corruption. A high score corresponds to high perception of corruption.

5/ CESEE includes Estonia, Czech Rep., Poland, Turkey, Lithuania, Latvia, Slovenia, Hungary, Bulgaria, Russia, Slovak Rep. Montenegro, Ukraine, Romania, Croatia, Bosnia and Herzegovina, Serbia.

6/ Calculated as the normalized average of six indices from the World Bank Governance Database: rule of law, political stability and absence of violence, control of corruption, government effectiveness, regulatory quality, and voice and accountability.

Table 1. Ukraine: Program Scenario – Selected Economic and Social Indicators, 2013–20

	2013	2014	2015	2016	2017	2018	2019	2020
		Est.	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
Real economy (percent change, unless otherwise indicated)								
Nominal GDP (billions of Ukrainian hryvnias) 1/	1,466	1,535	1,850	2,087	2,356	2,626	2,896	3,194
Real GDP 1/	0.2	-6.9	-5.5	2.0	3.5	4.0	4.0	4.0
Contributions:								
Domestic demand	1.1	-12.4	-7.7	2.6	4.1	4.5	4.8	5.2
Private consumption	5.3	-5.8	-5.2	2.0	2.8	3.0	3.2	3.2
Public consumption	-0.5	-0.5	-0.2	-0.9	0.5	0.5	0.3	0.3
Investment	-3.7	-6.1	-2.3	1.4	0.8	1.0	1.3	1.8
Net exports	-0.8	5.5	2.2	-0.6	-0.6	-0.5	-0.8	-1.2
GDP deflator	4.1	12.5	27.6	10.6	9.0	7.2	6.0	6.0
Unemployment rate (ILO definition; percent)	7.3	10.5	11.5	11.0	9.6	8.6	8.1	8.0
Consumer prices (period average)	-0.3	12.1	33.5	10.6	8.0	6.2	5.0	5.0
Consumer prices (end of period)	0.5	24.9	26.7	8.7	7.2	5.0	5.0	5.0
Nominal monthly wages (average)	8.2	5.9	14.5	10.6	11.8	10.2	9.2	9.3
Real monthly wages (average)	8.5	-5.5	-14.2	0.0	3.5	3.8	4.0	4.0
Savings (percent of GDP)	9.6	8.8	10.0	11.8	12.5	13.2	13.9	14.7
Private	12.4	12.1	11.7	12.9	12.6	12.8	13.2	13.7
Public	-2.8	-3.3	-1.7	-1.1	-0.1	0.4	0.7	1.0
Investment (percent of GDP)	18.8	13.6	11.4	13.1	13.6	14.4	15.5	17.0
Private	16.8	12.3	8.9	10.6	10.6	11.4	12.4	13.8
Public	2.0	1.3	2.5	2.5	3.0	3.0	3.1	3.2
Public finance (percent of GDP)								
General government balance 2/	-4.8	-4.6	-4.2	-3.7	-3.1	-2.6	-2.4	-2.2
Overall balance (including Naftogaz operational deficit)	-6.7	-10.3	-7.4	-3.9	-3.1	-2.6	-2.4	-2.2
Public and Publicly Guaranteed Debt (end of period)	40.6	72.7	94.1	92.6	88.9	83.3	77.3	71.0
Public debt excluding guarantees (end of period)	33.5	62.7	74.9	72.1	67.7	63.0	59.2	56.1
Public Debt Held Outside the Public Sector	30.5	50.7	72.3	74.8	74.7	72.8	70.0	65.3
Money and credit (end of period, percent change)								
Base money	20.3	8.5	27.3	11.3	11.0	9.7	9.1	8.5
Broad money	17.6	5.3	19.1	15.4	15.4	14.4	12.5	12.0
At program exchange rate	13.3	-16.8	8.5	15.1	14.8	14.5	12.6	12.1
Credit to nongovernment	11.8	12.4	13.0	11.8	9.2	5.6	5.9	8.1
At program exchange rate	9.5	-15.6	-0.6	10.9	8.8	5.9	6.1	9.0
Velocity	1.6	1.6	1.6	1.6	1.6	1.5	1.5	1.5
Interbank overnight rate (annual average, percent)	3.8	11.5	…	…	…	…	…	…
Balance of payments (percent of GDP)								
Current account balance	-9.2	-4.8	-1.4	-1.3	-1.1	-1.2	-1.6	-2.3
Foreign direct investment	1.8	0.3	1.4	1.9	2.1	2.1	2.1	2.1
Gross reserves (end of period, billions of U.S. dollars)	20.4	7.5	18.3	22.3	28.5	35.2	38.4	38.7
Months of next year's imports of goods and services	3.3	1.5	3.3	3.7	4.5	5.2	5.2	4.9
Percent of short-term debt (remaining maturity)	33.2	17.4	43.7	57.4	69.0	82.9	84.1	78.4
Percent of the IMF composite measure (float)	47.3	27.1	65.9	79.5	96.3	113.2	117.4	115.1
Goods exports (annual volume change in percent)	-6.4	-11.1	-4.2	5.1	5.8	6.1	6.5	6.5
Goods imports (annual volume change in percent)	-5.3	-26.9	-11.9	5.7	6.0	6.2	7.3	7.9
Goods terms of trade (percent change)	-1.1	-2.8	0.4	-0.7	0.0	-0.1	0.1	0.3
Exchange rate								
Hryvnia per U.S. dollar (end of period)	8.3	15.8	22.0	22.7	23.4	23.5	23.6	23.8
Hryvnia per U.S. dollar (period average)	8.2	12.0	21.7	22.5	23.1	23.5	23.6	23.7
Real effective rate (CPI-based, percent change)	-3.1	-22.7	-16.8	2.7	1.6	0.7	1.0	0.6
Real effective rate (CPI-based, 2010=100)	106.8	82.5	68.6	70.5	71.7	72.2	72.9	73.3
Memorandum items:								
Per capita GDP / Population (2013): US$3,928 / 45.4 million								
Literacy / Poverty rate: 100 percent / 2.9 percent								

Sources: Ukrainian authorities; World Bank, World Development Indicators; and IMF staff estimates.

1/ Data based on SNA 2008, exclude Crimea and Sevastopol; 2013 and 2014 data are IMF staff estimates.

2/ The general government includes the central and local governments and the social funds.

Table 2. Ukraine: Program Scenario – General Government Finances, 2013–20 1/

(Billions of Ukrainian hryvnia)

	2013	2014	2015		2016	2017	2018	2019	2020
		Est.	Budget	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
Revenue	634.9	639.7	770.4	792.5	840.2	959.5	1071.0	1179.8	1286.1
Tax revenue	551.2	561.2	656.2	682.5	759.0	868.3	970.3	1069.8	1178.8
Tax on income, profits, and capital gains	127.2	115.4	132.0	134.4	150.0	166.0	183.8	205.1	228.2
Personal income tax	72.2	75.2	95.5	95.5	106.2	116.5	128.6	141.2	154.3
Corporate profit tax	55.0	40.2	36.5	38.9	43.9	49.5	55.2	63.9	74.0
Payroll tax	193.7	184.2	194.2	195.6	217.5	244.6	273.3	299.9	327.7
Property tax	12.8	12.1	13.3	13.5	15.2	17.1	19.1	21.1	23.2
Tax on goods and services	175.8	201.3	237.0	253.2	295.3	330.7	366.6	408.1	449.0
VAT	128.3	139.0	157.8	170.9	198.7	222.9	247.8	274.5	303.9
Excise	36.7	45.1	68.1	70.5	80.9	91.1	101.2	113.3	123.6
Other	10.8	17.2	11.0	11.7	15.8	16.7	17.6	20.3	21.5
Tax on international trade	13.3	12.6	31.7	34.9	21.6	23.8	25.9	28.1	30.6
Other tax	28.4	35.6	48.0	51.0	59.4	86.0	101.6	107.5	120.0
Nontax revenue	83.7	78.5	114.2	110.0	81.2	91.2	100.7	110.0	107.3
Expenditure	704.9	710.5	835.6	870.7	916.4	1032.0	1139.9	1250.4	1357.4
Current	672.6	693.3	771.5	802.5	862.7	954.4	1046.9	1145.7	1245.2
Compensation of employees	167.7	162.5	182.2	182.2	196.1	221.1	243.8	265.3	292.2
Goods and services	103.7	116.9	142.0	141.9	150.7	169.2	188.7	208.1	227.4
Interest	35.9	52.5	79.0	99.4	106.0	110.1	109.9	116.3	121.4
Subsidies to corporations and enterprises	29.4	37.1	23.5	23.5	25.6	28.3	36.8	43.4	41.5
Social benefits	335.6	324.2	343.4	353.9	384.1	425.6	467.6	512.4	562.5
Social programs (on budget)	56.3	58.3	64.4	76.5	84.5	94.3	104.6	117.4	128.9
Pensions	250.3	243.6	253.4	251.8	271.2	300.4	329.9	359.9	396.4
Unemployment, disability, and accident insurance	29.0	22.3	25.6	25.6	28.3	30.9	33.1	35.1	37.2
Other current expenditures	0.3	0.2	1.4	1.6	0.2	0.2	0.2	0.2	0.2
Capital	29.3	20.1	46.4	46.3	52.3	70.8	78.9	91.2	102.3
Net lending	3.0	-2.8	11.7	11.8	0.8	0.9	1.9	2.0	0.3
Discrepancy / reserve fund	0.0	0.0	6.1	10.1	0.6	5.9	12.2	11.6	9.6
Overall balance	-70.1	-70.8	-65.2	-78.2	-76.2	-72.5	-68.9	-70.7	-71.2
Naftogaz balance	-27.5	-87.3		-58.0	-5.4	0.0	0.0	0.0	0.0
General government and Naftogaz balance	-97.6	-158.1		-136.2	-81.6	-72.5	-68.9	-70.7	-71.2
General government financing	70.1	70.8	65.2	78.2	76.2	72.5	68.9	70.7	71.2
External	19.0	37.0	83.4	167.3	53.4	58.1	48.3	19.5	-19.8
Disbursements	51.6	94.8	181.0	197.9	66.2	86.2	97.6	88.2	74.4
Exceptional Financing				92.0	50.7	76.3	0.0	0.0	35.6
Amortizations	-32.6	-57.9	-97.6	-122.6	-63.6	-104.5	-49.2	-68.7	-129.8
Domestic (net)	51.1	33.9	-18.2	-89.1	22.8	14.5	20.6	51.2	91.1
Bond financing	50.5	22.5	-39.1	-72.9	-12.7	2.5	6.6	35.2	71.1
Direct bank borrowing	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit finance	-1.4	10.4	3.9	-25.0	25.0	0.0	0.0	0.0	0.0
Privatization	2.1	0.8	17.0	8.8	10.5	12.0	14.0	16.0	20.0
Discrepancy									
Other financing	1.4	33.6	56.5	139.0	0.0	0.0	0.0	0.0	0.0
Bank recapitalization	1.4	26.7	56.5	139.0	0.0	0.0	0.0	0.0	0.0
VAT bonds	0.0	6.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Naftogaz financing	27.5	87.3		58.0	5.4	0.0	0.0	0.0	0.0
Government financing 2/	5.8	96.9	31.5	50.6	45.4	0.0	0.0	0.0	0.0
Accumulation of external arrears	16.1	1.0	0.0	0.0	-30.8	0.0	0.0	0.0	0.0
Other 3/	5.6	-10.6		7.4	-9.2	0.0	0.0	0.0	0.0
Total financing	99.0	191.7	121.7	275.2	81.6	72.5	68.9	70.7	71.2
Memorandum items:									
Structural general government primary balance 4/	-35.1	4.1		38.3	54.8	49.0	45.3	46.3	50.4
Primary balance (general government)	-34.2	-18.4		21.2	29.8	37.6	41.0	45.6	50.2
Primary balance (general government and Naftogaz)	-61.7	-105.7		-36.8	24.4	37.6	41.0	45.6	50.2
Primary current balance (general government)	-1.8	-1.1		89.4	83.5	115.1	134.0	150.4	162.3
Public and Publicly Guaranteed Debt	595.6	1,115.7	1,463.0	1,741.6	1,933.1	2,094.3	2,187.7	2,238.6	2,268.0
Of which: In foreign currency	349.4	696.9		1,176.8	1,315.0	1,448.7	1,519.4	1,532.7	1,517.2
Domestic	288.6	495.2		663.9	717.7	742.7	760.2	808.7	863.6
External	307.0	620.5		1,077.7	1,215.3	1,351.6	1,427.5	1,429.9	1,404.5
Public debt excluding guarantees	491.5	962.0	1,176.0	1,385.0	1,505.1	1,594.4	1,654.6	1,714.7	1,791.0
Nominal GDP (billions of Ukrainian hryvnia)	1,466	1,535	1,721	1,850	2,087	2,356	2,626	2,896	3,194

Sources: Ministry of Finance; National Bank of Ukraine; and IMF staff estimates and projections.

1/ National methodology, cash basis.

2/ Government spending on Naftogaz financing and recapitalization, including through T-bills issuance. In 2014, includes repayment of a US$1.6 billion

3/ Includes external and domestic net disbursements, trade credits, deposit drawdowns, as well as company receivables.

4/ The balance in 2014 treats part of the military spending and the EU grant as one-off operations. The balance in 2015 treats import duty surcharge, part of military spending and part of the NBU profit transfer as one-off operations.

Table 2. Ukraine: Program Scenario – General Government Finances, 2013–20 (Concluded) 1/

(Percent of GDP)

	2013	2014	2015		2016	2017	2018	2019	2020
		Est.	Budget	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
Revenue	43.3	41.7	44.8	42.8	40.3	40.7	40.8	40.7	40.3
Tax revenue	37.6	36.6	38.1	36.9	36.4	36.9	36.9	36.9	36.9
Tax on income, profits, and capital gains	8.7	7.5	7.7	7.3	7.2	7.0	7.0	7.1	7.1
Personal income tax	4.9	4.9	5.5	5.2	5.1	4.9	4.9	4.9	4.8
Corporate profit tax	3.8	2.6	2.1	2.1	2.1	2.1	2.1	2.2	2.3
Payroll tax	13.2	12.0	11.3	10.6	10.4	10.4	10.4	10.4	10.3
Property tax	0.9	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Tax on goods and services	12.0	13.1	13.8	13.7	14.1	14.0	14.0	14.1	14.1
VAT	8.8	9.1	9.2	9.2	9.5	9.5	9.4	9.5	9.5
Excise	2.5	2.9	4.0	3.8	3.9	3.9	3.9	3.9	3.9
Other	0.7	1.1	0.6	0.6	0.8	0.7	0.7	0.7	0.7
Tax on international trade	0.9	0.8	1.8	1.9	1.0	1.0	1.0	1.0	1.0
Other tax	1.9	2.3	2.8	2.8	2.8	3.6	3.9	3.7	3.8
Nontax revenue	5.7	5.1	6.6	5.9	3.9	3.9	3.8	3.8	3.4
Expenditure	48.1	46.3	48.6	47.1	43.9	43.8	43.4	43.2	42.5
Current	45.9	45.2	44.8	43.4	41.3	40.5	39.9	39.6	39.0
Compensation of employees	11.4	10.6	10.6	9.9	9.4	9.4	9.3	9.2	9.1
Goods and services	7.1	7.6	8.2	7.7	7.2	7.2	7.2	7.2	7.1
Interest	2.4	3.4	4.6	5.4	5.1	4.7	4.2	4.0	3.8
Subsidies to corporations and enterprises	2.0	2.4	1.4	1.3	1.2	1.2	1.4	1.5	1.3
Social benefits	22.9	21.1	20.0	19.1	18.4	18.1	17.8	17.7	17.6
Social programs (on budget)	3.8	3.8	3.7	4.1	4.0	4.0	4.0	4.1	4.0
Pensions	17.1	15.9	14.7	13.6	13.0	12.8	12.6	12.4	12.4
Unemployment, disability, and accident insurance	2.0	1.5	1.5	1.4	1.4	1.3	1.3	1.2	1.2
Other current expenditures	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Capital	2.0	1.3	2.7	2.5	2.5	3.0	3.0	3.1	3.2
Net lending	0.2	-0.2	0.7	0.6	0.0	0.0	0.1	0.1	0.0
Discrepancy / reserve fund	0.0	0.0	0.4	0.5	0.0	0.3	0.5	0.4	0.3
Overall balance	-4.8	-4.6	-3.8	-4.2	-3.7	-3.1	-2.6	-2.4	-2.2
Naftogaz balance	-1.9	-5.7		-3.1	-0.3	0.0	0.0	0.0	0.0
General government and Naftogaz balance	-6.7	-10.3		-7.4	-3.9	-3.1	-2.6	-2.4	-2.2
General government financing	4.8	4.6	3.8	4.2	3.7	3.1	2.6	2.4	2.2
External	1.3	2.4	4.8	9.0	2.6	2.5	1.8	0.7	-0.6
Disbursements	3.5	6.2	10.5	10.7	3.2	3.7	3.7	3.0	2.3
Exceptional Financing				5.0	2.4	3.2	0.0	0.0	1.1
Amortizations	-2.2	-3.8	-5.7	-6.6	-3.0	-4.4	-1.9	-2.4	-4.1
Domestic (net)	3.5	2.2	-1.1	-4.8	1.1	0.6	0.8	1.8	2.9
Bond financing	3.4	1.5	-2.3	-3.9	-0.6	0.1	0.3	1.2	2.2
Direct bank borrowing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit finance	-0.1	0.7	0.2	-1.4	1.2	0.0	0.0	0.0	0.0
Privatization	0.1	0.1	1.0	0.5	0.5	0.5	0.5	0.6	0.6
Discrepancy									
Other financing	0.1	2.2	3.3	7.5	0.0	0.0	0.0	0.0	0.0
Bank recapitalization	0.1	1.7	3.3	7.5	0.0	0.0	0.0	0.0	0.0
VAT bonds	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Naftogaz financing	1.9	5.7		3.1	0.3	0.0	0.0	0.0	0.0
Government financing 2/	0.4	6.3	1.8	2.7	2.2	0.0	0.0	0.0	0.0
Accumulation of external arrears	1.1	0.1	0.0	0.0	-1.5	0.0	0.0	0.0	0.0
Other 3/	0.4	-0.7		0.4	-0.4	0.0	0.0	0.0	0.0
Total financing	6.8	12.5	7.1	14.9	3.9	3.1	2.6	2.4	2.2
Memorandum items:									
Structural general government primary balance 4/	-2.4	0.3		2.0	2.5	2.1	1.7	1.6	1.6
Primary balance (general government)	-2.3	-1.2		1.1	1.4	1.6	1.6	1.6	1.6
Primary balance (general government and Naftogaz)	-4.2	-6.9		-2.0	1.2	1.6	1.6	1.6	1.6
Primary current balance (general government)	-0.1	-0.1		4.8	4.0	4.9	5.1	5.2	5.1
Public and Publicly Guaranteed Debt	40.6	72.7	85.0	94.1	92.6	88.9	83.3	77.3	71.0
Of which: In foreign currency	23.8	45.4		63.6	63.0	61.5	57.9	52.9	47.5
Domestic	19.7	32.3		35.9	34.4	31.5	28.9	27.9	27.0
External	20.9	40.4		58.3	58.2	57.4	54.4	49.4	44.0
Public debt excluding guarantees	33.5	62.7	68.3	74.9	72.1	67.7	63.0	59.2	56.1
Nominal GDP (billions of Ukrainian hryvnia)	1,466	1,535	1,721	1,850	2,087	2,356	2,626	2,896	3,194

Sources: Ministry of Finance; National Bank of Ukraine; and IMF staff estimates and projections.

1/ National methodology, cash basis.

2/ Government spending for Naftogaz financing, including through recapitalization bonds. In 2014, includes repayment of a US$1.6 billion Eurobond.

3/ Includes external and domestic net disbursements, trade credits, deposit drawdowns, as well as company receivables.

4/ The balance in 2014 treats part of the military spending and the EU grant as one-off operations. The balance in 2015 treats import duty surcharge, part of military spending and part of the NBU profit transfer as one-off operations.

Table 3. Ukraine: Program Scenario – Balance of Payments, 2014–20

(Billions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
	Est.	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
Current account balance	-6.1	-1.2	-1.2	-1.1	-1.3	-2.0	-3.1
Goods and services trade balance	-6.3	-0.4	-0.5	-0.5	-0.5	-0.9	-1.6
Merchandise trade balance	-7.0	-0.4	-1.2	-1.3	-1.5	-2.1	-2.9
Exports, f.o.b.	55.6	49.8	53.0	56.7	60.7	65.1	69.9
Imports, f.o.b. 1/	-62.6	-50.2	-54.1	-58.1	-62.3	-67.2	-72.8
Of which: gas	-6.6	-6.0	-4.7	-5.0	-5.6	-6.1	-6.1
Services (net)	0.7	0.1	0.6	0.8	1.0	1.2	1.4
Receipts	13.2	12.1	13.5	14.3	15.0	15.9	16.7
Payments	-12.5	-12.0	-12.9	-13.5	-14.1	-14.7	-15.3
Income (net)	-1.3	-2.4	-2.5	-2.7	-3.0	-3.3	-3.8
Current transfers (net)	1.5	1.5	1.8	2.2	2.2	2.2	2.2
Capital and financial account balance	-11.8	-8.1	-4.3	-1.4	3.2	5.3	2.7
Capital account 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-11.8	-8.1	-4.3	-1.4	3.2	5.3	2.7
Direct investment (net)	0.4	1.2	1.7	2.1	2.4	2.6	2.8
Portfolio investment (net)	-2.8	-3.4	-3.6	-3.5	0.3	2.1	-0.6
Of which: general government	-1.7	-2.5	-2.6	-2.3	2.0	1.0	-1.5
Of which: eurobond issuance	1.0	2.0	0.0	1.0	2.0	2.0	2.0
Other investment (net)	-9.4	-5.8	-2.4	0.1	0.5	0.5	0.5
Medium and long-term loans	-3.6	-5.3	-2.5	-0.3	-0.2	-0.1	-0.2
Official	-0.4	-0.9	-0.8	-0.7	-1.0	-0.9	-1.0
Disbursements 2/	...	...	...	...	...	...	...
Repayments	-0.4	-0.9	-0.8	-0.7	-1.0	-0.9	-1.0
Banks	-1.2	-0.6	0.1	0.1	0.2	0.2	0.2
Other sectors	-2.0	-3.8	-1.7	0.3	0.6	0.6	0.6
Short-term loans	-4.2	0.5	-0.2	0.3	0.5	0.5	0.5
Banks	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Other sectors 3/	-4.2	0.5	-0.3	0.2	0.4	0.4	0.4
Currency and deposits	-1.6	-1.0	0.3	0.1	0.1	0.1	0.1
Banks	1.1	-1.9	0.2	0.1	0.1	0.1	0.1
Other sectors 5/	-2.7	0.9	0.1	0.0	0.0	0.0	0.0
Of which: FX deposit outflows	-7.1	-1.5	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-17.9	-9.3	-5.5	-2.5	1.9	3.3	-0.4
Official financing 6/	4.2	6.3	3.6	2.7	2.2	1.7	1.2
World Bank	1.5	1.3	0.5	0.3	0.3	0.3	0.1
EU	2.2	1.8	0.7	0.0	0.0	0.0	0.0
EBRD/EIB/Others	0.5	3.2	2.4	2.5	1.9	1.5	1.0
Exceptional financing	0.0	5.2	3.4	4.4	2.3	0.0	1.5
Financing	13.8	-2.2	-1.5	-4.7	-6.3	-5.0	-2.2
Gross official reserves (increase: -)	12.9	-10.8	-3.9	-6.3	-6.7	-3.1	-0.3
Net use of IMF resources	0.9	8.6	2.5	1.6	0.4	-1.8	-1.9
Of which: Prospective Fund purchases	4.6	10.0	2.5	2.5	2.5	...	...
Memorandum items:							
Total external debt (percent of GDP)	102.4	158.4	149.5	141.2	134.3	125.0	114.8
Current account balance (percent of GDP)	-4.8	-1.4	-1.3	-1.1	-1.2	-1.6	-2.3
Goods and services trade balance (percent of GDP)	-4.9	-0.4	-0.6	-0.5	-0.5	-0.7	-1.2
Gross international reserves	7.5	18.3	22.3	28.5	35.2	38.4	38.7
Months of next year's imports of goods and services	1.5	3.3	3.7	4.5	5.2	5.2	4.9
Percent of short-term debt (remaining maturity)	17.4	43.7	57.4	69.0	82.9	84.1	78.4
Percent of the IMF composite measure (float)	27.1	65.9	79.5	96.3	113.2	117.4	115.1
Merchandise export value (percent change)	-14.4	-10.5	6.4	7.1	7.1	7.3	7.3
Merchandise import value (percent change)	-26.4	-19.7	7.8	7.3	7.3	8.0	8.3
Merchandise export volume (percent change)	-11.1	-4.2	5.1	5.8	6.1	6.5	6.5
Merchandise import volume (percent change)	-26.9	-11.9	5.7	6.0	6.2	7.3	7.9
Goods terms of trade (percent change)	-2.8	0.4	-0.7	0.0	-0.1	0.1	0.3
Gross domestic product (current prices)	128.0	85.4	92.6	101.9	111.9	122.8	134.7

Sources: National Bank of Ukraine; and IMF staff estimates and projections.

1/ For 2015-20, projected gas prices are: $287, $301, $310, $323, $326, and $326 per tcm, respectively. Naftogaz is currently disputing the arrears to Gazprom. For program financing and risk assessment considerations the potential liability to Gazprom was estimated using US$385.5 per tcm in 2014:Q2. This price is used for accounting purpose only and does not constitute an expression of a view by Fund staff on what the gas price should be.

2/ Financing and grants from World Bank, EU, EIB, EBRD, and official bilateral is recorded below the line.

3/ Includes trade credit and arrears, including those related to Naftogaz potential arrears to Gazprom.

5/ Mainly reflects residents' conversion of hryvnia cash to foreign currency held outside the banking system and cash financing of informal trade.

6/ Includes project financing to the public and private sector. The planned Eurobond issuance of $2 billion with U.S. guarantees is included above the line in portfolio investment, general government.

Table 4. Ukraine: Program Scenario – Gross External Financing Requirements, 2014–20

(Billions of U.S. dollars)

	2014	2015	2016	2017	2018	2019	2020
	Est.	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
Total financing requirements	66.9	48.2	51.6	48.2	47.5	47.1	52.5
Current account deficit	6.1	1.2	1.2	1.1	1.3	2.0	3.1
Portfolio investment	3.5	5.6	3.6	4.5	2.6	1.1	5.0
Private	0.7	1.2	1.0	1.2	2.6	0.1	1.5
Public	2.7	4.5	2.6	3.3	0.0	1.0	3.5
Medium and long-term debt	9.0	12.3	12.2	8.2	8.9	8.9	9.0
Private	8.6	11.4	11.4	7.5	8.0	8.0	8.0
Banks	2.9	2.5	2.5	2.5	2.5	2.5	2.5
Corporates	5.7	9.0	8.9	5.0	5.5	5.5	5.5
Public	0.4	0.9	0.8	0.7	1.0	0.9	1.0
Short-term debt (including deposits)	23.0	10.0	13.6	14.3	14.5	14.5	14.5
Other net capital outflows 1/	0.4	0.4	-0.1	0.0	0.0	0.0	0.0
Trade credit	24.9	18.6	21.1	20.1	20.1	20.6	21.0
Total financing sources	48.9	38.9	46.1	45.7	49.4	50.3	52.1
Capital transfers 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	0.4	1.2	1.7	2.1	2.4	2.6	2.8
Portfolio investment	0.7	2.2	0.0	1.0	2.9	3.3	4.4
Private	-0.4	0.2	0.0	0.0	0.9	1.3	2.4
Public	1.0	2.0	0.0	1.0	2.0	2.0	2.0
Of which: eurobond issuance	1.0	2.0	0.0	1.0	2.0	2.0	2.0
Medium and long-term debt	4.8	7.0	9.7	7.8	8.8	8.8	8.8
Private	4.8	7.0	9.7	7.8	8.8	8.8	8.8
Banks	1.7	1.9	2.5	2.6	2.7	2.7	2.7
Corporates	3.2	5.1	7.1	5.3	6.1	6.1	6.1
Public 2/	...	...	...	...	...	...	...
Short-term debt (including deposits)	22.1	8.8	14.6	14.7	14.7	14.7	14.7
Trade credit	20.9	19.7	20.1	20.1	20.6	21.0	21.4
Increase in gross reserves	-12.9	10.8	3.9	6.3	6.7	3.1	0.3
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total financing needs	5.1	20.1	9.4	8.7	4.8	-0.1	0.8
Official financing	5.1	14.9	6.0	4.3	2.5	-0.1	-0.7
IMF	0.9	8.6	2.5	1.6	0.4	-1.8	-1.9
Prospective purchases	4.6	10.0	2.5	2.5	2.5	...	...
Repurchases	3.7	1.4	0.0	0.9	2.1	1.8	1.9
Official creditors 3/	4.2	6.3	3.6	2.7	2.2	1.7	1.2
World Bank	1.5	1.3	0.5	0.3	0.3	0.3	0.1
EU	2.2	1.8	0.7	0.0	0.0	0.0	0.0
EBRD/EIB/Others	0.5	3.2	2.4	2.5	1.9	1.5	1.0
Exceptional financing	0.0	5.2	3.4	4.4	2.3	0.0	1.5
Memorandum items:							
Gross international reserves	7.5	18.3	22.3	28.5	35.2	38.4	38.7
Percent of short-term debt (remaining maturity)	17.4	43.7	57.4	69.0	82.9	84.1	78.4
Months of next year's imports of goods and services	1.5	3.3	3.7	4.5	5.2	5.2	4.9
Percent of the IMF composite measure (float) 4/	27.1	65.9	79.5	96.3	113.2	117.4	115.1
Loan rollover rate (percent)							
Banks	96.6	94.4	102.2	103.0	104.6	104.6	104.6
Corporates	63.9	70.0	97.1	103.8	104.0	104.0	104.0
Total	85.4	81.0	99.6	103.6	104.6	104.6	104.6

Sources: National Bank of Ukraine; and IMF staff estimates and projections.

1/ Mainly reflects residents' conversion of hryvnia cash to foreign currency held outside of the banking system.
2/ Financing and grants from official sources are recorded below the line.
3/ Includes project financing to the public and private sector.
4/ The IMF composite measure is calculated as a weighted sum of short-term debt, other portfolio liabilities, broad money, and exports in percent of GDP. Official reserves are recommended to be in the range of 100–150 percent of the appropriate measure.

Table 5. Ukraine: Program Scenario – Monetary Accounts, 2013–20

	2013	2014	2015				2016	2017	2018	2019	2020
			Mar.	Jun.	Sep.	Dec.					
			Prog.	Prog.	Prog.	Prog.	Prog.	Prog.	Prog.	Proj.	Proj.
	(Billions of Ukrainian hryvnias unless otherwise noted)										
Monetary survey											
Net foreign assets	51	-76	-148	-99	-87	-3	19	120	255	349	388
(In billions of US dollars)	6.4	-4.8	-6.4	-4.5	-3.9	-0.1	0.9	5.1	10.8	14.8	16.3
Foreign assets	273	249	…	…	…	…	…	…	…	…	…
Foreign liabilities	222	325	…	…	…	…	…	…	…	…	…
Net domestic assets	858	1,033	1,174	1,126	1,161	1,142	1,295	1,397	1,481	1,603	1,799
Domestic credit	1,198	1,507	1,688	1,643	1,676	1,731	1,936	2,063	2,152	2,278	2,482
Net claims on government	248	445	457	448	463	524	586	589	595	631	701
Credit to the economy	911	1,024	1,179	1,145	1,163	1,157	1,293	1,412	1,491	1,579	1,707
Domestic currency	601	549	656	647	651	665	755	849	914	985	1,109
Foreign currency	310	474	524	498	512	492	538	563	577	594	598
(In billions of US dollars)	38.8	30.1	22.8	22.6	23.3	22.4	23.7	24.1	24.5	25.1	25.2
Other items, net	-340	-474	-514	-517	-515	-589	-641	-665	-671	-675	-683
Broad money	909	957	1,026	1,027	1,074	1,139	1,315	1,517	1,735	1,952	2,187
Currency in circulation	238	283	291	321	346	359	396	434	470	507	544
Total deposits	668	672	734	705	727	778	917	1,080	1,263	1,442	1,640
Domestic currency deposits	422	366	341	351	373	421	525	636	763	889	1,031
Foreign currency deposits	246	307	393	354	354	358	392	445	500	553	609
(In billions of US dollars)	30.8	19.4	17.1	16.1	16.1	16.3	17.3	19.0	21.3	23.4	25.6
Accounts of the NBU											
Net foreign assets	124	30	-12	10.6	31	91	125	235	382	489	539
(In billions of US dollars)	15.5	1.9	-0.5	0.5	1.4	4.2	5.5	10.0	16.2	20.7	22.7
Net international reserves	114	25	-12	10.6	31	91	125	235	382	489	539
(In billions of US dollars)	14.2	1.6	-0.5	0.5	1.4	4.2	5.5	10.0	16.2	20.7	22.7
Reserve assets	157	115	221	262	310	404	507	668	829	908	920
(In billions of US dollars)	19.6	7.3	9.6	11.9	14.1	18.3	22.3	28.5	35.3	38.4	38.7
Reserve liabilities	43	90	234	251	279	312	381	433	447	419	381
Net domestic assets	183	303	364	376	382	333	347	289	192	138	141
Net domestic credit	218	413	461	466	470	428	488	448	354	301	306
Net claims on government	145	324	364	385	394	390	357	321	263	198	166
Claims on government 1/	149	338	378	399	408	404	372	335	277	212	181
Liabilities to government	4	14	14	14	14	14	14	14	14	14	14
Net claims on banks	72	90	97	81	76	38	130	127	92	103	140
Other items, net	-35	-111	-97	-90	-87	-96	-141	-159	-162	-163	-166
Base money	307	333	351	387	413	424	472	524	574	627	680
Currency in circulation	238	283	291	321	346	359	396	434	470	507	544
Banks' reserves	69	50	61	65	67	65	76	90	105	120	136
Cash in vault	24	22	24	23	24	25	30	35	41	47	53
Required reserves	27	39	37	42	44	39	46	55	64	73	83
Excess reserves	18	-11	0	0	0	0	0	0	0	0	0
Deposit money banks											
Net foreign assets	-73	-107	-135	-109	-118	-94	-106	-116	-127	-139	-151
(In billions of US dollars)	-9.2	-6.8	-5.9	-5.0	-5.3	-4.3	-4.7	-4.9	-5.4	-5.9	-6.4
Foreign assets	106	129	193	201	211	214	216	221	219	217	215
(In billions of US dollars)	13.3	8.2	8.4	9.1	9.6	9.7	9.5	9.5	9.3	9.2	9.1
Foreign liabilities	179	235	368	348	346	346	361	377	387	397	408
Net domestic assets	740	778	869	814	844	873	1,023	1,196	1,391	1,582	1,792
Domestic credit	1,048	1,142	1,275	1,231	1,262	1,356	1,507	1,682	1,876	2,067	2,276
Net claims on government	103	121	93	63	69	134	229	268	333	433	535
Credit to the economy	910	1,023	1,179	1,145	1,163	1,157	1,293	1,412	1,491	1,579	1,707
Other claims on the economy	40	39	39	39	39	39	39	39	39	39	39
Net claims on NBU	-4	-41	-37	-16	-9	26	-54	-37	13	17	-4
Of which : Refinancing loans	79	110	137	104	99	60	153	149	114	125	162
Other items, net	-308	-364	-406	-418	-418	-483	-484	-486	-486	-485	-485
Banks' liabilities	667	671	734	705	727	778	917	1,080	1,263	1,442	1,640
Demand deposits	197	239	…	…	…	…	…	…	…	…	…
Time deposits	470	432	…	…	…	…	…	…	…	…	…
Memorandum items:	(Year-on-year percent change, unless otherwise indicated)										
Base money	20.3	8.5	6.8	10.2	17.6	27.3	11.3	11.0	9.7	9.1	8.5
Broad money	17.6	5.3	8.6	8.3	8.1	19.1	15.4	15.4	14.4	12.5	12.0
At program exchange rate	13.3	-16.8	-16.0	-11.0	-8.4	8.5	15.1	14.8	14.5	12.6	12.1
Credit to the economy	11.8	12.4	17.7	15.7	16.2	13.0	11.8	9.2	5.6	5.9	8.1
At program exchange rate	9.5	-15.6	-14.4	-11.3	-7.2	-0.6	10.9	8.8	5.9	6.1	9.0
Real credit to the economy 2/	11.2	-10.0	-10.3	-16.5	-13.1	-10.7	2.8	1.9	0.6	0.9	3.0
Credit-to-GDP ratio, in percent	62.1	66.7	76.8	71.6	69.5	62.5	62.0	59.9	56.8	54.5	53.4
Velocity of broad money, ratio	1.61	1.60	1.50	1.56	1.56	1.62	1.59	1.55	1.51	1.48	1.46
Money multiplier, ratio	2.96	2.87	2.92	2.66	2.60	2.69	2.79	2.90	3.02	3.11	3.22
Hryvnia per U.S. dollar, market rate	8.3	15.8	23.0	22.0	22.0	22.0	22.7	23.4	23.5	23.6	23.8
Hryvnia per U.S. dollar, official rate	8.0	15.8	23.0	22.0	22.0	22.0	22.7	23.4	23.5	23.6	23.8

Sources: National Bank of Ukraine; and IMF staff estimates and projections.

1/ Includes Naftogaz recapitalization bonds and DGF financing

2/ Deflated by CPI (eop), at current exchange rates.

Table 6. Ukraine: Financial Soundness Indicators for the Banking Sector, 2009–14

(Percent, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014			
						Mar.	Jun.	Sep.	Dec.
Ownership									
Number of banks, *of which*	182	176	176	176	180	181	174	168	163
Active 1/	...	...	...	...	180	175	169	158	147
Ownership	182	176	176	173	176	177	170	164	159
Domestic	129	119	121	118	124	123	116	110	105
Foreign	51	55	53	53	49	51	51	51	51
Of which: 100% foreign-owned	18	20	22	22	19	19	19	19	19
State-owned	2	2	2	2	3	3	3	3	3
Foreign-owned banks' share in statutory capital	35.8	40.6	41.9	39.5	34.0	33.6	32.3	32.1	32.5
Concentration									
Share of assets of largest 10 banks	52.8	53.9	52.8	52.7	54.3	55.5	57.3	58.8	59.7
Share of assets of largest 25 banks	76.5	75.9	74.6	74.7	76.0	77.2	79.5	81.0	82.0
Number of bank with assets less than $150 million	107	92	81	75	77	95	95	91	103
Capital Adequacy									
Regulatory capital to risk-weighted assets	18.1	20.8	18.9	18.1	18.3	14.8	15.9	16.0	15.6
Capital to total assets	13.1	14.6	14.8	15.0	14.0	12.8	12.6	12.3	12.4
Asset Quality									
Credit growth (year-over-year percent change) 2/	-2.3	1.1	9.5	2.2	11.8	21.2	18.0	15.7	12.4
Credit to GDP ratio 2/	78.9	67.3	61.2	58.0	62.1	67.7	66.1	65.2	66.8
NPLs to total loans (NBU definition) 3/	13.1	14.9	14.3	16.5	12.9	13.3	14.6	16.7	19.0
NPLs to total loans (strict definition) 4/	37.6	40.3	37.7	26.7	23.5	26.1	27.7	30.6	32.0
NPLs net of provisions to capital (NBU definition) 3/	32.0	29.2	25.8	36.0	30.7	37.6	47.0	55.0	61.1
NPLs net of provisions to capital (strict definition) 4/	...	...	...	...	...	...	124.8	135.0	128.4
Specific provisions (percent of NPLs, NBU definition)	65.1	66.6	68.3	63.9	80.4	79.4	72.3	71.1	76.7
Specific provisions (percent of total loans, NBU definition)	8.9	10.2	10.1	12.7	13.6	13.8	13.7	15.6	19.1
Specific procisions (percent of NPLs, strict definition) 4/	...	...	...	...	...	...	34.6	36.1	42.6
Foreign Exchange Rate Risk									
Loans in foreign currency to total loans 2/	51.2	46.5	40.6	36.9	34.1	41.7	43.0	44.2	46.4
Deposits in foreign currency to total deposits	47.2	42.1	42.6	43.8	36.9	43.5	42.3	41.2	45.6
Foreign currency loans to foreign currency deposits 2/	239.2	194.8	155.7	121.1	126.0	143.4	153.5	162.3	154.8
Net open FX position to regulatory capital (NBU definition) 5/	28.5	21.6	8.4	2.5	6.9	13.4	14.6	23.7	31.7
Net open FX position to regulatory capital (staff estimate) 5/	-23.6	-36.9	-40.0	-28.9	-15.1	-18.3	-20.4	-20.9	-25.3
Liquidity Risk									
Liquid assets to total assets	11.5	18.8	18.7	22.2	20.6	21.6	...	...	...
Customer deposits to total loans to the economy 1/	45.3	56.7	61.2	69.6	73.3	66.8	66.1	66.1	65.6
Earnings and Profitability									
Return on assets (after tax; end-of-period)	-4.4	-1.5	-0.8	0.5	0.1	-0.6	0.2	-1.1	-4.1
Return on equity (after tax; end-of-period)	-32.5	-10.2	-5.3	3.0	0.8	-4.2	1.4	-7.9	-30.5
Net interest margin to total assets	6.2	5.8	5.3	4.5	4.1	4.6	4.4	4.3	4.2
Interest rate spreads (percentage points; end-of-period)									
Between loans and deposits in domestic currency	5.6	7.6	6.6	4.3	4.8	7.4	4.5	6.2	6.9
Between loans and deposits in foreign currency	0.7	4.7	2.8	4.5	2.4	1.9	2.3	2.6	1.9
Between loans in domestic and foreign currency	9.4	5.3	9.4	9.1	8.9	11.4	8.4	7.5	8.4
Between deposits in domestic and foreign currency	4.5	2.4	5.6	9.4	6.5	5.9	6.2	3.8	3.3
Number of banks not complying with banking regulations									
Not meeting capital adequacy requirements for Tier I capital	12	3	2	2	0	6	5	8	14
Not meeting prudential regulations	22	8	11	6	6	28	25	26	34
Not meeting reserve requirements	15	5	5	9	8	37	27	33	...

Sources: National Bank of Ukraine; and IMF staff estimates.
1/ Neither under provisional administration nor under liquidation.
2/ Monetary statistics data.
3/ From December 2012, NBU changed loan classification, which resulted in the NPL series break.
4/ Includes NPLs that are classified as substandard, doubtful, and loss. From December 2012, estimated by staff using NPL data published by NBU according to new methodology, which resulted in series break.
5/ NBU definition did not take into account the effects of NBU Resolution 109, which forced banks into holding large negative open foreign exchange (FX) positions.

Table 7. Information on Commitments Stipulated by the IMF Stand-By Program	
Commitments under the Program	**Deadline**
Prior actions and structural benchmarks that are completed	
Fiscal	
Government will approve a package of measures to yield additional revenues and reduce expenditure for the total amount UAH 45 bn and implement them by passing a supplementary budget for 2014.	Completed, April 12, 2014
Parliament will pass a reversal of the already introduced VAT rate reduction in 2015 and keep the rate at 20 percent.	Completed, April 12, 2014
As intermediate measure to cover the gap until VAT reform is implemented, Parliament will pass an extension in the recently expired special VAT regime for grain exporters.	Completed, April 12, 2014
Parliament will pass a supplementary budget, reflecting: (i) the new tax measures and expenditure measures (para 17) and (ii) the funds necessary to recapitalize Naftogaz (para 23).	Completed, August 15, 2014
Review education spending and develop measures needed to enhance cost-efficiency in the sector. Prepare a plan to introduce means-testing in providing benefits to students in secondary schools while protecting vulnerable groups as per our current plans.	Completed, End September 2014
Measures aimed at improvement in pension legislation, to support rationalization of spending of the Pension Fund of Ukraine, specifically: (i) restriction of the amount of pension benefits under special laws; (ii) closing privileged pension systems for new entrants; (iii) restrict eligibility for privileged pensions and length-of-service pensions.	End September 2014
After discussions within the Government and with private sector, we will prepare a proposal concerning VAT reform in the agricultural sector with a view to approximate the tax treatment in this sector to the general VAT application rules.	Not met
Energy	
The gas price regulator NERC will adopt and officially publish a decision to raise end-user gas tariffs for households by 56 percent, effective May 1, 2014.	Completed, April 10, 2014
The utility price regulator NURC will adopt decisions to raise the heating tariffs for households by 40 percent on average, effective July 1, 2014.	Completed, April 18, 2014
Publicly announce the decision and schedule for tariff increases through 2017, where the schedule will include the following: (i) in 2015, we will raise end-user gas and heating tariffs by 40 percent on average, effective May 1; and (ii) thereafter we will raise these tariffs by 20 percent on average each year, effective May 1, until losses of Naftogaz are eliminated by 2018.	Completed, April 2, 2014
To ensure de-politicization of tariff setting, Parliament will pass legislation to vest NURC with the exclusive authority to set heating tariffs in the country.	Completed, April 18, 2014
Approve a decision to introduce a new social assistance scheme effective of May 1, 2014	Completed, April 1, 2014
After the completion of Naftogaz's recapitalization procedure, the company will deposit US$3.1 billion in a restricted account with the NBU.	Completed, August 15, 2014
To strengthen payment discipline for the heating sector, parliament will pass legislation that will make distribution accounts fully operational and mandatory for utility payments.	Completed, End of June 2014
Financial	
Enhancing the DGF framework and financial position. Amend the DGF law to enhance its legal and operational capability to resolve banks, allow the DGF to issue securities and exchange them with government securities to cover gaps between assets and liabilities that are being transferred from insolvent to solvent institutions.	Completed, End September 2014
Supporting the introduction of the Code of Conduct, amend the Tax Code to allow banks to deduct losses stemming from such debt workouts, while borrowers should not be required to recognize income associated with interest, penalties, and exchange rate differences stemming from debt restructuring.	End of September 2014, MoF
Verkhovna Rada will pass the Law fostering resolution of the issue of non-performing loans and prevention of creation of new non-performing loans.	Not completed, End of September 2014

Table 7. Information on Commitments Stipulated by the IMF Stand-By Program (concluded)	
Commitments under the Program	**Deadline**
Prior actions and structural benchmarks that are completed	
Fiscal	
The practice to transfer the profit in advance to the budget by the National Bank will be terminated starting from July 2014. After the profit balances for the year 2013 in amount of approximately UAH 806 million have been transferred, NBU will not transfer the profits in the second half of 2014. Terminate the practice of adjustment of the profit distribution rules stipulated by the NBU Law by means of introduction of relevant provisions to the Law of Ukraine "On State Budget" and, respectively, we will stop the advance transfers of NBU profit to the budget during the current fiscal year. With this goal, we will enact legislative amendments as necessary.	Not completed
Structural	
Parliament will pass a new public procurement law to strengthen governance and checks and balances, including reducing exemptions from regular competitive procedures.	Completed, April 12, 2014
Submit to parliament draft law for the establishment of an independent anti-corruption agency with broad investigative powers.	Completed, September 1, 2014
Completion of a diagnostic study on governance	Completed July 15, 2014
Submit to parliament amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	Completed, September 1, 2014
Approve amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	Completed, End October 2014,
The government will make an official decision to establish by the end of August a mechanism to coordinate efforts aimed at simplification of the regulatory framework (Paragraph 24).	Not completed, End of August 2014
Approve the legislation allowing for establishment of an independent anti-corruption agency with wide powers to investigate.	Not completed, End of October 2014

Table 8. Ukraine: Prior Actions and Structural Benchmarks

Prior actions	**Status**	**Completion date**
Financial Sector		
Parliament will approve legislation that introduces unlimited liability of bank owners on losses arising from loans granted directly or indirectly to the benefit of bank shareholders holding 10 percent or more of total voting shares as of end-2014 (MEFP ¶13).		
Energy Sector		
The energy regulator will adopt and officially publish a decision to raise household gas prices to UAH 3600/tcm for consumption in Tier 1 and UAH 7187/tcm for consumption in Tier 2, effective April 1, 2015 (MEFP ¶28).		
The energy regulator will adopt and officially publish a decision to raise household heating prices to UAH 625/gcal on average, effective April 1, 2015 (MEFP ¶28).		
The Cabinet will submit to Parliament legislative amendments to improve Naftogaz collections. These amendments should include (i) lifting two long-lasting moratoria (Law 2711-IV/2005 and Law 2864-III/2001) that protect energy and other companies from enforcement proceedings; and (ii) disconnecting non-compliant customers from the gas supply grid (MEFP ¶28).		
Fiscal Policy		
Parliament will approve a 2015 supplementary state budget law and a package of tax and expenditure legislation consistent with the program deficit ceiling of UAH 78 billion for the general government, containing the elements described in MEFP ¶23.		
Government will hire financial and legal advisors to facilitate consultations with holders of public sector debt with a view to improving medium-term debt sustainability (MEFP ¶26)	Done	February 11, 2015
Governance		
Parliament will approve legal amendments to ensure that the NAB is subject to a robust external oversight process, can investigate former Presidents, can access all relevant information for its investigations, and that appropriate mechanisms are in place to ensure hiring of staff with high integrity (MEFP ¶32).	Done	February 25, 2015
Structural benchmarks	**Status**	**Completion date**
NBU and Financial Sector		
Parliament will approve amendments to the NBU Law to strengthen the governance and autonomy framework of the NBU (MEFP ¶9).		End-April 2015
NBU will notify banks of any identified discrepancies in the related party exposure reports based on steps (i) and (ii) as described in MEF P¶13.		End-July 2015
Judiciary/Enforcement		
Parliament will approve a law on a selective increase of court fees, aiming to double court fee revenue in real terms within 12 months (MEFP ¶35).		End-May 2015
Parliament will approve a law which strengthens the provisions in the Code of Civil Procedure on Order for Payment for domestic transactions and on garnishment of bank accounts (MEFP¶35).		End-August 2015

Table 8. Ukraine: Prior Actions and Structural Benchmarks (concluded)		
Structural benchmarks (continued)	**Status**	**Completion date**
Fiscal Policy		
Government will prepare a revenue administration reform plan in order to overhaul the state fiscal service. The plan will include measures to implement governance and institutional reforms that clarify the tax agency's reporting to the Minister of Finance; and remove large numbers of underperforming officials as described in MEFP ¶25.		End-April 2015
The State Fiscal Service will transfer all taxpayers meeting large taxpayer criteria to the LTO (MEFP ¶22).		End-December 2015
The State Fiscal Service will implement its new arrangements as specified under the revenue administration reform plan (MEFP ¶25).		End-December 2015
State-Owned Enterprises		
The Ministry of Economy in cooperation with the Ministry of Finance will prepare a statement of fiscal risks emanating from SOEs as described in MEFP ¶36.		End-April 2015
The government will adopt a broad-based strategy (prepared in consultation with the IMF and the World Bank staff) to reform the SOE sector as described in ¶36, including measures needed to improve budgetary oversight, develop a comprehensive ownership policy, strengthen corporate governance, prioritize which enterprises should be made subject to restructuring, and examine options for improving management of other state assets.		End-May 2015
Governance		
Take necessary measures to establish the National Anti-corruption Bureau (MEFP ¶32).		End-April 2015
Strengthen the implementation of the AML framework to prevent the misuse of the financial sector to launder the proceeds of corruption. This includes: (i) regulatory amendments to ensure proper implementation of the legal requirements related to domestic politically exposed persons (PEPs); (ii) the Financial Intelligence Unit (FIU) will develop a system to assist financial institutions in identifying domestic PEPs; and (iii) proper arrangements will be put in place to facilitate cooperation between the NBU, FIU and NAB (MEFP ¶32).		End-June 2015
Energy Sector		
Parliament will approve legislative amendments to improve Naftogaz collections. These amendments should include (i) lifting two long-lasting moratoria (Law 2711-IV/2005 and Law 2864-III/2001) that protect energy and other companies from enforcement proceedings; and (ii) disconnecting non-compliant customers from the gas supply grid (MEFP ¶28).		End-March 2015
Parliament will approve a new gas market law (MEFP ¶28).		End-April 2015
Undertake an independent audit of all Naftogaz receivables (MEFP ¶28).		End-June 2015

Table 9. Ukraine: Indicators of Fund Credit, 2014–25

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
						Projection						
Stock of existing and prospective Fund credit 1/ 2/												
In millions of SDRs	3,941	10,065	11,817	12,940	13,206	11,954	10,699	9,152	7,313	5,255	3,197	1,533
In percent of quota	287	734	861	943	963	871	780	667	533	383	233	112
In percent of GDP	4.5	16.6	18.1	18.2	17.0	14.4	11.9	9.5	7.1	4.8	2.8	1.3
In percent of exports of goods and services	8.3	22.9	25.2	26.1	25.1	21.9	18.5	14.8	11.1	7.5	4.2	1.9
In percent of gross reserves	75.8	77.4	75.4	64.9	54.0	46.2	41.4	34.3	28.4	22.3	15.2	8.4
Stock of existing Fund credit 1/ 2/												
In millions of SDRs	3,941	2,973	2,973	2,344	858	0	0	0	0	0	0	0
In percent of quota	287	217	217	171	63	0	0	0	0	0	0	0
In percent of GDP	4.5	4.9	4.6	3.3	1.1	0	0	0	0	0	0	0
In percent of exports of goods and services	8.3	6.8	6.4	4.7	1.6	0	0	0	0	0	0	0
In percent of gross reserves	75.8	22.9	19.0	11.7	3.5	0	0	0	0	0	0	0
Stock of prospective Fund credit 1/ 2/												
In millions of SDRs	0	7,092	8,844	10,596	12,348	11,954	10,699	9,152	7,313	5,255	3,197	1,533
In percent of quota	0	517	645	772	900	871	780	667	533	383	233	112
In percent of GDP	0	11.7	13.6	14.9	15.9	14.4	11.9	9.5	7.1	4.8	2.8	1.3
In percent of exports of goods and services	0	16.2	18.9	21.3	23.5	21.9	18.5	14.8	11.1	7.5	4.2	1.9
In percent of gross reserves	0	54.6	56.4	53.1	50.5	46.2	41.4	34.3	28.4	22.3	15.2	8.4
Obligations to the Fund from existing and prospective drawings 2/												
In millions of SDRs	0	966	246	928	1,864	1,641	1,601	1,839	2,066	2,207	2,126	1,692
In percent of quota	0	70	18	68	136	120	117	134	151	161	155	123
In percent of GDP	0	1.6	0.4	1.3	2.4	1.98	1.78	1.92	2.02	2.03	1.84	1.38
In percent of exports of goods and services	0	2.2	0.5	1.9	3.5	3.0	2.8	3.0	3.1	3.1	2.8	2.1
In percent of gross reserves	0	7.4	1.6	4.7	7.6	6.3	6.2	6.9	8.0	9.4	10.1	9.2
Obligations to the Fund from existing drawings 2/												
In millions of SDRs	0	851	32	660	1,506	862	0	0	0	0	0	0
In percent of quota	0	62	2	48	110	63	0	0	0	0	0	0
In percent of GDP	0	1.4	0.0	0.9	1.9	1.0	0	0	0	0	0	0
In percent of exports of goods and services	0	1.9	0.1	1.3	2.9	1.6	0	0	0	0	0	0
In percent of gross reserves	0	6.5	0.2	3.3	6.2	3.3	0	0	0	0	0	0
Obligations to the Fund from prospective drawings 2/												
In millions of SDRs	0	116	214	268	358	779	1,601	1,840	2,066	2,208	2,127	1,693
In percent of quota	0	8	16	20	26	57	117	134	151	161	155	123
In percent of GDP	0	0.2	0.3	0.4	0.5	0.9	1.8	1.9	2.0	2.0	1.8	1.4
In percent of exports of goods and services	0	0.3	0.5	0.5	0.7	1.4	2.8	3.0	3.1	3.1	2.8	2.1
In percent of gross reserves	0	0.9	1.4	1.3	1.5	3.0	6.2	6.9	8.0	9.4	10.1	9.2

Source: IMF staff estimates.

1/ End of period.

2/ Repayment schedule based on repurchase obligations and charges.

Table 10. Ukraine: Proposed Schedule of Purchases Under the Extended Arrangement

Date	Amount of purchase: Millions of SDRs	Millions of US$ 1/	Percent of quota	Conditions
Mar 11, 2015	3,546.000	4,999.86	258.45	Board approval of extended arrangement
June 15, 2015	1,182.100	1,666.76	86.16	First review and end-March 2015 performance criteria
September 15, 2015	1,182.100	1,666.76	86.16	Second review and end-June 2015 performance criteria
December 15, 2015	1,182.100	1,666.76	86.16	Third review and end-September 2015 performance criteria
March 15, 2016	437.975	621.92	31.92	Fourth review and end-December 2015 performance criteria
June 15, 2016	437.975	621.92	31.92	Fifth review and end-March 2016 performance criteria
September 15, 2016	437.975	621.92	31.92	Sixth review and end-June 2016 performance criteria
December 15, 2016	437.975	621.92	31.92	Seventh review and end-September 2016 performance criteria
March 15, 2017	437.975	626.30	31.92	Eigth review and end-December 2016 performance criteria
June 15, 2017	437.975	626.30	31.92	Ninth review and end-March 2017 performance criteria
September 15, 2017	437.975	626.30	31.92	Tenth review and end-June 2017 performance criteria
December 15, 2017	437.975	626.30	31.92	Eleventh review and end-September 2017 performance criteria
March 15, 2018	437.975	630.68	31.92	Twelfth review and end-December 2017 performance criteria
June 15, 2018	437.975	630.68	31.92	Thirteenth review and end-March 2018 performance criteria
September 15, 2018	437.975	630.68	31.92	Fourteenth review and end-June 2018 performance criteria
December 15, 2018	437.975	630.68	31.92	Fifteenth review and end-September 2018 performance criteria
Total	12,348	17,516	900	

Source: IMF staff estimates.

1/ For 2015-18, the USD/SDR rates used in this table are: 1.41, 1.42, 1.43, 1.44, respectively.

Annex I. Regional Economic Developments in Ukraine

Tale of Three Regions

Recent indicators suggest that economic developments in the conflict region of Donbass are increasingly decoupling from the rest of the country.

- **In 2014, the economic indicators in Donetsk and Luhansk plummeted, with the exception of agriculture, as the conflict in the East intensified** (Figure 1). Industrial production and exports—a significant part of which goes to Russia—were the most affected. Retail sales also dropped significantly, weighed down by declining real wages, growing outward migration, and accumulation of economy-wide wage arrears.

- **Meanwhile, economic developments in the rest of the country have started to show some signs of stabilization, although economic activity and trade continue to be depressed**. The decline in industrial production and exports in the South and the Western regions in particular, appear to have bottomed out. This trend partly reflects the economic orientation towards the EU in these regions. Domestic demand continues to weaken however, albeit at a much slower pace than in the conflict zone, as evidenced by a persisting decline in retail sales and imports.

- **While bank performance is weakening across the country, pressures appear more acute in the East**. Deposit withdrawals have been more sizable in the east reflecting the low confidence. In 2014 households deposit outflows in these regions reached 57 percent and was stronger than the average for Ukraine (24.3 percent). Trend decline continues in all the regions reflecting the generalized loss of confidence and banking sector difficulties across the whole country.

Deposit and Credit Growth by Regions since end-2013

(percentage, at fixed ER of 7.993 UAH/US$)

	Deposit	Credit			NPLs at end-Dec 2014 1/		
	Household	Total	Household	Corporate	Total	Household	Corporate
Donetsk	-57.0	-41.3	-18.9	-48.2	15.4	16.7	15.0
Luhansk	-50.9	-11.3	-19.6	-2.9	31.3	16.7	42.4
Rest of Ukraine	-20.1	-11.3	-12.2	-11.1	12.7	20.4	11.0
Ukraine, total	-24.3	-13.2	-12.9	-13.2	13.0	20.1	11.4

Source: National Bank of Ukraine.

1/ Overdue loans to total loans in percent.

Growth Rates of Budget Revenue
(percent; 2014 relative to 2013)

	State Budget	Local Budgets	Social Security Funds	Total
East Ukraine (Donetsk and Luhansk)	-32	-23	-21	-26
Share of total in 2014	*6*	*13*	*14*	*9*
Rest of Ukraine	13	7	4	5
Ukraine, Total	8	2	-1	5

Source: Ukrainian authorities.
1/ Before VAT refunds.

- **Tax revenues from the East declined heavily, and were exacerbated by the government decision on evacuation effective from December 1, 2014 of government offices from the region which is not directly controlled by the authorities**. Tax collection in the rest of the country continues to grow in nominal terms given the high inflation and exchange rate depreciation.

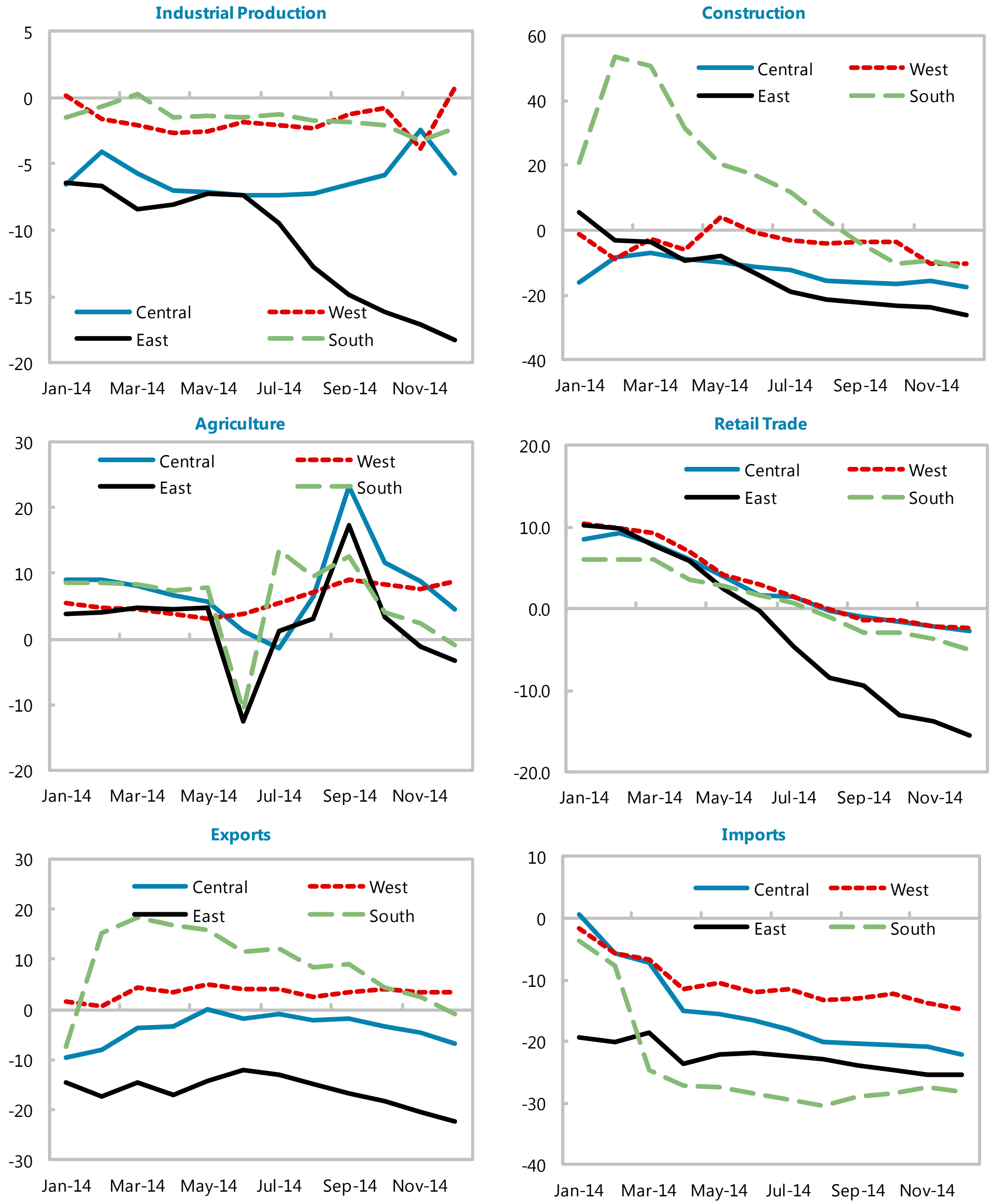
- **Within Donbass itself, there are also increasing signs of divergences**. Developments in Donetsk and Luhansk stay in sharp contrast to those in neighboring Eastern sub-regions of Dnipropetrovsk and Kharkiv (Figure 2, 3). To some extent, this reflects (i) reallocation of businesses and population from the direct conflict zone, and (ii) the fact that key large businesses are able to move part of their goods and money across the demarcation line. In addition, both Dnipropetrovsk and Kharkiv are gaining importance as exports centers in the East.

- **The divergence between the east and rest of Ukraine appears to reflect the limited direct regional interlinkages between the regions**. The main link appears to be from the sourcing of energy. Aside from iron ore and thermal coal, the domestic supply chain between the East and the rest of the country is limited. The loss of access to coal, important specifically for steel production and heating, is partially compensated via imports from other countries, including South Africa and Russia. Consequently, the direct spillover impact on the rest of Ukraine has not been large.

- **The data also reflects the loss of government control in the East**. Based on the government decision, all government offices from the areas not under direct authorities' control have been evacuated, starting December 1, 2014. The authorities maintain data coverage of the region, despite growing difficulties in obtaining information. Public wage and pension payments in the regions have been halted. Pensioners are encouraged to migrate from the rebel-controlled areas and seek an internally displaced person (IDPs) status in order to be able to claim their pensions. Currently, over 500,000 pensioners have already obtained an IDP status. The government offers social assistance to support the reallocation process.

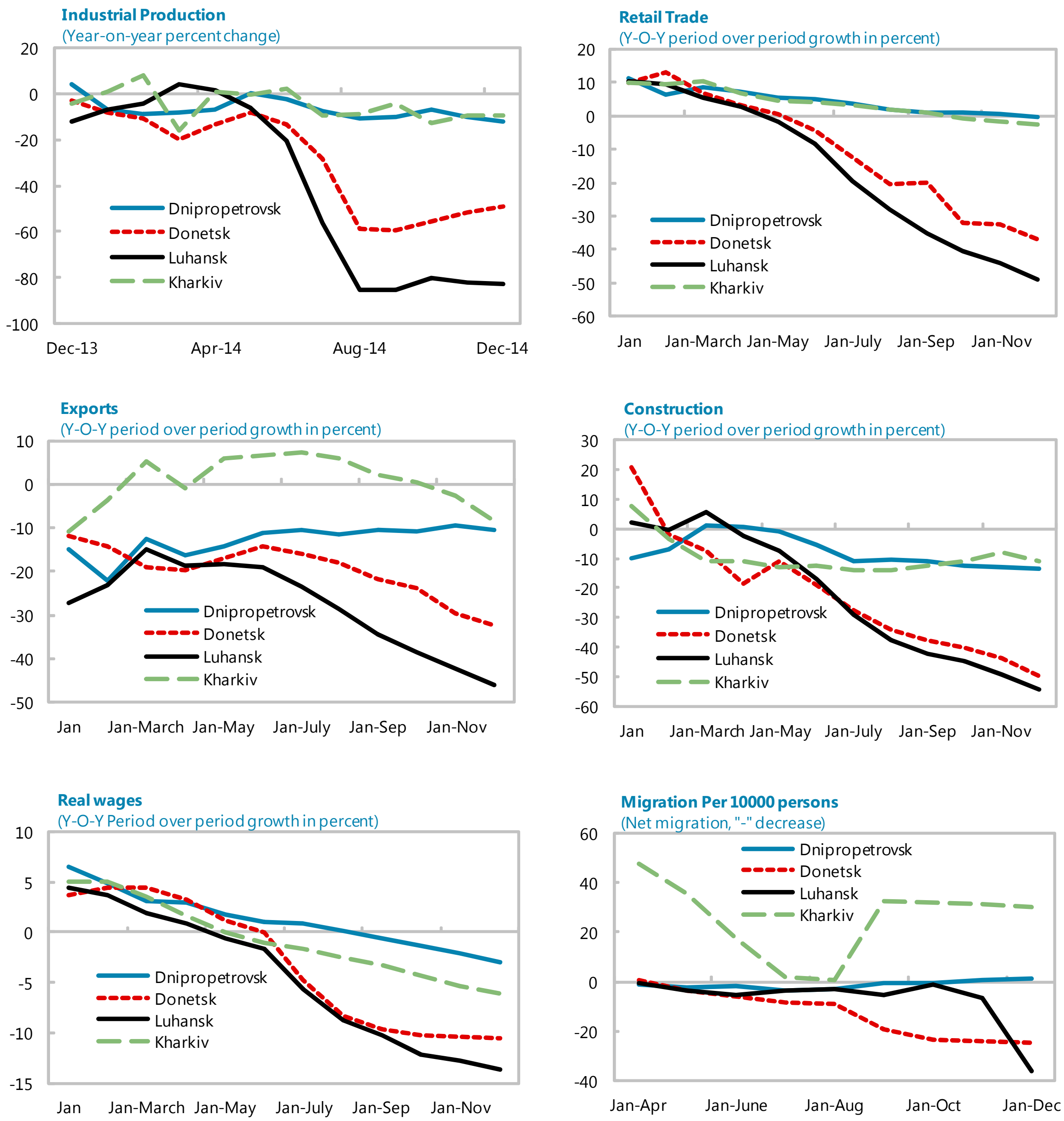
Figure 1. Ukraine: High Frequency Indicators by Regions

(Y-O-Y Period over Period Growth in Percent)



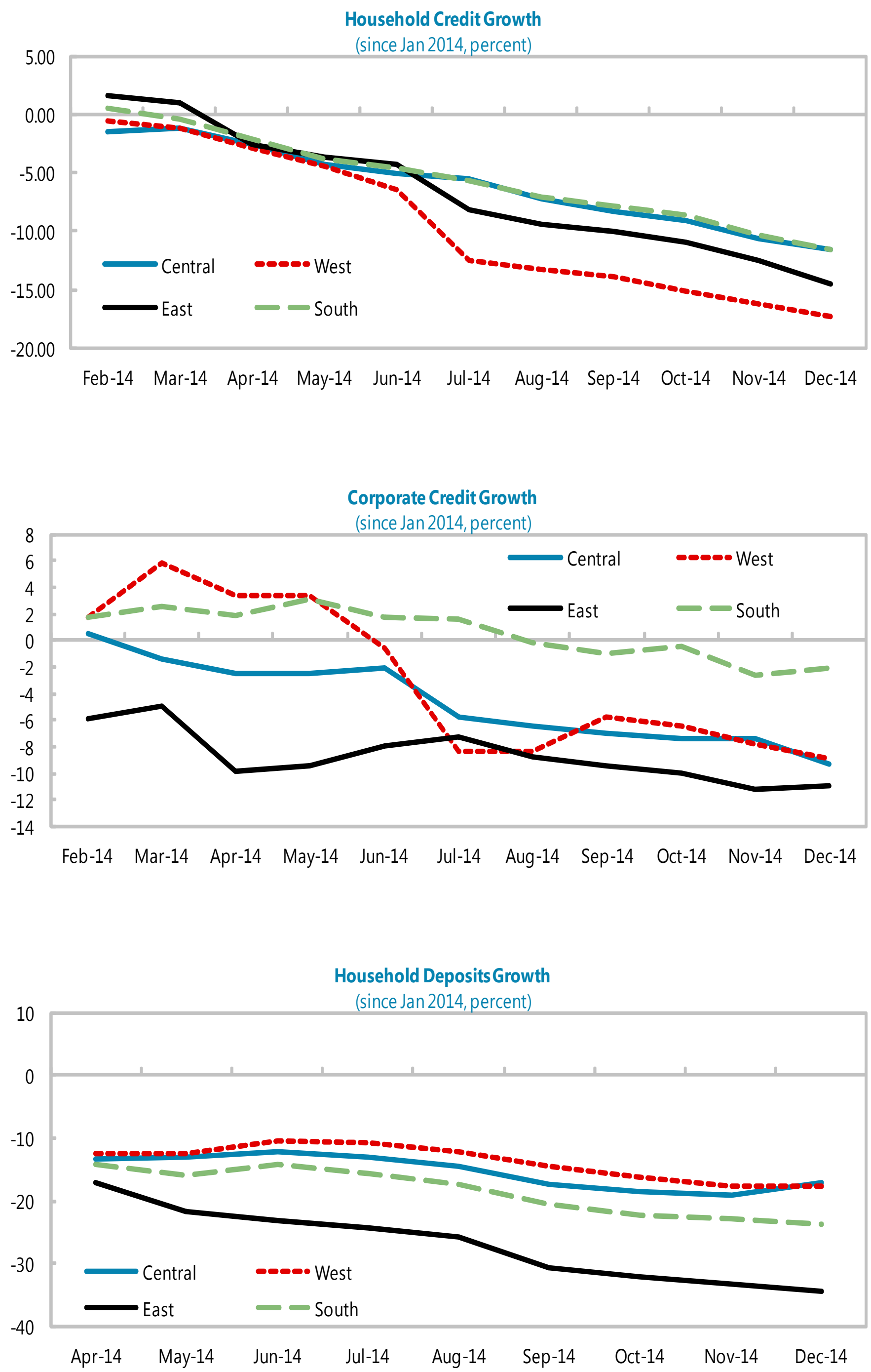
Source: State Statistics Service of Ukraine.

Figure 2: Ukraine: Developments in the East, 2014



Source: State Statistics Service of Ukraine.

Figure 3. Ukraine: Credit Developments by Region, 2014



Source: National authorities.

Annex II. Debt Sustainability Analysis

Under the policy and financing package supporting the proposed extended arrangement under the EFF including the expected outturn from the debt operation, Ukraine's public debt is assessed as sustainable with high probability. Such an assessment hinges crucially on four main assumptions: (i) the full implementation of policies under the program; (ii) adequate and timely external financing from the official sector; (iii) completion of a debt operation with holders of Ukraine's public sector debt; and (iii) the non-intensification of the conflict in the East. Given the sizable exchange rate depreciation and quasi-fiscal financing needs during 2014-15, public debt is projected to peak at 94 percent of GDP in 2015, above the 70 percent of GDP high-risk benchmark used in the debt sustainability framework. Debt is projected to decline thereafter—reaching 71 percent of GDP by 2020—driven by the successful completion of the envisaged debt operation, sustained fiscal adjustment, the elimination of quasi-fiscal losses in the energy sector, and growth recovery. The projected downward trajectory of Ukraine's public debt is subject to considerable risks, particularly from growth and real exchange rate shocks, and larger than expected contingent liabilities emanating from the banking sector. The average gross financing needs during the program and post-program period are forecast to remain below 15 percent of GDP, somewhat mitigating the risks associated with the high debt level. The shift in the composition of debt towards official debt with longer maturity and lower cost also lessens the risks. The external DSA points to significant solvency concerns as external debt would peak at about 158 percent of GDP in 2015, but the presence of significant corporate assets in foreign currencies provides a buffer for maintaining external debt service while a sustained reduction in current account deficits and the ongoing process of voluntary private debt restructuring would put external debt on a downward path. Though external debt would remain on a downward trend, growth and export shocks would keep it more elevated than under the baseline.

1. **This appendix considers the analysis of sustainability of Ukraine's public and external debt**. Section A provides an overview of the macro, policy, and financing assumptions underpinning the program macro framework. Section B considers public debt sustainability, examining the debt trajectory under the program baseline, and under a variety of stress scenarios. Section C considers external debt sustainability. The analysis shows that the EFF-supported program would help place Ukraine's debt on a sustainable trajectory, but there are significant risks that its downward path may be interrupted by shocks.

A. Key assumptions in the DSA

2. **Macroeconomic and fiscal assumptions**. Real GDP growth is projected at -5½ percent in 2015, gradually rising to 4 percent by 2018. Inflation (measured by the GDP deflator) is projected to peak at 27½ percent in 2015, as the effect of the large exchange rate depreciation in 2014–15 and energy price increases are fully transmitted. The combined general government and Naftogaz overall deficit is projected to shrink from 10.1 percent of GDP in 2014 to 7.4 percent in 2015, and then embark on a gradual consolidation reaching 2.7 percent of GDP by 2020. The near-term adjustment path involves a primary surplus of 1.1 percent of GDP in 2015 (an improvement of 2¼ percentage points of GDP over 2014), followed by a medium-term sustained fiscal effort to

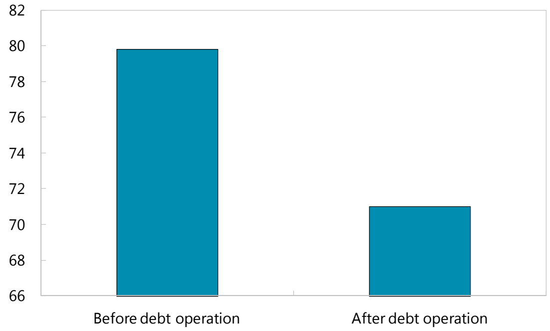
attain a primary surplus of about 1.6 percent (Figure 3). This path is ambitious in the context of previous fiscal performance in Ukraine (an average primary deficit of 2.4 percent of GDP over 2004–13) and international comparisons (well above the 75th percentile of historical primary balance adjustments in countries with IMF-supported programs, Figure 2), though it is not unprecedented.

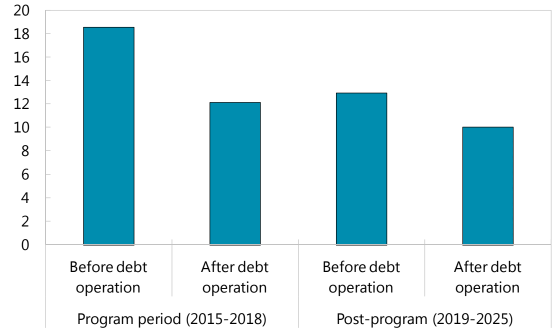
3. **Banking system support**. The program estimate of fiscal needs to support bank restructuring in 2014-15 is 9¼ percent of GDP. This is mainly explained by the incorporation of potential additional losses associated with the conflict in the East and the higher than expected exchange rate depreciation. Given uncertainties and risks associated with the estimates of the effect of these shocks, as well as private efforts to recapitalize and restructure banks, this estimate (and the DSA) incorporates a buffer of nearly 4 percent of GDP in public funds to absorb additional bank recapitalization and resolution needs.

4. **Debt operation**. Given Ukraine's high debt level, resolving its balance of payments problem and achieving debt sustainability with high probability also call for private sector involvement through a debt operation. The DSA is underpinned by the following program objectives that will guide the debt operation: (i) generate US$15 billion in public sector financing during the program period; (ii) bring the public and publicly guaranteed debt/GDP ratio from a projected 80 percent of GDP to under 71 percent of GDP by 2020; and (iii) keep the budget's gross financing needs at an average of 10 percent of GDP (maximum of 12 percent of GDP annually) in 2019–2025. As expected, the debt operation would also reduce notably the gross financing needs during the program period (2015-18), from an average of 18 percent of GDP to 12 percent (charts below).

5. **Official financing**. Multilateral and bilateral funding is provided at low borrowing costs (tied to Euribor/Libor and fixed annual rates below two percent, respectively), with loans amortizing in the range of 10-20 years (with multilaterals granting around 5 year grace period). IMF lending is calibrated to be on EFF terms.

6. **Market access**. Evidence points to an early return to market access in past successful debt operations with time to re-access at about 3 years. Ukraine's time to re-access markets after its 1998 debt restructuring was also about 3 years. It is then assumed that by late 2017 Ukraine would be able to re-access international capital markets. The re-access would be facilitated by the improved liquidity needs with an average GFN during 2017-2025 below 10 percent of GDP as a result of the debt operation. Market access is expected to gradually increase during the post-program period.





B. Public Sector DSA

7. **The coverage of public debt in this DSA includes**: (i) central government direct debt (including domestic debt held by the NBU amounting to 21 percent of GDP at end-2014); (ii) government guarantees on loans/bonds extended to state-owned enterprises; (iii) debt of local governments; and (iv) National Bank of Ukraine's (NBU's) liabilities to the IMF.

Ukraine: Public and Publicly Guaranteed Debt, 2014

	UAH (Billion)	USD (Billion)	Percent of GDP	Percent of total
Public and publicly guaranteed debt	**1116**	**70.8**	**72.7**	**100.0**
Domestic debt	**495**	**31.4**	**32.3**	**44.4**
Direct debt in UAH	400	25.4	26.1	35.8
Direct debt in FX	67	4.3	4.4	6.0
Guaranteed debt	28	1.8	1.8	2.5
External debt	**621**	**39.4**	**40.5**	**55.6**
External direct debt	**495**	**31.4**	**32.3**	**44.4**
Multilateral 1/	171	10.8	11.1	15.3
of which: IMF budget support	86	5.4	5.6	7.7
Bilateral 2/	43	2.7	2.8	3.9
Sovereign Eurobonds	273	17.3	17.8	24.4
Local government Eurobonds 3/	9	0.6	0.6	0.8
External guaranteed debt	**126**	**8.0**	**8.2**	**11.3**
of which: IMF loans to NBU	34	2.2	2.2	3.1
of which: Eurobonds	29	1.8	1.9	2.6

Sources: Ministry of Finance
1/ Includes IMF, WB, EBRD, EIB.
2/ Includes EU.
3/ Issued by the city of Kyiv.

8. **Baseline projections indicate that the debt ratio would fall to 71 percent of GDP in 2020 after the debt operation** (Figure 3). Debt reached 73 percent of GDP at end-2014, a jump of about 30 percentage points from 2013, driven by the large exchange rate depreciation and notable external and domestic financing needs, mainly for Naftogaz. Similar factors at play in 2015 would

lead public debt to peak at about 94 percent of GDP. Once the debt operation is completed, fiscal adjustment entrenched, and growth restored, the debt ratio is expected to gradually converge to 71 percent of GDP, near the DSA high-risk benchmark.

9. **A heat map and fan charts indicate that Ukraine faces significant risks to debt sustainability** (Figure 1). Even with a successful program implementation and debt operation, significant uncertainty remains. However, risks stemming from the elevated debt level are mitigated by improved gross financing needs, projected to average below 15 and 10 percent during and after the program period, respectively. The fan charts illustrate the possible evolution of the debt-to-GDP ratio over the medium term, based on both a symmetric and asymmetric distribution of risks. In the former, upside and downside risks to the main macro variables are treated as equally likely, while in the latter shocks to the primary balance and REER are restricted to be negative to reflect the ambitious fiscal adjustment plan and the possibility of continued depreciation. The asymmetric fan chart therefore shows that risks to the debt outlook are skewed upward if the envisaged fiscal consolidation and FX market stabilization fall short of expectations. Risks to the debt profile are mixed. Current public perceptions of risk as captured by EMBIG spreads are high as they are reflecting investors' expectations of debt restructuring. The share of public debt held by non-residents is high, but the shift from private to official creditors is reducing the implied risks. On the other hand, short-term debt ratios are very low, and the share of external debt is projected to decline in the coming years, mitigating rollover and exchange rate risks.

10. **Stress tests point to a number of sensitivities, with the balance of risk mostly tilted to the downside**. The projected decline in public debt remains fragile, vulnerable to lower growth, continued exchange rate depreciation, and contingent liabilities emanating from the banking system. Under a growth shock, entailing a cumulative growth decline of over 9 percentage points in 2016–17, the debt-to-GDP ratio reaches nearly 119 percent in 2017. A real exchange rate shock not dissimilar to the one in 2014 would also keep the debt ratio above 100 percent of GDP throughout the projection period. The combined macro-fiscal shock, an aggregation of the shocks to real growth, interest rate, primary balance and exchange rate, produces unsustainable dynamics, sending debt above 200 percent of GDP in 2017. The contingent liabilities shock highlights the risk of a further deterioration of the banking sector and associated higher fiscal costs. Its impact is mitigated by the buffer embedded under the baseline for larger-than-expected bank restructuring costs. By imposing a large associated shock to growth (14 percentage points below the baseline in 2016–17) and given the resulting deterioration in the primary balance together with an increase in interest rates, under the contingent liabilities shock debt peaks at 116 percent of GDP in 2017.

11. **The baseline and shocks scenarios highlight the considerable risks related to potentially larger than expected financing needs of the banking sector and Naftogaz in the near term**. However, under the baseline, gross financing needs breach the high-risk benchmark of 15 percent of GDP only in 2015, as a result of the extensive support to the banking sector and Naftogaz. The average gross financing need for the remainder of the program period lies below 10 percent of GDP. Under stress tests, only the combined shock has a meaningful impact on gross

financing needs, raising it to an average of more than 20 percent of GDP during the projection period.

C. External Sector DSA

12. **Baseline projections suggest that external debt could drop by 44 percentage points of GDP by 2020, while remaining high**. Assuming a successful implementation of policies under the program, adequate and timely external financing from the official and private sectors, and non-intensification of the conflict in the East, the gross external debt-to-GDP ratio would peak at 158 percent of GDP in 2015 from a level close to 100 percent in 2014 before declining to 115 percent of GDP by end-2020. The medium term sustainability of external debt is underpinned by the significant external adjustment, with the trade balance of goods and services moving from a deficit of close to 10 percent of GDP in 2013 to almost balance in the medium term. Its downward path is also supported by the impact of the debt operation through the income balance in the current account. Moreover, private corporations maintain significant foreign currency assets—covering 86 percent of their foreign currency liabilities as of September 2014—which reduce their net exposure to external shocks and help them maintain external debt service. Finally, a number of large corporations have already engaged in voluntary debt restructuring/rollover operations.

13. **However, external debt dynamics are subject to downside risks due to macroeconomic shocks or a quick reversal of the recent external adjustment** (Figure 6). A slower-than-expected resumption of export growth, due to a protracted impact of the war-induced supply shocks or to delays in finding suitable markets for products previously targeted to CIS trading partners, could undo the adjustment of the current account deficit at the time when imports start to respond to growth recovery. If the current account deteriorates on average by 1 percent of GDP per year compared to the baseline, the external debt ratio would increase by about 10 percent of GDP by 2020. More importantly, the external debt dynamics are significantly affected by a growth shock. A half historical standard deviation shock from the growth path under the baseline, about 2½ percentage points lower growth on average per year, increases the external debt ratio by about 25 percentage points of GDP by 2020. Reduced FDI due to confidence effects from a prolongation or intensification of the conflict in the East would also significantly affect external debt dynamics, with a sizable upward shift in the debt adjustment path.

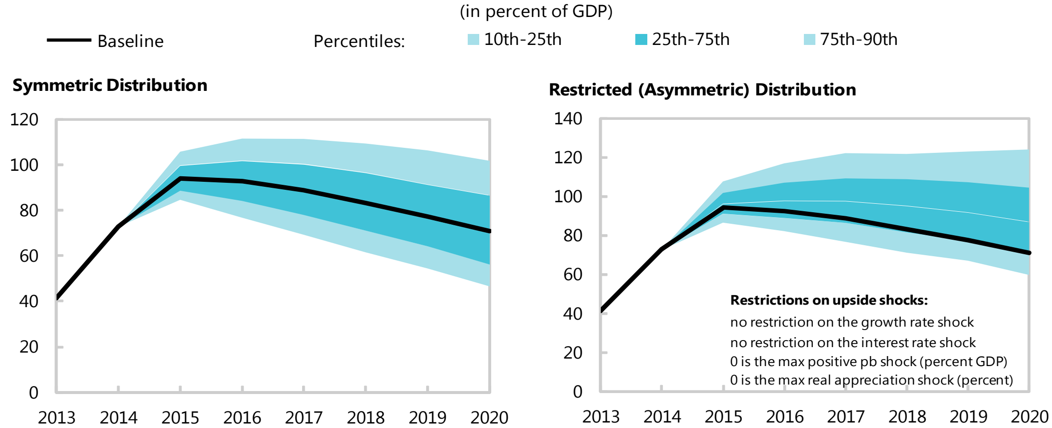
Annex II. Figure 1. Ukraine Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

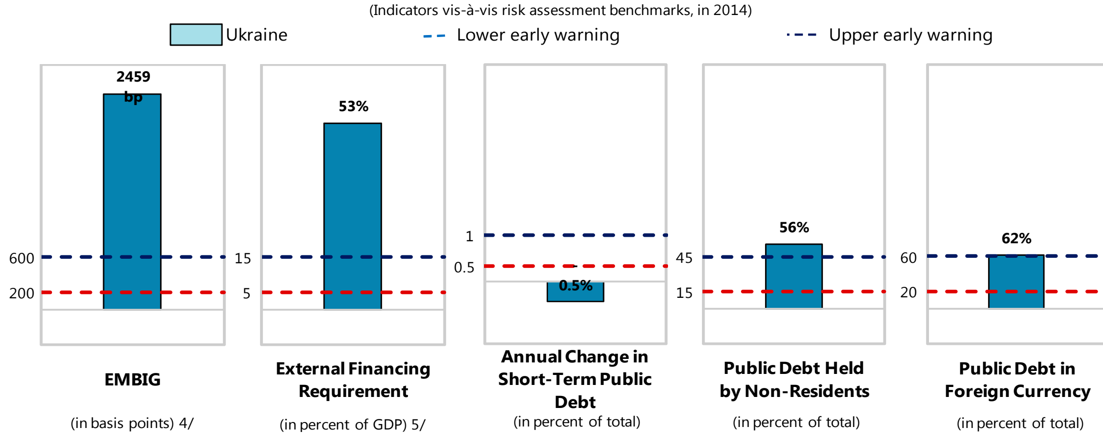
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

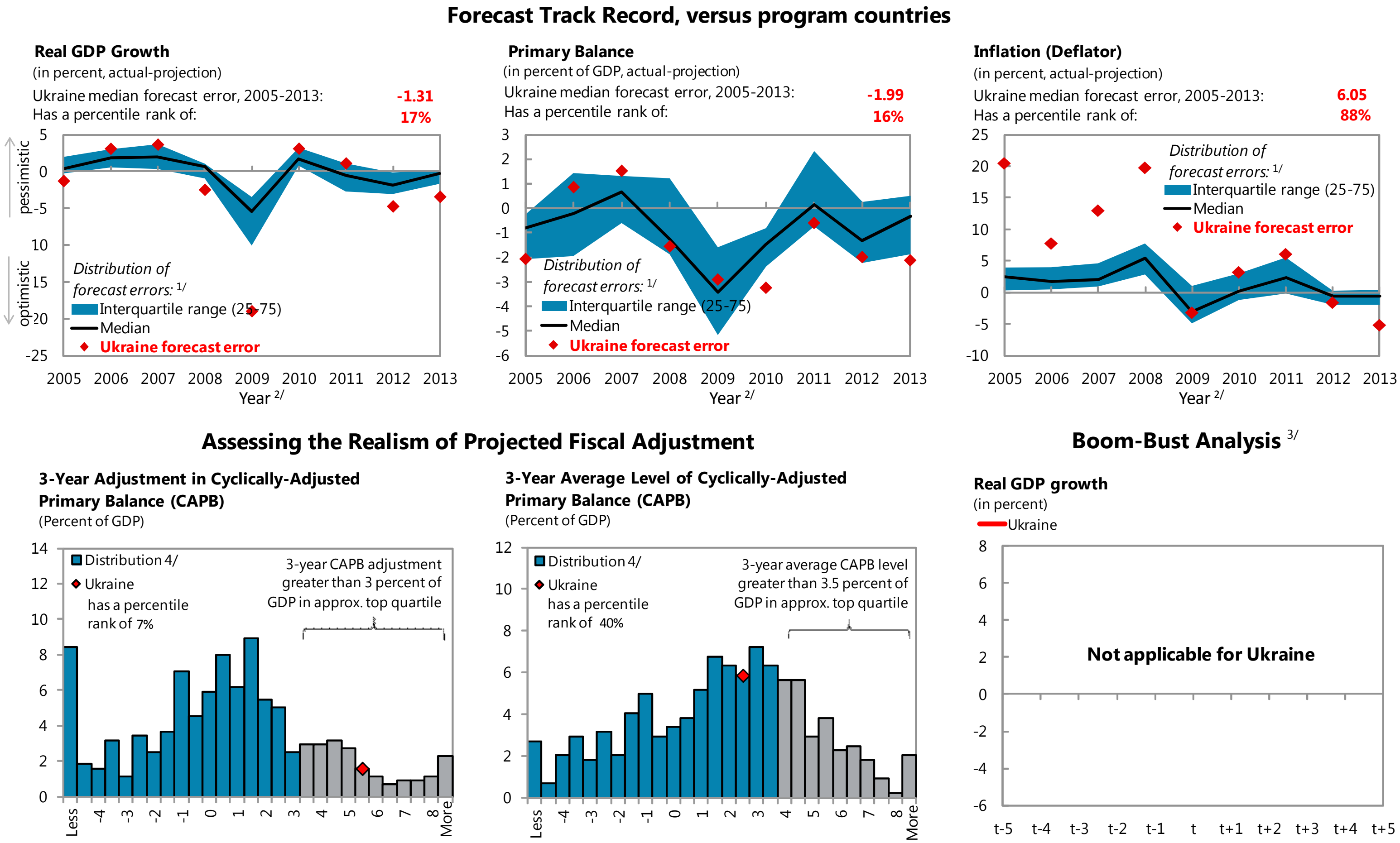
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 15-Nov-14 through 13-Feb-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex II. Figure 2. Ukraine Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Ukraine, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex II. Figure 3. Ukraine Public DSA – Baseline Scenario

(in percent of GDP unless otherwise indicated)

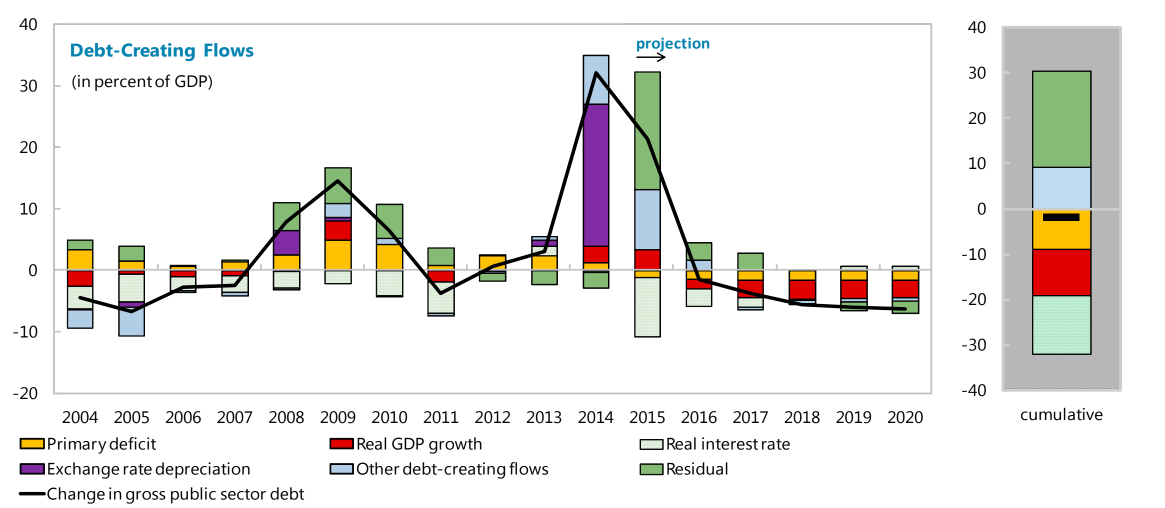
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	26.2	40.6	72.7	94.1	92.6	88.9	83.3	77.3	71.0
Of which: guarantees	6.2	7.3	10.0	19.8	21.0	21.8	20.8	18.6	15.2
Public gross financing needs	6.1	9.9	12.4	20.5	10.9	8.8	10.3	9.1	9.8
Real GDP growth (in percent)	2.6	0.2	-6.9	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation (GDP deflator, in percent)	17.2	4.1	12.5	27.6	10.6	9.0	7.2	6.0	6.0
Nominal GDP growth (in percent)	20.4	4.4	4.7	20.5	12.8	12.9	11.5	10.3	10.3
Effective interest rate (in percent) [4]	6.5	8.7	10.8	10.0	7.5	7.5	7.3	7.1	7.2

As of February 24, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		2671
5Y CDS (bp)		2500
Ratings	Foreign	Local
Moody's	Caa3	Caa3
S&Ps	CCC	B-
Fitch	CC	CCC

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	1.0	3.1	32.1	21.4	-1.5	-3.7	-5.6	-6.0	-6.4	-1.8	
Identified debt-creating flows	-1.4	5.3	34.7	2.3	-4.2	-6.5	-5.5	-4.5	-4.4	-22.8	
Primary deficit	2.4	2.3	1.2	-1.1	-1.4	-1.6	-1.6	-1.6	-1.6	-8.9	-2.2
Primary (noninterest) revenue and grants	41.3	43.3	41.7	42.8	40.3	40.7	40.8	40.7	40.3	245.6	
Primary (noninterest) expenditure	43.8	45.6	42.9	41.7	38.8	39.1	39.2	39.2	38.7	236.7	
Automatic debt dynamics [5]	-3.1	2.5	25.5	-6.3	-4.5	-4.4	-3.4	-2.4	-2.2	-23.2	
Interest rate/growth differential [6]	-3.5	1.6	2.3	-6.3	-4.5	-4.4	-3.4	-2.4	-2.2	-23.2	
Of which: real interest rate	-3.0	1.7	-0.3	-9.7	-2.8	-1.5	-0.2	0.6	0.6	-12.9	
Of which: real GDP growth	-0.5	-0.1	2.7	3.3	-1.7	-2.9	-3.2	-3.0	-2.8	-10.2	
Exchange rate depreciation [7]	0.4	0.9	23.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.7	0.5	8.0	9.8	1.7	-0.5	-0.5	-0.6	-0.6	9.2	
Net Privatization Proceeds (negative)	-1.3	-0.1	-0.1	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6	-3.2	
Bank and Naftogaz recapitalization	0.6	0.6	8.0	10.2	2.2	0.0	0.0	0.0	0.0	12.4	
Other adjustments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	2.4	-2.3	-2.5	19.1	2.8	2.8	-0.2	-1.4	-2.0	21.0	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as domestic and external guarantees. Projections assume new guarantees issuance of 1.6 percent of GDP in 2015, 1 percent in 2016-17, and 0.5 percent in 2018-2020.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes changes in the stock of guarantees (including IMF financing to NBU), and asset changes. For projections, includes exchange rate changes during the projection period.

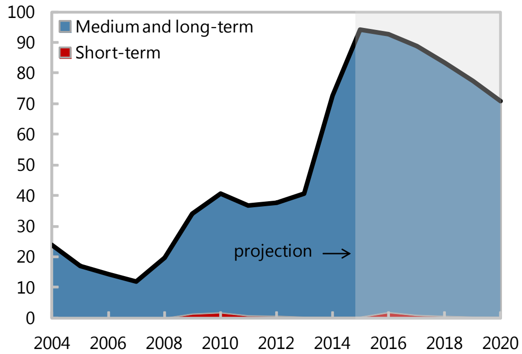
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex II. Figure 4. Ukraine Public DSA – Composition of Public Debt and Alternate Scenarios

Composition of Public Debt

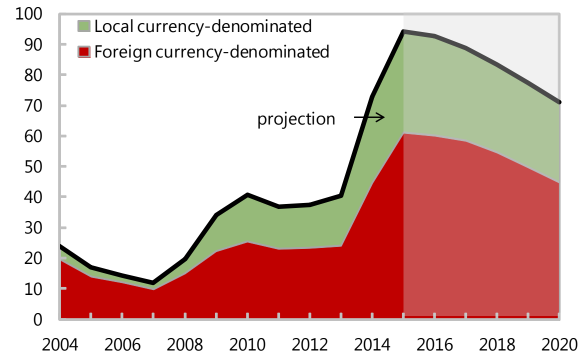
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

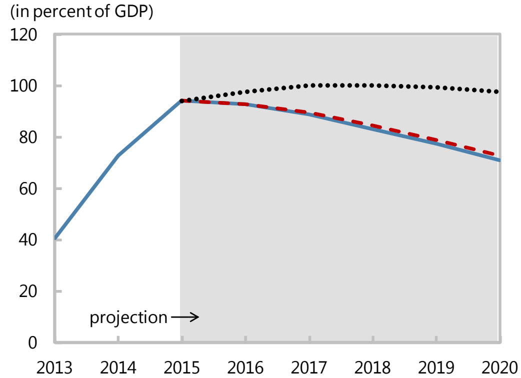


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

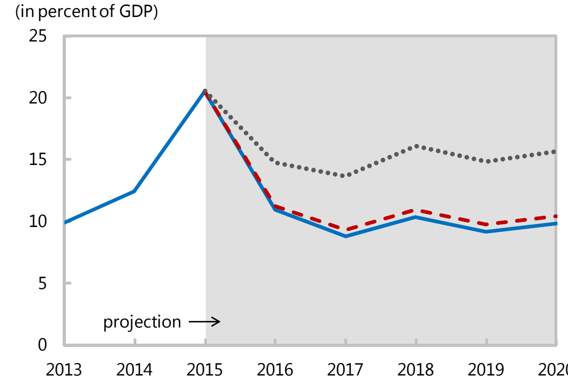
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

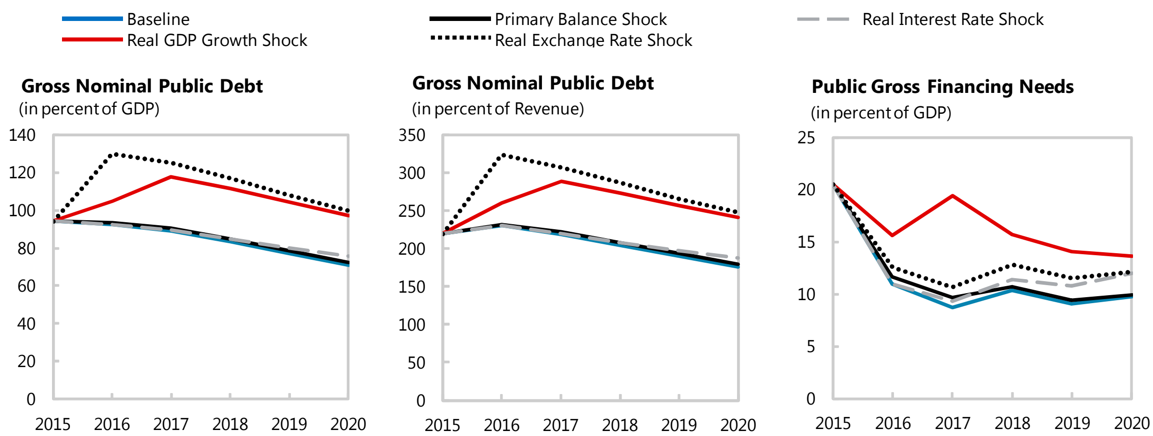
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation	27.6	10.6	9.0	7.2	6.0	6.0
Primary Balance	1.1	1.4	1.6	1.6	1.6	1.6
Effective interest rate	10.0	7.5	7.5	7.3	7.1	7.2
Constant Primary Balance Scenario						
Real GDP growth	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation	27.6	10.6	9.0	7.2	6.0	6.0
Primary Balance	1.1	1.1	1.1	1.1	1.1	1.1
Effective interest rate	10.0	7.5	7.5	7.3	7.1	7.2

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-5.5	0.5	0.5	0.5	0.5	0.5
Inflation	27.6	10.6	9.0	7.2	6.0	6.0
Primary Balance	1.1	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	10.0	7.5	6.9	6.2	5.4	5.0

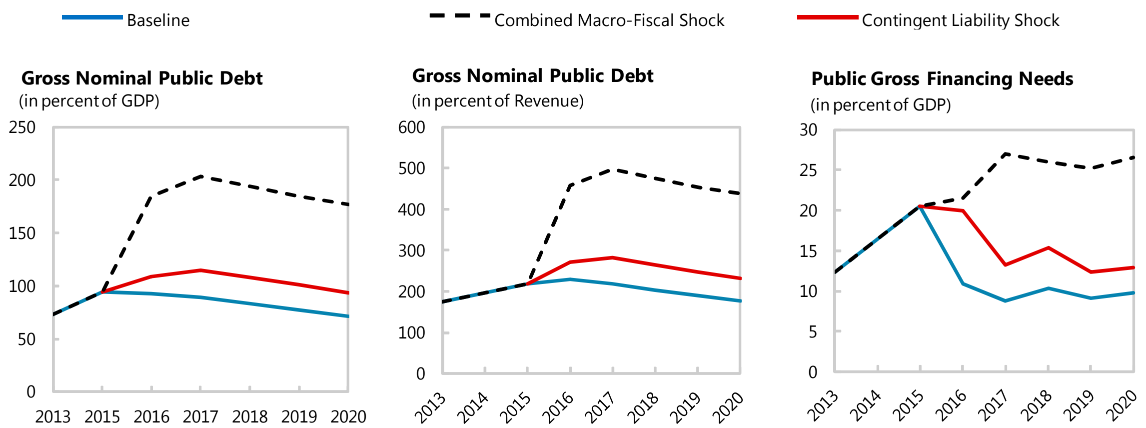
Source: IMF staff.

Annex II. Figure 5. Ukraine Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

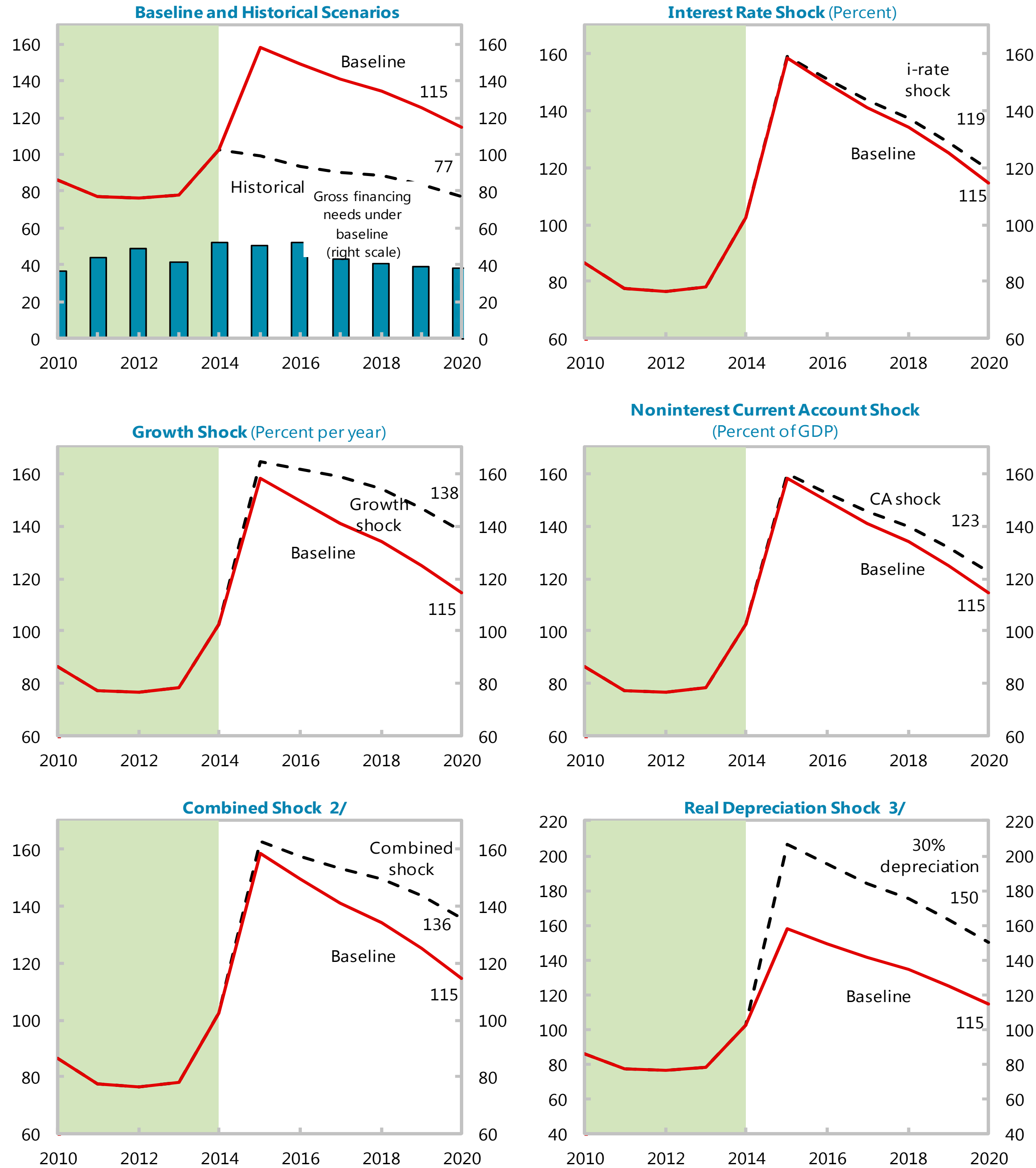
Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation	27.6	10.6	9.0	7.2	6.0	6.0
Primary balance	1.1	0.7	0.9	1.6	1.6	1.6
Effective interest rate	10.0	7.5	7.6	7.3	7.1	7.2
Real Interest Rate Shock						
Real GDP growth	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation	27.6	10.6	9.0	7.2	6.0	6.0
Primary balance	1.1	1.4	1.6	1.6	1.6	1.6
Effective interest rate	10.0	7.5	8.4	8.9	9.5	10.4
Combined Shock						
Real GDP growth	-5.5	-5.0	-3.5	4.0	4.0	4.0
Inflation	27.6	8.9	7.3	7.2	6.0	6.0
Primary balance	1.1	-2.1	-5.8	1.6	1.6	1.6
Effective interest rate	10.0	10.4	6.3	7.1	7.7	8.7

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-5.5	-5.0	-3.5	4.0	4.0	4.0
Inflation	27.6	8.9	7.3	7.2	6.0	6.0
Primary balance	1.1	-2.1	-5.8	1.6	1.6	1.6
Effective interest rate	10.0	7.5	7.8	7.9	7.5	7.4
Real Exchange Rate Shock						
Real GDP growth	-5.5	2.0	3.5	4.0	4.0	4.0
Inflation	27.6	40.6	9.0	7.2	6.0	6.0
Primary balance	1.1	1.4	1.6	1.6	1.6	1.6
Effective interest rate	10.0	10.4	6.3	6.2	6.2	6.4
Contingent Liability Shock						
Real GDP growth	-5.5	-5.0	-3.5	4.0	4.0	4.0
Inflation	27.6	8.9	7.3	7.2	6.0	6.0
Primary balance	1.1	-6.1	1.6	1.6	1.6	1.6
Effective interest rate	10.0	8.0	7.7	7.4	7.0	7.1

Source: IMF staff.

Annex II. Figure 6. Ukraine: External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ In line with standard IMF stress tests, the shock simulates the impact of a one-time real depreciation of 30 percent in 2015.

Annex II. Table 1. Ukraine: Program External Debt Sustainability Framework, 2012–20

(Percent of GDP, unless otherwise indicated)

	Actual			Projections					
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Baseline: external debt	76.6	78.3	102.4	158.4	149.5	141.2	134.3	125.0	114.8
Change in external debt	-0.7	1.6	24.2	55.9	-8.9	-8.3	-6.9	-9.3	-10.2
Identified external debt-creating flows (4+8+9)	-4.3	0.8	37.5	6.5	-3.3	-6.6	-8.4	-7.1	-5.0
Current account deficit, excluding interest payments	2.4	3.2	-1.3	-7.3	-6.7	-6.4	-6.0	-5.0	-4.1
Deficit in balance of goods and services	8.2	8.7	4.2	0.4	0.6	0.5	0.5	0.7	1.2
Exports	51.2	47.6	53.7	72.5	71.8	69.7	67.7	66.0	64.3
Imports	59.4	56.3	57.9	72.9	72.3	70.2	68.2	66.7	65.4
Net non-debt creating capital inflows (negative) 1/	-7.0	-6.7	1.9	-3.4	-1.6	-2.9	-4.5	-3.9	-2.8
Automatic debt dynamics 2/	0.3	4.3	36.9	17.3	5.0	2.7	2.1	1.8	1.8
Contribution from nominal interest rate	5.7	6.0	5.4	8.8	8.0	7.5	7.2	6.7	6.4
Contribution from real GDP growth	-0.2	-0.2	7.6	8.5	-2.9	-4.8	-5.1	-4.9	-4.6
Contribution from price and exchange rate changes 3/	-5.3	-1.5	23.9	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 4/	3.7	0.8	10.6	49.4	-5.6	-1.6	1.5	-2.2	-5.2
External debt-to-exports ratio (percent)	149.5	164.5	190.7	218.5	208.3	202.6	198.3	189.5	178.6
Gross external financing need (billions of U.S. dollars) 5/	85.4	73.7	66.0	43.0	48.2	43.8	45.2	47.1	51.0
Percent of GDP	48.6	41.0	51.5	50.4	52.0	43.0	40.4	38.4	37.9
Scenario with key variables at their historical averages 6/			102.4	98.8	93.4	90.1	88.1	83.6	76.8
Key macroeconomic assumptions underlying baseline									
Real GDP growth (percent)	0.2	0.2	-6.9	-5.5	2.0	3.5	4.0	4.0	4.0
GDP deflator in U.S. dollars (change in percent)	7.3	2.0	-23.4	-29.3	6.3	6.2	5.6	5.5	5.5
Nominal external interest rate (percent)	8.0	8.0	4.9	5.7	5.4	5.5	5.6	5.4	5.6
Growth of exports of goods and services (U.S. dollar terms, percent)	1.3	-5.1	-19.5	-10.0	7.4	6.8	6.7	6.9	6.9
Growth of imports of goods and services (U.S. dollar terms, percent)	5.4	-3.1	-26.6	-16.0	7.6	6.8	6.7	7.3	7.6
Current account balance, excluding interest payments	-2.4	-3.2	1.3	7.3	6.7	6.4	6.0	5.0	4.1
Net non-debt creating capital inflows	7.0	6.7	-1.9	3.4	1.6	2.9	4.5	3.9	2.8

1/ Includes debt securities due to data limitations on the composition of FDI and portfolio flows.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as the sum of current account deficit, amortization on medium- and long-term debt, short-term debt at end of previous period, and other net capital outflows (mainly reflecting residents' conversion of hryvnia cash to foreign currency held outside the banking system). Excludes IMF transactions.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Appendix. Ukraine: Letter of Intent

Kyiv, February 27, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC, 20431

Dear Ms. Lagarde:

1. The unresolved conflict in Eastern Ukraine has taken a significant toll on our economy, including a large shock to our industrial base and on our financial markets. Despite our efforts supported by the IMF Stand-by Arrangement as well as other official financing, recent developments have held back progress toward macroeconomic stabilization, worsened the near-term outlook, and generated significant balance of payments pressures. The large exchange rate depreciation since early 2014 raised public debt, weakened bank balance sheets, and eroded gains made towards cost recovery in the state-owned gas company Naftogaz. Notwithstanding this exceptionally difficult environment, we made steadfast efforts to implement policies under the program as a demonstration of our strong commitment to economic adjustment and reforms. Our actions ensured that all performance criteria (PC) for end-September and most benchmarks due in the fall were met (except for the standard continuous PCs on exchange restrictions and multiple currency practices), and the government was able to keep the budget on track through December 2014. However, other end-December targets proved out of reach given the intensification of capital outflows after the recent escalation of the conflict.

2. In the current challenging context, it is our view that Ukraine needs a longer period for our reforms and economic adjustment to restore macroeconomic stability and set the stage for robust growth. We therefore request a new four-year extended arrangement under the Extended Fund Facility (EFF) in an amount equivalent to SDR 12.34806 billion (900 percent of quota and about US$17.5 billion) and intend to cancel our 2014–16 Stand-By Arrangement immediately before approval of the new extended arrangement. Our international partners have committed additional funds to help ensure that the proposed program is fully financed and we are consulting with the holders of public sector debt with a view to improving medium-term debt sustainability.

3. We will use this support to implement an ambitious economic program including a strong and frontloaded macroeconomic adjustment and deep structural reform agenda to lift Ukraine’s economic prospects and improve the living standards of the population. Our policies will be geared

towards: (i) a low and stable inflation within a flexible exchange rate policy that allows the economy to adjust to its new equilibrium, while fostering steady reserve accumulation; (ii) a sound banking system that is better able to play its key intermediation role, subject to prudent oversight; (iii) short- and medium-term fiscal policies that strengthen fiscal sustainability while making space for social protection spending and investment in infrastructure; and (iv) measures to eliminate Naftogaz's deficit by 2017. Critical to achieving our objectives is an extensive structural reform agenda that will focus on strengthening investment and growth through (v) governance reforms, including anti-corruption and judicial reform measures; (vi) deregulation and tax administration reforms to improve business climate; and (vii) reforms of state-owned enterprises to reduce fiscal risks, as well as restructuring of Naftogaz, and strengthen corporate governance. The attached Memorandum of Economic and Financial Policies (MEFP) lays out in detail the economic program that the Government of Ukraine will be undertaking, supported by the IMF and other international partners.

4. We also request approval of the retention of the exchange restrictions and multiple currency practices that we maintain temporarily due to balance of payments difficulties and that are inconsistent with our obligations under Article VIII Sections 2 (a) and 3.

5. We believe that the policies set forth in the attached MEFP are adequate to achieve the macroeconomic and financial objectives of the program, but we will take any additional measures that may be appropriate for this purpose. We will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultation. We will provide IMF staff with the data and information it requests for the purpose of monitoring program implementation. Reaffirming commitment to our policy of transparency, we consent to the IMF's publication of this letter, the MEFP, the Technical Memorandum of Understanding (TMU), and the accompanying Executive Board documents.

Yours sincerely,

/s/
Petro Poroshenko
President

/s/
Arseniy Yatsenyuk
Prime Minister

/s/
Natalie Jaresko
Minister of Finance

/s/
Valeria Gontareva
Governor, National Bank of Ukraine

Attachment I. Ukraine: Memorandum of Economic and Financial Policies

I. Recent Developments and Outlook

1. **Domestic and external shocks as well as the escalation of the conflict in the East have taken a significant toll on the economy, affecting confidence and disrupting financial markets**. Economic activity is estimated to have contracted by 6.9 percent in 2014, and high frequency indicators for December show continued falls in industrial production, retail trade turnover, and construction. While the unresolved conflict in the East adds uncertainty to the outlook, economic activity could bottom out by mid-2015, as our policies take hold, confidence begins to rise, and reconstruction work commences, leading to a slower decline of 5.5 percent in 2015. For robust growth to be achieved over the medium term, which is so critical for Ukraine, we aim to move decisively on strengthening economic and financial stability and implementing wide-ranging and ambitious structural reforms that would improve the business climate, attract higher investment, and enhance competitiveness. In 2016–18, as economic and banking stability is restored and reforms take hold, growth is expected to return and gradually strengthen, reaching 4 percent over the medium term.

2. **Consumer price inflation accelerated in 2014, reflecting pass-through from the currency depreciation and increases in administered prices, but inflationary pressures are expected to abate in the coming years**. Inflation reached 25 percent at end-2014, as the hryvnia lost almost half of its value against the US dollar. During 2015, inflation is projected to remain at broadly similar levels, due to the effects of the further exchange rate depreciation in February 2015 and increases in administered prices. Inflation is expected to decelerate rapidly thereafter, dropping to single digits in 2016 and to 5 percent by 2018, as the impact of exchange rate depreciation and energy price increases dies out and the implementation of prudent monetary and financial policies help anchor inflation expectations.

3. **The current sizable balance of payments pressures are expected to moderate over the medium term**. Exports are projected to decline in 2015, reflecting the significant impact of the crisis on export-oriented sectors, deteriorating terms of trade, and a large decline in tourism and transportation receipts. Reduced FDI, continuing lack of access to Eurobond markets, and a decline in rollover rates for corporate and bank debt continue to aggravate financial pressures. Foreign currency interventions provided some support to the exchange rate in 2014, but also contributed to a significant loss of our international reserves. Our broad based-economic reform program will

strengthen competitiveness and the business environment and together with a return of confidence will restore public and private sector access to capital markets, making Ukraine an attractive destination for investment and boost its medium-term prospects. The current account deficit will stabilize to around 1–1½ percent of GDP in 2016–18, and reserves will gradually be replenished to comfortable levels.

II. Policies under the program

4. **We are determined to implement an ambitious, deep, and comprehensive economic reform program to tackle deep seated problems that have weighed down Ukraine's prospects for too long**. The key objectives of the program are to restore macroeconomic and financial stability, achieve and sustain fiscal and external sustainability, and lay the foundation for a robust medium-term growth. To this end, we are committed to implementing a strong, front-loaded policy-driven economic adjustment and fundamental reforms to improve economic governance and business climate in order to restore confidence and catalyze support from the investment and international community. Specifically, policies will be geared towards:

a. A flexible and sustainable exchange rate policy to support adjustment and a gradual restoration of adequate reserves accompanied by a prudent monetary policy aiming to bring inflation to single digits;

b. Financial sector policies to support the rehabilitation of the banking system, and strengthen its ability to intermediate and support economic activity;

c. Fiscal adjustment based on expenditure consolidation to place public finances on a sound footing and restore debt sustainability with high probability, supported also by donor financing and a debt operation that would help alleviate the debt servicing burden in the coming years;

d. Deep and broad structural reforms to improve business climate, attract sizable domestic and foreign investment, and boost Ukraine's growth potential through deregulation, governance, and state-owned enterprise reforms, including of Naftogaz.

A. Monetary and Exchange Rate Policy

5. **Monetary policy will aim to reduce inflation to single-digit levels by end-2016**. In support of this goal, we are committed to: (i) further strengthening the NBU's monetary policy and operational framework; (ii) maintaining a flexible exchange rate and pursuing a gradual recovery of

international reserves over the medium term; (iii) strengthening the NBU's institutional foundation and effectiveness, including safeguarding a strong balance sheet; and (iv) sharpening the NBU's accountability and communication with the market and general public to better guide their decisions and inflation expectations.

6. **Monetary policy will be formulated consistent with inflation objectives, based on a monetary aggregate targeting regime**. The NBU will use its NIR and NDA as operational targets, and base money as intermediate target, and rely on open market operations to achieve them. Quantitative performance criteria and indicative targets are set out in Table 2.

7. **We expect our monetary program will strengthen the signaling of the monetary policy stance and help guide inflation expectations**. In the context of managing systemic liquidity through open market operations, the NBU will enhance the policy signaling role of its main policy interest rate (the discount rate). The NBU will move ahead with adopting market instruments for interest rate management. As the outflow of deposits from the banking system is bottoming out, liquidity support to banks will be delivered mainly through the standard monetary facilities and their cost will be closely linked to the main policy rate. The NBU will gear the policy rate towards achieving monetary aggregate targets consistent with its inflation objective. In this context, we anticipate maintaining a positive real policy rate on a 12–18-month forward-looking basis. Given a segmented money market, NBU monetary operations will also play an intermediary role by reallocating surplus liquidity to banks in need by performing weekly two-sided tenders.

8. **We are firmly committed to a flexible exchange rate regime to serve as a buffer against external shocks, while aiming for a gradual rebuilding of FX reserve buffers**. In support of this, we will undertake actions in the following areas.

a. **Rebuild reserves**. We will rebuild a strong international reserve position over the medium term in line with the program and via official sector support and gradual interventions as conditions permit. FX sales by the NBU will be limited to facilitating external payments by the central government, as well as critical energy imports by Naftogaz, and the nuclear power corporation Energoatom, for amounts factored into our program (TMU, Section I, Table C). To this end, we will abolish regulations preventing Naftogaz from purchasing foreign exchange from the market. To relieve pressures on reserves, the Ministry of Finance will seek to roll over the government's domestic FX debt liabilities by offering suitable interest rate and maturity instruments. The Debt Management Unit of the Ministry of Finance (which is responsible for issuance of domestic FX-linked debt) and the NBU units responsible for monetary policy formulation and implementation will continue close coordination of their operations to support reserve targets. Furthermore, we are discussing with the People's Bank of China an extension of the existing swap line and its use to mitigate our foreign exchange needs and strengthen the balance of payments.

b. **Restrictions**. We are committed to removing administrative measures implemented on an emergency basis to help contain BOP pressures. The 2015 budget introduced a temporary surcharge on imports (with exceptions for energy and pharmaceuticals), effective February 26, 2015 and based on Article XII of the GATT (1994). While we took all precautions to ensure that this measure is compatible with our WTO commitments, we are committed to removing it by end-2015 or earlier if the WTO does not approve it. We are also committed to removing other administrative measures, including exchange restrictions and MCPs. We do expect that our policy program and the financial support of the international community will lead to steady improvement in the balance of payments, financial stability, and accumulation of international reserves in the course of 2015. To this end, by May 15, 2015, we will prepare a plan for the removal of the exchange restrictions and capital controls that will be conditioned on sufficient progress achieved in these areas as projected under the program. However, for the time being and until financial conditions have stabilized, capital controls will remain effective and we are ready to tighten administrative measures temporarily to the extent necessary, should downside risk materialize and financial stability and FX market conditions deteriorate.

9. **To strengthen the NBU's institutional foundation and effectiveness, we will draft legislative amendments to the NBU Law in consultation with IMF staff by end-February 2015**. Parliamentary approval of these amendments is a **structural benchmark** for end-April 2015. The reform focuses primarily on the following key items:

a. **NBU Board**. We will transform the Board into an Executive Committee, composed of the Governor and Deputy Governors. The reformed Board will be charged with formulating and implementing monetary and exchange rate policy (in line with the Monetary Policy Fundamentals approved by the NBU Council) as well as with regulating the banking system.

b. **NBU Council**. We will strengthen the oversight mandate of the Council by: (i) charging the Council with ultimate responsibility for internal controls and risk management; and (ii) authorizing the establishment of an Audit Committee.

c. **NBU Autonomy**. We will strengthen the personal autonomy of NBU Council members and Deputy Governors by enhancing appointment and dismissal procedures and taking steps to mitigate conflict of interest, including a new Code of Conduct. We will uphold the NBU financial autonomy by keeping its administrative budget in line with the Law on the National Bank.

d. **NBU general reserves and profit distribution**. Profit distribution rules between the NBU and the government will seek a gradual build-up of general reserves to reach 4, 7, and 10 percent of monetary liabilities at end-2014, 2015, and 2016 respectively. In 2015, profit distribution to the government, based on the 2014 financial operations, is expected to be at least UAH 60 billion, pending verification from the NBU's financial audit for 2014. We will limit the disbursement of the 2014 profit distribution, ahead of the completion of audit, to a maximum of 25 percent of the projected annual amount. In future years, we will not disburse any amount of the NBU profit distribution before the NBU financial audit is completed, consistent with current NBU law. To reinforce this, we will amend the Budget Code to prevent inclusion of advance profits in annual budgets.

10. **We have also initiated a restructuring of the NBU organizational structure and communications**. These include:

a. **Monetary policy formulation and implementation**. In relation to monetary policy, we will seek to ensure a clear organizational and operational separation of monetary policy formulation from the monetary policy implementation function. In particular, to ensure that monetary policy decisions are unbiased and have strong analytical support, we will set up a Monetary Policy Committee to advise the Executive Board.

b. **Communications**. We view stronger communication and public accountability as critical components of effective monetary and financial policies. The recently created communications department will support timely and policy-focused outreach. It will help convey to key stakeholders, including parliament, the financial sector, and the public how the NBU operates. To this end, the NBU will regularly publish inflation and financial stability reports, and will continue disseminating its policy decisions and other communications. The NBU and the Ministry of Finance will closely coordinate their public communications on matters of common interest.

11. **We will continue efforts towards future adoption of inflation targeting**. The NBU will continue strengthening its technical and operational capacity for the future adoption of inflation targeting when macro-financial conditions will permit it. The NBU will continue to refine its own inflation projection capacity, and has discontinued past practice of using projections developed by the Cabinet of Ministers for setting monetary policy targets.

B. Financial Sector Policies

12. **A central objective of our program is the steady and full rehabilitation of the financial system, so that sound financial institutions within a modern prudential and regulatory environment can play their fundamental role in supporting credit and sustainable growth**. As a first step, it is critical to restore the public's confidence in the banking system so that banks can gradually resume their normal functioning and funding the real economy. It is also critical to bring financial surveillance, lending policies, and internal governance of all banks up to international best practice. To this end we are working on four fronts: (i) upgrading our regulatory and supervisory framework to identify and reduce related-party lending; (ii) updating our banking capitalization strategy, which is likely to call for additional private and public resources; (iii) enhancing asset recovery and official investigations of bank failures; and (iv) strengthening bank capacity to resolve bad loans.

Upgrading our regulatory and supervisory framework to identify and reduce related-party lending

13. **We are working toward ensuring proper identification, monitoring and, where applicable, unwinding of above-limit loans to insiders (related parties)**. In this regard, we will take the following actions:

a. **Legislation**. We will approve legislation to introduce unlimited liability of bank owners on losses arising from loans granted directly or indirectly to the benefit of bank shareholders holding 10 percent or more (including shareholders acting in concert) of total voting shares as of end-2014 (***prior action***). The legislation will also contain other measures to ensure enforcement of best practices on related lending, including by furnishing the NBU with powers to presume the existence of economic (related) relationship between banks and borrowers on the basis of objective criteria.

b. **Lending rules**. By end-March 2015, in consultation with IMF and World Bank staff, we will pass legislation and revise NBU regulations on related parties to close loopholes that may leave room for the circumvention of lending limits to insiders.

c. **Bank reporting of related loans**. By end-May 2015, as instructed by the NBU and on the basis of end-March 2015 data, the 10 largest operating private banks ("banks") will submit reports of related party exposure according to the new legal and regulatory framework. The next 10 largest banks will submit their reports by end-July 2015. All other banks will report by end-September 2015 (see Annex).

d. **Prudential review of bank reports**. By end-September 2015, the NBU, with technical support of the four largest international accounting firms (with teams led by foreign partners) and on the basis of terms of reference agreed with the IMF and WB staff, will complete comprehensive reviews of the 10 largest banks' related party exposure reports. The review process will include the following steps:

   i. A check whether the banks have reported all loans to individuals and legal entities above 1 percent and 3 percent of bank equity, respectively, that meet the revised related party criteria;

   ii. Verification by the auditors that banks' information security frameworks (policies, protocols and processes) ensure the integrity and confidentiality of bank records, as defined in the agreed terms of reference; and

   iii. NBU's notification of the banks of any identified discrepancies based on steps (i) and (ii) no later than end-July 2015 (***structural benchmark***). Banks will be given until end-August 2015 to prove otherwise. The NBU will then review the banks' responses and issue its final report to each bank, listing all related party loans and the amounts by which they exceed limits by end-September 2015 as noted above.

e. **Prudential review of remaining banks**. Following the same procedures, the NBU will complete reviews of the next 10 largest banks by end-December 2015 and reviews of all other banks by end-April 2016. A more detailed underlying timetable for the latter group of banks will be agreed with IMF staff no later than end-May 2015.

f. **Bank related party unwinding action plans**. By end-October 2015, each of the top 10 banks will submit to the NBU an action plan to unwind above-limit related party exposures within 3 years. The NBU and the banks will reach agreement on these plans by end-November. Bank related party unwinding action plans ("unwinding plans") for the next 10 largest banks should be agreed by end-February 2016 and by end-June 2016 for the remaining banks. These unwinding plans should include: (i) credible quarterly schedules; (ii) minimum first payments or related exposure reductions of no less than 5 percent of excess loans to insiders ; (iii) proper loan collateralization; (iv) securing non-revocable written guarantees issued by qualified shareholders controlling (more than 10 percent of votes as regards to all of their related loans. These guarantees should remain in place until the bank is fully compliant with the legal and regulatory related lending framework. Details on time schedules for plan implementation will be agreed with staff no later than end-May 2015.

i. **NBU monitoring**. The NBU will closely monitor implementation of agreed unwinding plans, including by quarterly assessing financial information submitted by the key related businesses that owe the banks money with the aim to follow their debt repayment plans and use of cash flow.

ii. **Resolution**. If a bank has two breaches to the agreed unwinding plan, this will lead to cancellation of the plan and bank resolution.

g. **NBU Monitoring Unit**. We are strengthening our supervisory capabilities to monitor economically related parties and industrial and financial groups. To this end, the NBU has established a specialized group to identify all major economic groups as well as those related to banks and monitor their structure and credit exposure on a continuous basis. To this end, with technical assistance from the IMF and the World Bank, by end-September 2015 we plan to have this unit fully operational and with an action plan for the following 12 months, which would include the mapping of the largest 10 industrial and financial groups by end-December 2015.

14. **We are also taking actions on several other supervisory and regulatory fronts in order to strengthen supervision of banking risks with support of the IMF**. These include (i) establishment of a credit registry at the NBU; (ii) full adoption by banks of IFRS for financial reporting in the second half of 2015; (iii) a review of the NBU supervisory model; (iv) improving financial performance and monitoring of majority state-owned banks, for which we will develop a comprehensive strategy by September 1, 2015 with IMF technical assistance; and (v) legal protection for bank supervisors. Specific measures will be developed with IMF technical assistance.

Updating our banking capitalization strategy

15. **We have revisited our resolution strategy to go hand-in-hand with the gradual unwinding of related loans**. Based on the 2014 diagnostic studies, 9 of the largest 15 banks are required to submit credible and binding recapitalization plans. To this end, we will require a minimum contribution of 25 percent from these banks through cash injection or debt-to-equity swaps by end-January 2015. Otherwise, provided they have not been declared as a problem bank by the NBU, they will be subjected to temporary prudential restrictions, including: (i) zero growth ceiling on net lending; (ii) prohibition on any new lending to related parties; (iii) prohibition on repayment of related deposits; and (iv) the appointment of a senior NBU observer to the executive board and key managerial committees of the bank. We will require full implementation of the recapitalization plans by end-June 2015. Where capital needs will be complemented by asset deleveraging measures, the NBU will obtain from their parents or qualified shareholders written

commitments to maintain their credit lines or related deposits in the banks in amounts not less than the needed capital. Banks that do not meet final capitalization deadlines will be subject to restructuring and resolution. We have also submitted to parliament amendments to modify the law on measures to facilitate bank capitalization and restructuring with the view to: (i) allowing DGF to bail-in non-deposit creditors; (ii) eliminating provisions that may delay the bank restructuring process; and (iii) ensuring banks are adequately capitalized. We will coordinate with IMF staff regarding any potential measure that affects financial stability. Recapitalization plans for the next largest 20 banks have been approved and will be completed by end-February 2015.

16. **Banks that do not comply with their recapitalization plans will be resolved**. If bank owners of systemic banks are unwilling or unable to recapitalize their institutions, the bank will be intervened and either resolved or recapitalized with state funds, as prescribed by the DGF law and the law on measures to facilitate bank capitalization and restructuring. Prior to state recapitalization, the DGF authorized officer will bail-in related deposits, as defined in the law (mostly related to top management and shareholders holding above 10 percent of voting rights), subordinated debt, and unsecured non-deposit creditors up to 25 percent of regulatory capital so that the state becomes the controlling shareholder with a participation of 75 percent or more of the voting rights. The budget stands ready to provide all justified funds necessary for bank restructuring and recapitalization.

17. **We will develop a specific timetable to address any additional capital needs arising from recent extraordinary events**. By end-July 2015 and end-September 2015 on the basis of end-2014 and end-March 2015 data, respectively, we will update the diagnostic exercises for all operating banks among the top 10 and 10 subsequent banks, respectively, to identify additional losses associated with the conflict in the East and the downgraded economic outlook through 2017. This update will be made on the basis of terms of reference that will be agreed with IMF and WB staff by end-March 2015 and include two steps: (i) *Asset quality review:* To be completed on the basis of the regulation on credit risk assessment and *w*ith the participation of NBU inspection teams; (ii) *Stress test.* On the basis of the program's baseline macro scenario and using NBU internal modeling forward looking losses through 2017 will be identified. This review will be closely monitored by a Steering Committee. The IMF and the WB will appoint independent observers to this committee. If this exercise reveals a bank undercapitalization with a CAR below 10 percent, the bank will be asked to present credible plans by end-August 2015 and end-October 2015 for the group of 10 top and 10 subsequent banks, respectively, to meet: (i) the 5 percent (tier 1 capital of 4 percent and tier II capital 1 percent) minimum capitalization level by end-January 2016; (ii) 7 percent (tier 1 capital of 6 percent and tier II capital 1 percent) by end-December 2017; and (iii) 10 percent (tier 1

capital of 7 percent and tier II capital 3 percent) by end-December 2018. Should the exercise find insolvency in certain banks, these banks must be brought into solvency (positive equity) by end-August 2015 and end-October 2015 for the group of 10 top and 10 subsequent banks, respectively.

Enhancing asset recovery and official investigations of bank failures

18. **We will continue to improve prospects for asset recovery and DGF accountability, and identification of bad banking practices in failed banks**. We will take action on three fronts:

a. **Extend timeframe to complete bank liquidation**. To this end, by end-May 2015 we will pass legislation to allow the DGF to complete bank liquidation within five years (up from the current 3 years).

b. **Assess options to improve asset recovery**. With technical assistance from the World Bank and on the basis of international experience, by end-June 2015 we will complete an assessment of options available to maximize recovery value, taking into account the lack of fiscal resources to establish expensive arrangements. We will also develop an action plan with the World Bank staff that includes key performance indicators to assess progress made by the DGF in asset recovery.

c. **Initiate due diligence investigations (forensic audits) of failed banks**. By end-February 2015 we will complete the terms of reference to guide due diligence of banks under temporary administration to identify whether wrongdoing or bad banking practices led the bank into insolvency. The tender process for the selection of the firms responsible for the due diligence investigations of the first two cases will be initiated by end-April 2015 with the view to launch the investigations by end-June 2015. In case of discovery of fraud and other illegal action by bank managers or owners, DGF will report it to law enforcement agencies. We will approach the donor community for funds to support the audits.

Strengthening bank capacity to resolve bad loans

19. **We will ensure that the framework for addressing NPLs is effective**. We will work on three fronts:

a. **Legislation**. With technical assistance from the IMF, by mid-May 2015 we will identify a set of reforms that are needed to strengthen our legal framework related to private debt restructuring, on the basis of international best practice and cross-country experience, covering foreclosure procedures, corporate and personal insolvency and tax incentives. By end-July 2015, we commit to submit to parliament legislation to introduce such reforms to ensure that a proper framework to facilitate the return to normal operations of viable but troubled borrowers is in place.

b. **Out of court mechanism**. With technical assistance from the EBRD, in consultation with Fund staff, and in close cooperation between the NBU, MoF, DGF and banks, by end-June 2015 we will establish a coordinated out-of-court restructuring system, in line with international best practice including the INSOL principles, and the Istanbul approach. This could include setting up a Coordination Secretariat, Arbitration Council function as well as development of all relevant regulations. We will ensure time-bound implementation of this framework, consistent with key financial objectives in the program.

c. **FX mortgages**. We remain committed to supporting a voluntary negotiation process between borrowers and banks for the restructuring of foreign currency denominated mortgage loans serviced by struggling but still performing borrowers. The state and the NBU should not interfere in bilateral negotiations between borrowers and banks while ensuring fair process. In this regard, should a law imposing mandatory conversion of foreign currency mortgages into hryvnia be passed, the president will veto its enactment. On the basis of NBU existing guidelines on loan in arrears and international best practice, with technical assistance from the IMF, by end-March 2015, the NBU will issue a Code of Conduct to guide negotiations between borrowers in difficulty and banks, establish debt restructuring guidelines, and an appeal process. The Code will seek to induce fair and balanced negotiations between banks and borrowers.

C. Fiscal Policy

20. **We will restore sound public finances and secure a sustainable path for public debt through a bold and durable medium-term fiscal adjustment**. Given Ukraine's high levels of public debt and public spending relative to GDP, we will pursue an ambitious but necessary expenditure-led consolidation that targets a smaller and more efficient government. At the same time, we will make the tax system growth-friendly, transparent, and equitable to support private activity. We will also bring Naftogaz, a long-standing fiscal drain, to financial health as quickly as possible and eliminate government subsidies to the company by 2017. We will limit other debt creating operations to the strictly needed, while providing adequate government resources to support the rehabilitation of the banking system. Notwithstanding our ambitious fiscal efforts, support from our external creditors will be necessary to bring debt firmly on a sustainable downward path towards to our debt target of below 71 percent of GDP by 2020.

21. **To this end, and notwithstanding the adverse economic environment, we are aiming for sustainable budget deficit targets over the medium term, taking into account the changing needs of the budget**. Our program targets are as follows (fiscal quantitative performance criteria and indicative targets for program monitoring purposes are set out in Table 2):

a. **Combined general government-Naftogaz balances**. We aim to reduce the *combined general government and Naftogaz deficit* from 10.3 percent of GDP in 2014 to 7.4 percent of GDP in 2015, and take any measures necessary to achieve it. Moreover, we will continue to reduce the combined deficit toward 2.6 percent of GDP by 2018.

b. **General government fiscal deficit**. *The headline deficit* will fall from 4.6 percent of GDP in 2014 to 2.6 percent of GDP by 2018. Behind these numbers lays a strong fiscal effort, as *the primary balance* will move from a deficit of 1.2 percent of GDP in 2014 to a surplus of 1.6 percent of GDP by 2018. We make sure that the consolidation is mainly expenditure-led as evidenced by the *primary expenditure* fall from 43 percent of GDP in 2014 to 39.2 percent of GDP by 2018.

c. **Naftogaz balances**. *Naftogaz's deficit* will improve from 5.7 percent of GDP in 2014 to 3.1 percent of GDP in 2015 and 0 percent of GDP by 2017 and thereafter. Starting with the 2017 budget, any government support to Naftogaz will be in line with ESA/GFSM accounting standards, where government support to state-owned enterprises is shown as a current subsidy.

22. **The 2015 budget passed in December 2014 targeted an overall deficit of UAH 65 billion, based on a sizable optimization in current primary expenditure through spending restraint and fiscal discipline, as well as tax reform**.

a. On the expenditure side, given the challenging financing conditions and the need to optimize current spending to make room for needed social and infrastructure spending, we have kept the current nominal levels of minimum and maximum pension benefits until December 1, 2015; adjusted further the pension replacement rate for special pensions from 80 percent in 2013 and 70 percent in 2014 to 60 percent this year, except pensions for military pensioners; restrained spending on goods and services; eliminated price subsidies to the coal-mining industry; and committed to maintain until December 1, 2015 the minimum and basic wage for the first tariff grade that is used to determine basic wages in the budgetary sector unchanged at the level of December 2013. As a result of these bold but necessary actions, and the optimization of staff in budgetary institutions, the wage bill of the budgetary sector (excluding the military) is maintained at the 2014 level.

b. On the revenue side, in view of the need to reduce the heavy tax burden while broadening the tax base, we reduced distortive and nuisance taxation through the elimination of various small taxes and fees and abolished the foreign exchange transaction tax for non-cash transactions. We expanded the base for property taxation and introduced a new excise on retail sales at 5 percent. A new annual assessment tax on luxury vehicles was also introduced. In view of the widespread underreporting of wages, we have reduced the social security contribution rate by 60 percent for those entities who significantly increase their reported overall wage bill and raise average wages. We increased progressivity in the personal income tax, and expanded the base to include income from capital gains while increasing the associated tax rate from 15 percent to 20 percent. We reduced the taxable threshold for pension benefits from ten to three minimum wages. Moreover, we extended the effective period of levying the military tax on income until parliament decides that the military forces reform is complete.

c. To improve compliance, we amended the transfer pricing legislation extending the scope of transfer pricing rules. To strengthen VAT compliance we introduced electronic VAT administration. We will also mandate cash registers for individual entrepreneurs starting July 1, 2015. In addition, we have eliminated the discretion for large taxpayers to choose a tax office to manage their tax affairs. Currently, almost 60 percent of large taxpayers are serviced outside the Large Taxpayer Office (LTO). By end-2015, we will transfer all taxpayers meeting large taxpayer criteria to the LTO (**structural benchmark**).

23. **To achieve our 2015 fiscal targets and put our medium-term fiscal adjustment on a sound footing, we have decided to take supplementary budget measures**. Parliamentary approval of a 2015 supplementary state budget law and a package of related tax and expenditure legislation consistent with the program deficit ceiling of UAH 78.2 billion for the general government is a ***prior action***. The most important amendments in terms of budget impact are:

i. **Social assistance**. We will increase utility subsidies to households to mitigate the impact of retail energy price increases on the most vulnerable, costing up to an additional UAH 12.5 billion. Already in the budget is the introduction of income means-testing of households eligible for various benefits, as well as a reduction of unaffordable social insurance and non-insurance payments.

ii. **VAT, profits, and royalties**. Prices of domestically produced gas by Naftogaz's subsidiary Ukrgazvydobuvannya (UGV) will be increased by 355 percent. While part of the additional UGV revenue will help raise investment in domestic gas extraction, improving our energy independence, the rest of the extra revenue will be collected by the government in the form of tax revenues (VAT, profit, and royalty taxes), helping to offset the additional costs related to greater energy-related social spending.

iii. **Wage bill**. Aiming for a smaller, but more efficient government, we will reduce the number of budget-paid employees by 3 percent over the course of 2015, including a 20 percent reduction of the civil service workforce. The latter will reflect in part closure of redundant regulatory agencies. We will begin the process in earnest on March 1, 2015, and aim to complete it by end-September 2015. At the same time, as part of our anti-corruption efforts, we will repeal the law limiting wages to government and NBU employees to 7–10 minimum wages, as this could force many of our top tier employees out of public service and lead to loss of valuable human capital. We will offset the impact of the repeal within our budgeted wage bill.

iv. **Pensions**. To adapt to demographic trends and strengthen the soundness of the pension system, which would allow the government to provide fair pensions in the future, we will apply several saving measures. Specifically, we will reduce benefits for working pensioners and limit early retirement options by gradually (6 months a year) increasing the retirement age by 5 years and the qualified period of service by 5 years as well for a number of professions eligible for early retirement (as defined in the TMU Annex), effective April 1, 2015. While the increase in the qualified period of service affects both men and women, the increase in the retirement age is only for women. These measures will bring total savings of not less than UAH 1.6 billion already in 2015. The government will make legal provisions and ensure adequate funds for pensioners who remain in the territories outside of government control and did not receive pension benefits in 2014, were these to be requested by them.

24. **Over 2016–18, we will continue our gradual expenditure-based fiscal consolidation to reduce imbalances, reduce the size of government, build confidence, and facilitate growth**. On the expenditure side, we will underpin efforts with structural fiscal measures while creating fiscal space for growth-enhancing investment. A key adjustment anchor is pension reform, with additional steps in public sector wages, goods and services (procurement), while strengthening social assistance to those most in need. On the revenue side, we will continue our drive for a more efficient and equitable tax system, aiming for a shift from direct to indirect taxation and investment-friendly natural resource taxation. We will continue to simplify the tax system, lower the tax burden, limit opportunities for tax evasion, eliminate tax exemptions and encourage formalization of economic activity. Specific measures and benchmarks will be elaborated in the course of the program.

Expenditure reforms

a. **Parametric pension reform**. We recognize the need for a comprehensive pension reform to revamp the overall objectives and design of the pension system. Despite low average pensions, low retirement age, early retirement options and generous occupational retirement conditions make the overall pension spending as a share of GDP is one of the highest in Europe. We will build on the reforms begun in 2011 to improve the system's long-term fiscal sustainability, and make it more equitable. With assistance from the IMF, we will review our pension system with the goal of reducing the pension deficit and achieving European standards. To this end, we will submit to parliament a revised pension law no later than September 15, 2015 to become effective by January 1, 2016. During the course of the program, we will index pensions (including civil service and special pensions) to prices and lower the threshold for pension benefits' income tax liability. We shall also seek to gradually unify special pensions' calculation rules with those of the general system.

b. **Size and efficiency of government**. We will continue efforts to rationalize the size of the budget-paid workforce with the goal of lowering the wage bill to around 9 percent of GDP over the medium term. In this context, we will review salary structures to ensure competitive remuneration, especially at the managerial level of the central government. With the help of our international partners, we will design and implement reforms in the health and education sectors aiming to improve outcomes with more efficient use and mix of resources and resulting in budget savings.

c. **Healthcare**. Healthcare reform will aim to open up the sector to private financing and gradually move to a medical insurance system. To this end, by end-March 2015, we will submit to parliament draft legislation that will:

   (i) Change the basis of public financing of the secondary healthcare by moving from hospital bed to service-based financing and for primary healthcare from infrastructure-based to capita-based financing.

   (ii) Allow medical facilities to legally generate own revenue.

   (iii) Change public procurement regulation to allow purchasing medicines and medical supplies through direct, multi-year procurement involving UN based organizations.

d. **Education**. We will continue the reforms in education sector, commenced in 2014, aiming to improve the quality and efficiency of education spending. Reforms will focus on:

(i) rationalization and reduction of higher education institutions from 802 to 317; (ii) streamlining the network of vocational schools; (iii) streamlining the general secondary school system, reducing the number of schools by 5 percent by consolidating small schools and reducing employment accordingly; and (iv) reducing public appropriation for training specialists depending on the needs of the economy and demographic trends. These reforms will enable reduction in expenditures by at least UAH 300 million in 2015 and thereafter. To this end, we will submit by end-May 2015 draft legislation to parliament with the objective to enact all necessary legislation by the beginning of the next academic year (September 1, 2015) and complete all reforms during the course of 2015–16.

e. **Social assistance**. To protect the most vulnerable groups from higher energy bills, we plan to improve the design of existing social assistance programs (currently comprising of category-based for housing utilities; means-tested subsidies for housing utilities; and a new tariff compensation scheme). We will prioritize the general guaranteed minimum income (GMI) program, as it is better targeted to low-income households, though this will require substantial administrative effort.

f. **Investment**. To support growth, we will increase and maintain capital investment levels, from 1 percent of GDP in 2014 to over 3 percent of GDP by 2018, to fund Ukraine's immediate reconstruction needs and long-term infrastructure development objectives.

Tax policy reforms

g. **Social security contributions**. We will continue reducing the social security contribution wedge, which should help encourage de-shadowing of wage payments. The outcome of the legalization efforts in 2015 will inform the direction of further reform of social security contribution rates. The pace of this reform will be closely linked to progress in reducing pension spending.

h. **Agriculture VAT**. We recognize that agriculture has become one of the most profitable sectors of the Ukrainian economy. We will therefore bring the agriculture sector fully under the general VAT regime in line with international practice, effective January 2016.

i. **Personal income tax**. We will continue with measures, begun in 2015, to broaden the base and further increase progressivity of taxation. This will include steps to better detect and tax the income and wealth of high net worth individuals, drawing on technical support from the IMF.

j. **Property taxes**. We will gradually eliminate exemptions and raise tax rates. The additional revenue will help strengthen the own revenue base of subnational governments.

k. **Extractive industry taxation**. We will introduce a new fiscal regime for the extractive industries from 2016 that will make a transition to taxation based on international best practice, including a review of the current level of royalties. We will prepare and submit to parliament the relevant amendments to the tax code by July 1, 2015 and in parallel strengthen administrative capacity in this area, drawing on IMF technical expertise.

25. **Over the course of the program, we will also pursue reforms to improve our revenue administration and public financial management**. We will develop specific measures and deadlines as needed, in consultation with the IMF, focusing in the following areas:

a. **Revenue administration reform**. We will prepare, in consultation with IMF staff, a revenue administration reform plan by end-April 2015 to overhaul the State Fiscal Service (***structural benchmark***). The plan will include governance and institutional reforms that streamline regional offices, removing large numbers of underperforming officials, modernize and computerize the customs system as well as strengthen its governance, and clarify the revenue authority's reporting responsibilities by subordinating the State Fiscal Service to the Ministry of Finance, which will help the ministry better coordinate tax policy and administration. Implementation of the new arrangements is expected to start from January 2016 ***(structural benchmark)***. We will also continue with efforts to improve the tax dispute resolution framework and collection of tax arrears by focusing on the largest debtors and promoting arrangements that fit the current conditions. We will ensure that the amount of tax arrears, excluding the regions of Crimea, Donetsk, and Luhansk, does not increase. We will strengthen administrative capacity in the application of the transfer pricing legislation.

b. **Compliance with social security contributions**. We will undertake measures to strengthen compliance, including through directing more resources to fight evasion as soon as April 2015.

c. **Public finance management**. We will: (i) strengthen medium-term budget planning by introducing medium-term fiscal framework and expenditure ceilings on key spending units and (ii) develop the design features of the medium-term budget framework and prepare relevant amendments to the Budget Code in order to introduce a full-fledged MTBF from 2018.

d. **Cash management**. We will: (i) review the use of all central government commercial bank accounts, including foreign currency accounts, and close those that are not necessary; (ii) establish a cash planning unit in the Ministry of Finance or State Treasury; and (iii) reduce volatility of the Treasury Single Account through alignment of major receipts and expenditure.

e. **Budget execution**. We will: (i) Introduce commitment control system to the budget execution framework; (ii) Eliminate distinction between protected and unprotected items.

f. **Debt ceiling.** We will revisit recent amendments, aiming to introduce escape clauses for the deviation from the statutory debt limit, and re-insert the 5 percent limit on the issuance of government guarantees.

26. **To secure adequate public sector financing in the coming years, while also putting public debt firmly on a downward path, we intend to consult with the holders of public sector debt on a debt operation to improve medium-term debt sustainability**. To facilitate this consultation, and in line with international best practice, we have hired financial and legal advisors **(*prior action*)**. While the specific terms of the debt operation would be determined following our consultations with creditors, it would be guided by the following program objectives: (i) generate US$15 billion in public sector financing during the program period; (ii) bring the public and publicly guaranteed debt/GDP ratio under 71 percent of GDP by 2020; and (iii) keep the budget's gross financing needs at an average of 10 percent of GDP (maximum of 12 percent of GDP annually) in 2019–2025. The restructuring is expected to be based on the program baseline macro framework applicable at the time the debt operation is launched. The debt operation is expected to be finalized by the time of the first review.

D. Energy Sector Policy

27. **Our ambitious and comprehensive energy sector reform agenda, which began in 2014, marks a decisive break from the past.** The loss-making and opaque gas sector in Ukraine weighs heavily on public finances, the external sector, and the overall economy. The very low tariffs for residential gas and district heating (DH) encourage excessive energy consumption and lead to large quasi-fiscal losses by Naftogaz, push gas imports up, discourage investment in domestic production, and breed governance problems. To address these problems, our reforms aim to: (i) bring Naftogaz to profitability by raising gas and heating prices to cost recovery levels based on international gas prices, strengthening its governance, and restructuring the company; (ii) enhance the energy-related social safety net to provide adequate support to the most vulnerable; and (iii) undertake complementary structural reforms to attract capital investment, increase energy efficiency, and foster energy independence.

28. **Restoring the financial health of Naftogaz is an overarching goal of the program.** To this end, we will undertake bold measures to increase household tariffs, improve collection rates, and lower costs, aiming to reduce Naftogaz's deficit to 3.1 percent of GDP in 2015 and eliminate it

by 2017. These steps will be supported by a fundamental restructuring of the company aimed at strengthening corporate governance and increasing operational efficiency.

a. **End-user price hikes**. While end-user gas and heating prices were raised by 56 and 40 percent, respectively, in mid-2014, subsequent Hryvnia depreciation eroded the gains. We will implement ambitious price hikes of end-user prices, and work on strengthening collections.

   i. **Retail gas prices.** We will complete the process of increasing gas prices to levels consistent with full import parity by April 2017. As a first step, we will reform our current system for household gas prices, reducing the number of price tiers from four to two. Moreover, the energy regulator will adopt and officially publish a decision to raise gas prices for households by 285 percent on average. This is consistent with a price of UAH 3600/tcm for consumption in Tier 1 (below 200 m3 a month for consumers that use gas for heating in the cold season) and UAH 7187/tcm for consumption in Tier 2 (above 200m3 a month as well as gas used only for cooking and hot water), effective April 1, 2015 (***prior action***). This will allow bringing the price Naftogaz receives to not less than UAH 2200/tcm without VAT for Tier 1 and not less than UAH 5100/tcm without VAT for Tier 2. We will abolish the two-tier pricing structure and raise the household price as needed to reach 75 percent of the level consistent with import parity in April 2016 and 100 percent of that level in April 2017. Until that point, prices will not be adjusted downwards. Once full import parity is reached, we will adopt a new methodology for retail gas prices, linking them to movements in the import gas prices and the exchange rate, among other relevant factors, on a quarterly basis. Prices paid to Naftogaz subsidiaries that extract gas will be gradually increased to the equivalent of at least $150/tcm by April 2017 in order to allow them to invest and raise future gas production. We will ensure that our energy pricing frameworks do provide for covering all investment costs in full. Moreover, should retail price components not related to Naftogaz rise over the year, the retail price will change to accommodate them rather than the price Naftogaz receives.

   ii. **Retail heating prices.** We will adjust heating prices to levels consistent with gas priced at full import parity by April 2017, providing time for investment in energy efficiency measures that reduce losses in the system and allow consumers to better manage their consumption through measures such as installation of meters, heat valves, and insulation. Consistent with this, the energy regulator will adopt and officially publish a decision to raise retail heating prices to households by 67 percent on average, to UAH 625/gcal, effective April 1, 2015 (***prior action***). This will allow bringing the price Naftogaz receives to not less than UAH 1793/tcm, excluding VAT and mark-up tax. After that, heating prices will increase to 75 percent of the level consistent with gas priced at full import parity in April 2016, and to 100 percent of that level in April 2017. Until that point, prices will not be adjusted downward. Thereafter, we will adopt a new methodology for retail heating prices as well, linking them to quarterly movements in the import gas prices and the exchange rate among other relevant factors. Should price components not related to Naftogaz rise over the year, the retail price will change to accommodate them rather than the price Naftogaz receives.

iii. **Industrial gas prices.** We will continue to adjust industrial gas prices to reflect exchange rate and gas import price movements.

b. **Structural reform**. To increase Naftogaz efficiency and governance, we will implement the following measures:

i. **Collections.** In consultation with the IMF, we will submit to Parliament legislative amendments to improve Naftogaz collection **(*prior action*)** and have them adopted by Parliament by March 31, 2015 **(*structural benchmark*)**. These amendments are critical to increase Naftogaz collections of existing receivables (over 2 percent of GDP at end-2014) and should include (i) lifting two long-lasting moratoria (Law 2711-IV/2005 and Law 2864-III/2001) that protect energy and other companies from enforcement proceedings; and (ii) disconnecting non-compliant customers from the gas supply grid. With technical assistance from the IMF, we will develop regulations on the application of the law.

ii. **Independent audit of receivables.** To support our efforts to collect old receivables, enhance transparency, and avoid future collection problems, we will undertake an independent audit of all Naftogaz receivables by June 30, 2015 (**structural benchmark**). The objective of the audit is to identify the debtors, the size of the corresponding debts, as well as the reasons for their persistence. In addition, the audit will be useful in highlighting possible weaknesses in Naftogaz internal procedures to collect payments. The audit will be a key diagnostic tool that will help us clean up the company's balance sheet and tighten collection efforts going forward. We will approach our international partners with a request to finance the audit externally.

iii. **Audit.** We will complete full IFRS audit of Naftogaz by reputable auditors for 2012 and 2013 on a consolidated basis by end-March, 2015, and for 2014 – by end-July 2015.

iv. **Naftogaz restructuring.** We support Naftogaz's restructuring to reduce losses caused by governance issues and raise social acceptance of cost-recovery prices.

- **Gas market law**. A new draft gas market law has been presented to the Cabinet of Ministers. This law is paving the way for the restructuring of Naftogaz by establishing a new model of the gas market in Ukraine. The law will provide the framework for: (i) third party access to the gas infrastructure, (ii) approval of methodologies and tariffs by the energy regulator, and (iii) free and good faith competition through price liberalization. Notably the law establishes specific mechanisms for unbundling of the gas infrastructure management activities from gas production and supply. We will seek Parliamentary approval of the law by end-April 2015 (***structural benchmark***).

- **Gas sector reform and implementation plan**. In collaboration with the World Bank staff, the Ministry of Energy and Coal Industry and Naftogaz are currently finalizing a plan to reform the gas sector, including (i) the unbundling of Naftogaz's main business lines (transmission, storage, and gas sales) and (ii) improving transparency in gas distribution via audits of distribution companies and of metering throughout the gas chain. The Cabinet of Ministers will adopt this plan by end-February 2015.

v. **Promoting Competition.** The emergency measure implemented in November 2014 to oblige over 170 companies to purchase natural gas exclusively from Naftogaz will be allowed to lapse at end-February, and we do not intend to reactivate it in the future.

c. **Energy SOE reform.** With the assistance of the EBRD, we are also seeking to improve corporatisation of the key state companies (including, but not limited to, NEC Ukrenergo, NAEC Energoatom, NAK Naftogas and its subsidiaries). We will introduce best international standards and practices in their corporate governance based on the OECD Guidelines. We are also preparing to privatize the Centrenergo generation company and other key energy producers.

29. **Eliminating energy subsidies requires an effective strategy for protecting lower-income households from the adverse impact of higher energy prices**. While recent reforms have sought to achieve this by means testing of energy privileges, elimination of duplication, and creation of a new energy compensation program for the poorest, further reform is needed to cope with the expected large increase in applicants and contain the fiscal cost. We will undertake measures to consolidate existing programs, improve the targeting of benefits, and ensure better coverage of lower-income groups. Specifically:

a. **Program consolidation, benefits, and administrative capacity**: By May 31, 2015, we shall merge the energy privileges program and the energy compensation program into an expanded energy housing utilities subsidy program by transferring energy compensation beneficiaries to the subsidy program. To this end, we will prepare a plan for the merger by March 31, 2015 and discuss it with IMF and World Bank staff. In the context of the merger, we will also revise the benefit formula in consultation with the IMF and World Bank staff to provide strong incentives for energy efficiency while ensuring poverty relief. Furthermore, we will allocate sufficient fiscal and administrative resources to prepare for an influx of new beneficiaries given the large upcoming tariff increases. Over the medium term, we will seek to integrate the energy bill assistance program as a component of the broader social safety net system built around a reformed and affordable General Minimum Income (GMI) program. This reform will streamline existing benefits and consolidate them into a single cash transfer program focused on protecting households from poverty. To this end, we will set out a timeline for transition to the new system by 2017.

b. **Payments system**: We will revise the billing methodology for energy allowing bill payments to be smoothed over the year—with payments for the previous heating season completed before the beginning of the new one—to avoid undue strain on households and maintain payments compliance.

c. **Information campaign**: We shall conduct extensive public information campaigns to explain the tariff increases and how they will help improve energy service provision, energy independence, and the finances of Naftogaz, as well as the availability of the new energy subsidy programs.

30. **Energy efficiency and investment programs will be needed to reduce the cost of energy over time.** Inefficiencies currently result in large energy losses at the production, distribution and household consumption stages. We will step up our efforts to install gas and heat meters to allow households to monitor and control their energy consumption. While metering is almost complete for households that use large amounts of gas, the gas meter coverage in low-consumption households and for heating is much lower. As of mid-2014, metering for heat was only at 36 percent. By end-2016, we shall seek to achieve universal gas and heat metering, make it compulsory to bill based on meter reading where meters exist, and move to universal consumption-based billing. Improved energy efficiency will also require legal and institutional reforms that specify responsibilities for expanding the use of meters and individual heat substations and facilitate the financing of these investments. With IFC and USAID assistance, we are making legislative changes to

allow for investment in multi-housing apartment buildings where the majority of heating losses are generated.

E. Governance, Transparency and the Business Climate

31. **We are fully committed to tackling Ukraine's deep-rooted problems of governance and weaknesses in its business climate**. In October, Parliament ratified the government's comprehensive reform strategy for 2014-2017 focusing on: (i) overhauling governance by reducing corruption, strengthening law enforcement and reforming the judiciary; (ii) improving the business climate; and (iii) reforming the public sector and political campaign financing. By end-February, the government will publish its program to implement the October reform strategy.

32. **Strengthening governance and the transparency of government operations and improving the business climate remain key reform priorities under the program.** We are gradually implementing the recommendations of last July's diagnostic study on governance, including adoption of a set of laws on anti-corruption and anti-money laundering (AML) last October. Significant progress has been made towards the goal of establishing a strong anti-corruption investigative agency, and amendments to the AML law and the criminal code have strengthened our tools to fight money laundering. However, in light of a track record of failed initiatives to address high-level corruption, we are committed to further strengthening the anti-corruption legal framework and prioritizing its implementation. Specifically, we will:

a. **Strengthen the National Anti-corruption Bureau (NAB) legislative framework**. We will enact legal amendments to ensure that the NAB is subject to a robust external oversight process, can investigate former Presidents, can access all relevant information necessary for its investigations, and that appropriate mechanisms are in place to ensure the hiring of staff with high integrity (***prior action***). Specifically, the NAB Law will be amended to include the following elements:

   i. **External Oversight**. Provision for an independent external oversight process that will entail an annual published report on the NAB's operational performance, independence and institutional conditions. The report will focus on general issues and will not comment on specific, ongoing cases. The oversight will be conducted by a panel of respected experts with international experience in the work of specialized anti-corruption investigative agencies. The Law will ensure that panelists: (1) have recognized ethical standards and experience in anti-corruption investigations in other countries that can bring to bear their international experience; (2) act independently and are not subject to instructions from any source; and (3) have the ability to obtain from the NAB any information on investigations, if relevant for the performance of its functions and without interfering in the conduct of investigations in progress.

ii. **Jurisdiction and Information**. The NAB will be able to investigate all high-level officials, including former Presidents. The Law will empower the NAB to obtain all relevant information to perform its functions, from public authorities and private persons, including information covered by banking secrecy, without restriction or court order requirement.

iii. **Staff Integrity**. To guarantee the professional integrity of staff, the NAB Law will ensure competitive and stable remuneration for the Director and personnel hired, commissioned and seconded at the NAB, and ensure that applicants and holders of positions at the NAB consent to having thorough background checks performed (criminal records, analysis of disclosures of assets beneficially owned and of potential conflicts of interests) beyond those required for all public servants.

iv. **Legal Consistency**. We will ensure that the NAB legal framework remains consistent with the specifications of the end-October structural benchmark and with the Constitution.

b. **Establish the NAB.** We will take necessary measures to establish the NAB by end-April 2015 (***structural benchmark***). In particular, steps will be taken to ensure that: (i) the NAB Director is selected; (ii) an adequate budget is provided and available for the NAB to use in organizing itself and in performing its ongoing functions; and (iii) secure and appropriate premises are made available for NAB's central office.

c. **Enhance Ukraine's AML framework.** We will strengthen the implementation of the AML framework to prevent the misuse of the financial sector to launder the proceeds of corruption, by end-June 2015 (***structural benchmark***). This work will include the following:

i. **Regulations**. The NBU will amend the relevant AML/CFT regulations to implement the legal requirements related to domestic politically exposed persons (PEPs).

ii. **Guidance to Financial Institutions**. The Financial Intelligence Unit (FIU) will assist financial institutions and other reporting entities in identifying domestic PEPs (in particular, by issuing relevant guidance and conducting training events).

iii. **Domestic Cooperation**. Proper arrangements will be put in place to facilitate the cooperation between the NBU, the FIU, and the NAB. The latter should include implementation of procedures requiring the FIU to report financial institutions' potential breaches of compliance with AML/CFT requirements to the NBU, and for the NBU to report to the FIU suspicious transactions which have not been reported by financial institutions when it discovers them in the course of inspections. It should also include measures by the NAB and the FIU to formalize and facilitate their cooperation, in particular to ensure that the FIU disseminates information and the results of its analysis to the NAB when there are grounds to suspect corruption offenses or related money laundering offenses, and that the NAB is able to request all relevant information held by the FIU (in line with the Financial Action Task Force (FATF) standard).

d. **Strengthen asset disclosure process**. We will strengthen the framework for asset disclosures of high-level officials. By end-March 2015, the relevant legal framework will be revised to ensure that asset disclosures for the high-level officials subject to NAB's jurisdiction include information on beneficial ownership and control of any funds or other assets (as defined by the FATF), and that the NAB can use its powers to ensure the reliability of these assets disclosures at any point in time. High-level officials will be prohibited from receiving any gifts and advantages other than of very low value, and from receiving any salary or emoluments other than those related to their official functions or that are allowed by the Constitution.

e. **Other measures.** Going forward, and in line with the July diagnostic study and the Anti-Corruption Strategy for 2014-2017, the government will supplement the above measures by tackling needed reforms of the Prosecutor General's Office and establishing a robust and effective institutional framework for preventive anti-corruption measures.

33. **We will advance efforts to streamline the regulatory framework pertaining to economic activity.** In consultation with civil society, we have identified excessive regulatory barriers which need to be removed. These barriers have been specified and their removal prioritized, based on their substantive impact and timeline, in an action plan, which the Council of Ministers will adopt by March 11, 2015. We will publish the approved action plan together with the background note which will provide explanations on how the measures in the plan were prioritized and how their impact was assessed. The Ministry of Economy in cooperation with the State Regulatory Service (SRS) will monitor implementation of the plan and publish quarterly progress reports within 15 days of the end of the quarter beginning April 15, 2015. The SRS will be responsible for the conduct of proper regulatory impact assessment (RIA) of new regulatory proposals. To this end, the SRS--in consultation with the WB--will create and implement a proper RIA mechanism that ensures

that all draft laws and regulations include proper RIAs to protect against reemergence of overregulation.

34. **Improving business climate to attract investors remains our key priority.** In close cooperation with the World Bank staff, we have prepared a draft law on investors' protection. Specifically, the law aims at (i) introduction of the minority shareholder's right to bring a suit to indemnify for damages in the company's interests; (ii) introducing disclosure requirements of the transactions, for which there is interest; and (iii) introducing requirement to invite an independent auditor in order to made assessment of the transaction in terms of compliance of its conditions with regular market conditions. We will pass the law by end-March, 2015. In addition, the government has also been working on a considerable reduction in the number of inspection agencies.

35. **We will implement measures to strengthen the effectiveness of the judiciary.** Following up on the recommendations of the July 2014 diagnostic report, we will press for measures to enhance the efficiency and effectiveness of the legal enforcement process and the integrity of legal institutions. Specifically, our reform program will encompass the following areas: (i) judicial reform; (ii) financial efficiency; and (iii) effective enforcement of commercial claims. These reforms will be supported by a number of measures:

a. **Judiciary and Status of Judges.** It is expected that the Parliament will adopt a Law on the Judiciary and the Status of Judges during February 2015. By end-March 2015, we will submit the Law to the Venice Commission of the Council of Europe (COE) for its review and opinion against European standards established by the COE, of which Ukraine is a member. By end-July 2015, with the goal of achieving greater efficiency and legal certainty, we will complete the preparation of a concept note assessing the impact of a potential consolidation of the superior courts, including with regard to jurisdiction, case process, personnel, budget, and buildings.

b. **Court Fees**. To enhance efficiency in civil litigation, by end-May 2015, a Law will be adopted on a selective increase of court fees, aiming to double court fee revenues in real terms within 12 months (***structural benchmark***).

c. **Order of Payment Procedure and Garnishments**. By end-August 2015, a Law will be adopted which strengthens the provisions in the Code of Civil Procedure on Order for Payment for domestic transactions and on garnishment of bank accounts (***structural benchmark***). In particular, the Order of Payment provisions will be amended to expand substantially the range of claims covered, streamline the evidence required, and make use of standardized forms. Regarding garnishment, our goal is to remove bottlenecks that have been identified as hampering the effectiveness of the procedure in such areas as definitional issues, locating debtor bank accounts, service of process, adherence to strict timelines, and the liability of banks for non-compliance. We will complete an implementation plan for the new provisions by end-August 2015. The law will take effect according to a schedule allowing assessment of the results of its implementation and mitigating the risks of negative consequences.

d. **Private Enforcement Profession**. With the aim of strengthening the enforcement of claims, a Law establishing a profession of private enforcement agents will be adopted by end-September 2015. The Law will specify the expected jurisdiction of the new profession, professional standards, oversight and disciplinary mechanisms, a fee structure, and access of the profession to registers and records, with reference to the standards established by the CoE.

36. **Reforming the state-owned enterprises (SOEs) and other state owned assets could yield significant benefits**. The SOE sector in Ukraine is a source of significant value and employment, and also of fiscal risk. In total there are over 3,300 central government controlled SOEs in Ukraine, of which just under two-thirds are operational. In 2014, transfers from government to the SOE sector amounted to about 2½ percent of GDP (excluding the large transfers to Naftogaz), while dividends were less than 0.2 percent. We recognize the need for a comprehensive reform of the SOE sector to enhance the financial viability and reduce the fiscal burden of SOEs while more clearly separating ownership and regulatory functions of the state. Specific near-term measures include:

a. **Fiscal risk assessment.** The Ministry of Economy in cooperation with the Ministry of Finance will prepare by end-April a statement of fiscal risks emanating from SOEs to include; an inventory of enterprises that pose the largest fiscal risks and identification of the top 30 SOEs with the largest fiscal risks among them; an assessment of the size and probability of realization of these risks; and proposed mitigating actions. A monitoring and reporting system will also be designed and implemented (***structural benchmark***).

b. **Oversight.** By end-February, we will assign a unit at the Ministry of Economy responsible for (a) preparing reform strategy; (b) preparing an inventory of SOEs, and developing and implementing a fiscal risk management system. We will ensure adequate resources for proper functioning of the unit.

c. **Reform strategy**. The government will adopt, by end-May 2015, a strategy in consultation with the IMF and the WB, to reform the SOE sector. The strategy will lay out a specific timeline for implementation of measures needed to improve budgetary oversight, develop and implement a comprehensive ownership policy, strengthen corporate governance, prioritize which enterprises should be made subject to restructuring, propose specific measures to restructure large SOEs requiring such intervention, and propose transparent privatization of identified assets in the medium run. The strategy will also examine options for improving management of other state assets such as real estate owned by central government entities (***structural benchmark***). In preparation of this reform strategy, the Ministry of Economy in cooperation with the Ministry of Finance and other line ministries, will:

- **Corporate governance**: By end-May 2015, (i) prepare, an inventory of all legislation governing the SOE sector, that relates to the institutional arrangements surrounding regulatory, ownership and oversight policies; and (ii) develop a reform plan to consolidate the existing legislative framework and specify the preferred option for separation of the government's regulatory and SOE ownership functions; (iii) articulate the main measures to be taken to improve corporate governance standards of individual enterprises by adopting international standards;

- **Financial viability**: (i) By end-March, prepare an inventory of at least the 50 largest (in terms of assets or losses) SOEs, specifying their (a) turnover, sales, revenues, expenses, assets and liabilities, arrears, including wage arrears, number of employees, average salary, (b) subsidies and other transfers from the government, dividends paid to the budget, government guarantees issued and other contingent liabilities, and (c) legal status and functions, including their corporate status. (ii) By end-July, we will extend the coverage to all other SOEs and categorize them in terms of their commercial and non-commercial status, and economic viability.

- **Restructuring plans**: By end-April, identify the available options for SOEs restructuring, and set out a preliminary list of 30 key SOEs that may be subject to a restructuring process on a priority basis;

- **Communication**: prepare a communications strategy on the government's proposals for reform of the SOE sector.

d. **Inventory of state property**. The Ministry of Economy, in close cooperation with line ministries and the State Property Fund, will prepare by end-August an inventory of real estate owned by the central government.

e. **Transparency**: The Ministry of Economy will by end June propose and begin implementation of the key transparency policies to be introduced with the objective of publishing details of the value, yield and size of the portfolio. This will include (a) creation and management of a public database with historic and current information on the financial performance of the 50 largest SOEs; (b) preparation and publication of a comprehensive report on SOEs operating and financial performance. This will form the basis for expanding the database to all SOEs and subsequent publication of annual reports on SOE performance.

III. Safeguards

37. **We will ensure that adequate safeguards are in place**. An IMF safeguards assessment completed in August 2014, made recommendations to improve NBU governance, financial autonomy, and internal controls. These recommendations have been or are being addressed in the context of the proposed program.

a. **NBU governance and autonomy**. The draft legislative amendments to the NBU Law, described in ¶9 above, will address the legislative issues flagged in the safeguards assessment. Draft legislative amendments to the Budget Code will block the annual budget from requiring advance NBU profit distributions.

b. **NBU internal controls**. In May 2014, the government and the NBU signed an Agreement concerning the servicing of future financial obligations related to the budget support under the current program and provided a copy of this Agreement to the IMF. We have resumed the quarterly data audits first introduced during the 2008 IMF-supported program and will communicate the results to the IMF within six weeks of each test date. The NBU will establish a permanent senior level credit committee by the first review of the program. The committee will oversee the NBU's lending operations, including emergency liquidity assistance. In this context, the NBU will shift the origination and management of these operations to a function outside of banking supervision.

IV. Program Monitoring

38. **Program implementation will be monitored through prior actions, quarterly reviews, quantitative performance criteria and indicative targets, continuous performance criteria and structural benchmarks**. The first review is set for mid-June 2015 based on end-March 2015 quantitative targets and taking into consideration relevant structural benchmarks. We anticipate that the next three reviews will take place in mid-September 2015; mid-December 2015; and mid-March 2016. These reviews will require observance of conditionality for end-June 2015, end-September 2015, end-December 2015, respectively and continuous performance criteria and structural

benchmarks. For all reviews, quantitative performance criteria will include: a ceiling on the cash deficit of the general government; a ceiling on the combined deficits of the general government and Naftogaz; a ceiling on publicly guaranteed debt; a floor on cumulative change in the NIR; a ceiling on cumulative change in the NBU's NDA; and non-accumulation of external debt payments arrears by the general government. The ***prior actions*** and ***structural benchmarks*** are set out in Table 1. The quantitative targets for target dates through end-December 2015, along with a **continuous quantitative performance criterion** are set out in Table 2. The understandings between the Ukrainian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this memorandum are further specified in the Technical Memorandum of Understanding (TMU) attached to this memorandum.

Table 1. Ukraine: Prior Actions and Structural Benchmarks		
Prior actions	**Status**	**Completion date**
Financial Sector		
Parliament will approve legislation that introduces unlimited liability of bank owners on losses arising from loans granted directly or indirectly to the benefit of bank shareholders holding 10 percent or more of total voting shares as of end-2014 (¶13).		
Energy Sector		
The energy regulator will adopt and officially publish a decision to raise household gas prices to UAH 3600/tcm for consumption in Tier 1 and UAH 7187/tcm for consumption in Tier 2, effective April 1, 2015 (¶28).		
The energy regulator will adopt and officially publish a decision to raise household heating prices to UAH 625/gcal on average, effective April 1, 2015 (¶28).		
The Cabinet will submit to Parliament legislative amendments to improve Naftogaz collections. These amendments should include (i) lifting two long-lasting moratoria (Law 2711-IV/2005 and Law 2864-III/2001) that protect energy and other companies from enforcement proceedings; and (ii) disconnecting non-compliant customers from the gas supply grid (¶28).		
Fiscal Policy		
Parliament will approve a 2015 supplementary state budget law and a package of tax and expenditure legislation consistent with the program deficit ceiling of UAH 78 billion for the general government, containing the elements described in ¶23.		
Government will hire financial and legal advisors to facilitate consultations with holders of public sector debt with a view to improving medium-term debt sustainability (¶26)	Done	February 11, 2015
Governance		
Parliament will approve legal amendments to ensure that the NAB is subject to a robust external oversight process, can investigate former Presidents, can access all relevant information for its investigations, and that appropriate mechanisms are in place to ensure hiring of staff with high integrity (¶32).	Done	February 25, 2015
Structural benchmarks	**Status**	**Completion date**
NBU and Financial Sector		
Parliament will approve amendments to the NBU Law to strengthen the governance and autonomy framework of the NBU (¶9).		End-April 2015
NBU will notify banks of any identified discrepancies in the related party exposure reports based on steps (i) and (ii) as described in ¶13.		End-July 2015
Judiciary/Enforcement		
Parliament will approve a law on a selective increase of court fees, aiming to double court fee revenue in real terms within 12 months (¶35).		End-May 2015
Parliament will approve a law which strengthens the provisions in the Code of Civil Procedure on Order for Payment for domestic transactions and on garnishment of bank accounts (¶35).		End-August 2015

Table 1. Ukraine: Prior Actions and Structural Benchmarks (concluded)

Structural benchmarks (continued)	**Status**	**Completion date**
Fiscal Policy		
Government will prepare a revenue administration reform plan in order to overhaul the state fiscal service. The plan will include measures to implement governance and institutional reforms that clarify the tax agency's reporting to the Minister of Finance; and remove large numbers of underperforming officials as described in ¶25.		End-April 2015
The State Fiscal Service will transfer all taxpayers meeting large taxpayer criteria to the LTO (¶22).		End-December 2015
The State Fiscal Service will implement its new arrangements as specified under the revenue administration reform plan (¶25).		End-December 2015
State-Owned Enterprises		
The Ministry of Economy in cooperation with the Ministry of Finance will prepare a statement of fiscal risks emanating from SOEs as described in ¶36.		End-April 2015
The government will adopt a broad-based strategy (prepared in consultation with the IMF and the World Bank staff) to reform the SOE sector as described in ¶36, including measures needed to improve budgetary oversight, develop a comprehensive ownership policy, strengthen corporate governance, prioritize which enterprises should be made subject to restructuring, and examine options for improving management of other state assets.		End-May 2015
Governance		
Take necessary measures to establish the National Anti-corruption Bureau (¶32).		End-April 2015
Strengthen the implementation of the AML framework to prevent the misuse of the financial sector to launder the proceeds of corruption. This includes: (i) regulatory amendments to ensure proper implementation of the legal requirements related to domestic politically exposed persons (PEPs); (ii) the Financial Intelligence Unit (FIU) will develop a system to assist financial institutions in identifying domestic PEPs; and (iii) proper arrangements will be put in place to facilitate cooperation between the NBU, FIU and NAB (¶32).		End-June 2015
Energy Sector		
Parliament will approve legislative amendments to improve Naftogaz collections. These amendments should include (i) lifting two long-lasting moratoria (Law 2711-IV/2005 and Law 2864-III/2001) that protect energy and other companies from enforcement proceedings; and (ii) disconnecting non-compliant customers from the gas supply grid (¶28).		End-March 2015
Parliament will approve a new gas market law (¶28).		End-April 2015
Undertake an independent audit of all Naftogaz receivables (¶28).		End-June 2015

Table 2. Ukraine: Quantitative Performance Criteria and Indicative Targets 1/

(End of period; millions of Ukrainian hryvnias, unless otherwise indicated)

	2014	2015			
	December	March	June	September	December
		PC	PC	IT	IT
I. Quantitative performance criteria					
Ceiling on the cash deficit of the general government (- implies a surplus) 2/	-	20,400	32,700	40,700	78,200
Ceiling on the cash deficit of the general government and Naftogaz (- implies a surplus) 2/	-	36,500	62,000	94,700	136,200
Floor on cumulative change in net international reserves (in millions of U.S. dollars) 2/ 3/	1,827	-2,502	-1,448	-511	2,291
Ceiling on cumulative change in net domestic assets of the NBU 2/ 3/	304,385	57,704	76,176	88,146	54,671
Ceiling on publicly guaranteed debt 2/	-	30,000	30,000	30,000	30,000
II. Continuous performance criterion					
Non-accumulation of new external debt payments arrears by the general government 2/	0	0	0	0	0
III. Indicative Targets					
Ceiling on cumulative change in base money 2/	333,194	18,256	53,350	80,086	90,796
Ceiling on net accumulation of VAT refund arrears 4/	697	0	0	0	0
IV. Memorandum Items					
External project financing 2/	-	4,523	11,064	19,287	25,274
NBU loans to DGF and operations with Government bonds issued for DGF financing or banks recapitalization 3/	-	25,000	44,000	53,000	55,000
Government bonds issued for banks recapitalization and DGF financing 2/	26,716	29,000	59,500	59,500	139,000
Programmed disbursements of international assistance except IMF (millions of U.S. dollars) 2/ 3/	-	476	3,233	3,733	5,461
Percent of it applied to adjustment		*100*	*100*	*100*	*100*
Purchases of foreign exchange from the NBU for the purposes of critical energy imports (incl. those of Naftogaz, millions of US dollars) 2/	-	1,486	1,686	1,686	1,686
NBU purchases of T-bonds Issued by Government for Naftogaz recapitalization 2/	-	17,200	26,100	28,300	28,300
Projected Payments of Interest on government bonds held by NBU 2/	-	7,100	17,400	27,400	38,000
Program exchange rate, Hryvnia per U.S. dollar	*15.7686*	*15.7686*	*15.7686*	*15.7686*	*15.7686*

Sources: Ukrainian authorities; and IMF staff estimates and projections.

1/ Definitions and adjustors are specified in the Technical Memorandum of Understanding (TMU).
2/ Targets and projections are cumulative flows from January 1, 2015. Data for December 2014 are stocks as of end-December, 2014.
3/ Calculated using program exchange rates specified in the TMU.
4/ Data for December 2014 is a stock as of the end of the month. Quarterly targets are cumulative flows from end-December, 2014.

Annex. Schedule of Bank Reporting, NBU Review, and Banks' Reduction of the Excess of Related Party Lending

	10 largest	***Next 10 largest***	***Rest***
2015			
May	Banks report to NBU		
July	NBU notifies banks on discrepancies	Banks report to NBU	
August	Banks responds on discrepancies (provide proof)		
September	NBU issues final report (decision)	NBU notifies banks on discrepancies	Banks report to NBU
October	Banks submit reduction plans	Banks responds on discrepancies (provide proof)	
November	NBU approves reduction plans		
December		NBU issues final report (decision).	
2016			
January		Banks submit reduction plans	
February		NBU approves reduction plans	
April			NBU issues final report (decision)
June			NBU approves reduction plans

Attachment II. Ukraine: Technical Memorandum of Understanding

February 27, 2015

1. This Technical Memorandum of Understanding (TMU) sets out the understandings between the Ukrainian authorities and IMF staff regarding the definitions of the variables subject to quantitative targets (performance criteria and indicative targets) for the economic program supported by the Extended Arrangement under the Extended Fund Facility, as described in the authorities' Letter of Intent (LOI) dated February 27, 2015 and the attached Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets.

2. Prior actions and structural benchmarks are listed in Table 1 of the MEFP, with corresponding definitions in Section I below. The quantitative performance criteria are shown in Table 2 of the MEFP. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. The official exchange rate is defined in Section II. Reporting requirements are specified in Section III.

3. For the purposes of the program, all exchange rates used to evaluate reserve levels and monetary aggregates are (i) the official exchange rate of the Ukrainian hryvnia to the U.S. dollar of 15.7686 set by the NBU as of December 31, 2014, and (ii) reference exchange rates of foreign currencies reported by the European Central Bank (ECB) on its web site as of December 31, 2014, which the NBU used to set official exchange rates of hryvnia to those currencies. In particular, the Swiss Franc is valued at 0.9904 per dollar, the Euro is valued at 1.2141 dollars, the Pound Sterling is valued at 1.5587 dollars, the Australian dollar is valued at 0.8187 U.S. dollars, the Canadian dollar is valued at 0.8633 dollars the Japanese yen is valued at 119.6195 per dollar, and the Norwegian Krone is valued at 0.1343 dollars. The accounting exchange rate for the SDR will be 0.690224 per dollar. Official gold holdings were valued at 1,206.00 dollars per fine ounce. These program exchange rates are kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing monetary aggregates does not imply that there is any target exchange rate for policy purposes.

4. For the purpose of the program, gross domestic product is compiled as per the System of National Accounts 2008 and excludes Crimea and Sevastopol.

I. Quantitative Performance Criteria, Indicative Ceilings, and Continuous Performance Criteria

A. Floor on Cumulative Change in Net International Reserves (Performance Criterion)

Definition

5. Net international reserves (NIR) of the NBU are defined as the dollar value of the difference between usable gross international reserve assets and reserve-related liabilities to nonresidents, evaluated at program exchange rates.

6. Usable gross international reserves comprise all readily available claims on nonresidents denominated in convertible foreign currencies, consistent with the Balance of Payments Manual (Fifth Edition) and the Special Data Dissemination Standard (SDDS) (Table A, item 1). Excluded from usable reserves, *inter alia*, are:

- any assets denominated in foreign currencies held at, or which are claims on, domestic institutions (i.e., institutions headquartered domestically, but located either domestically or abroad, or institutions headquartered abroad, but located domestically). Also excluded are all foreign currency claims of the NBU on domestic banks, and NBU deposits held at the Interbank Foreign Currency Exchange Market and domestic banks for trading purposes;

- any precious metals or metal deposits, other than monetary gold and gold deposits, held by the NBU;

- any assets that correspond to claims of commercial banks in foreign currency on the NBU and any reserves assets that are: (i) encumbered; or (ii) pledged as collateral (in so far as not already included in foreign liabilities, or excluded from reserve assets); or (iii) frozen; and

- any reserve assets that are not readily available for intervention in the foreign exchange market, *inter alia*, because of lack of quality or lack of liquidity that limits marketability at the book price.

7. For the purpose of this program, reserve-related liabilities comprise:

- all short-term liabilities of the NBU vis-à-vis nonresidents denominated in convertible foreign currencies with an original maturity of one year or less;

- the stock of IMF credit outstanding;

- the nominal value of all derivative positions[1] (including swaps, options, forwards, and futures) of the NBU and general government, implying the sale of foreign currency or other reserve assets; and
- all foreign exchange liabilities of the NBU to resident entities (e.g., claims in foreign exchange of domestic banks, and NBU credits in foreign exchange from domestic market) excluding foreign exchange liabilities to the general government, or related to deposit guarantees.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability[2]		NBU Balance Sheet and Memorandum Accounts
1.	**International reserves**	
	Monetary gold	1100, 1107
	Foreign exchange in cash	1011, 1017
	Demand deposits at foreign banks	1201, 1202,
	Short-term time deposits at foreign banks	1211,
	Long-term deposits at foreign banks	1212
	SDR holdings and Reserve Position in the IMF	IMF, Finance Department[3]
	Securities issued by nonresidents	1300, 1305, 1307, 1308, minus 1306
	Settlement of foreign securities	2746, minus 4746
2.	**Short-term liabilities to nonresidents** *(in convertible currencies)*	
	Correspondent accounts of nonresident banks	3201
	Short-term deposits of nonresident banks	3211
	Operations with nonresident customers	3230, 3232, 3233
	Use of IMF credit	IMF, Finance Department

[1] This refers to the notional value of the commitments, not the market value.

[2] The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on December 31, 2014. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

[3] Before receiving the monthly data from the IMF's Finance Department, these components will be calculated on the basis of preliminary data from the NBU and memorandum accounts.

Adjustment mechanism

- The NIR targets will be adjusted upward (downward) by the full amount of the cumulative excess (shortfall) in program disbursements relative to the baseline projection (Table B). Program disbursements are defined as external disbursements (excluding project financing disbursements) from official multilateral creditors (World Bank, European Commission, European Investment Bank, and European Bank for Reconstruction and Development), official bilateral creditors (net), and external bond placements that are usable for the financing of the central government budget deficit.

- NIR targets will be adjusted upward by the cumulative shortfall in purchases of foreign exchange from the NBU for the purposes of paying critical energy imports (including those of Naftogaz) relative to the baseline projection (Table C).

- NIR targets will be adjusted downward by the full amount of the cumulative excess in government purchases of foreign exchange from the NBU for the purpose and in the event of early repayment of the government-guaranteed part of a maturing external loan to Naftogaz (in case this loan is repaid ahead of schedule). The downward adjustment of the NIR targets will be capped at US$500 million.

- NIR targets will be adjusted upward by the amount that will be converted from Renminbi into US Dollar through an outright sale under the activated swap agreement between the People's Bank of China and the NBU.

Table B. Eurobond Placements and Disbursements from IFIs and Official Sources: Projections for NIR/NDA Adjustment

(Cumulative flows from end-December 2014, millions of US dollars at program exchange rate)

	Eurobond placement	World Bank	EU	Others (Canada, Japan, Switzerland, Norway)	**Total**
End-March 2015	0	0	304	173	**476**
End-June 2015	1,000	500	1032	701	**3,233**
End-September 2015	1,000	1,000	1032	701	**3,733**
End-December 2015	2,000	1,000	1,760	701	**5,461**

Table C. Purchases of Foreign Exchange from NBU for the Purposes of Critical Energy Imports: Projections for NIR Adjustment

(Cumulative flows from end-December 2014, millions of US$)

	Purchases of foreign exchange from the NBU for critical energy imports (incl. those of Naftogaz)
End-March 2015	**1,486**
End-June 2015	**1,686**
End-September 2015	**1,686**
End-December 2015	**1,686**

B. Ceiling on Cumulative Change in Net Domestic Assets of the NBU (Performance Criterion)

Definition

8. Net domestic assets (NDA) of the NBU are defined as the difference between the monetary base (as defined below) and the NIR of the NBU (as defined above). For the purpose of computing the NDA target, the NIR is valued at the program exchange rate defined in paragraph 3 and expressed in hryvnia.

Adjustment mechanism

- Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted downward (upward) by the full amount of the cumulative excess (shortfall) in program disbursements relative to the baseline projection (Table B) and evaluated at the program exchange rate.

- Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted downward by the full amount of the cumulative shortfall in NBU purchases of T-bonds issued by government for Naftogaz recapitalization relative to the baseline projection (Table D).

- Consistent with the NIR target adjustment mechanism (as defined above), NDA targets will be adjusted upward by the hryvnia equivalent of the full amount of the cumulative excess in government purchases of foreign exchange from the NBU for the purpose of repaying the government-guaranteed part of a maturing external loan to Naftogaz (in case this loan is repaid ahead of schedule). The upward adjustment of the NDA target will be capped to hryvnia equivalent of US$500 million, calculated using the program exchange rate defined in paragraph 3.

- NDA targets will be adjusted upward by the full amount of the cumulative excess in the total amount of NBU loans to the Deposit Guarantee Fund (DGF) as well as total amount of NBU purchases of government bonds issued for the purposes of DGF financing, and NBU purchases of government bonds issued for bank recapitalization, relative to the baseline projection, and evaluated at the program exchange rate if provided in foreign exchange (Table D).

- In case the People's Bank of China uses the hryvnia provided under the swap agreement between the People's Bank of China and the NBU, a symmetric adjustor will be applied to NDA targets. NDA targets will be adjusted upward by the amount of hryvnia placed in a commercial bank's account at the NBU, when the People's Bank of China uses the hryvnia. NDA targets will be adjusted downward by the amount of hryvnia (both the principal and interest due), when the People's Bank of China repays the used hryvnia.

Table D. NBU Loans to DGF and Purchases of Government Bonds Issued for DGF Financing or Banks Recapitalization and for Naftogaz Recapitalization: Projections for NDA/Monetary Base Adjustment

(Cumulative flows from end-December 2014, millions of hryvnia)

	NBU loans to DGF and purchases of government bonds issued for DGF Financing or Bank Recapitalization	NBU purchases of government bonds issued for Naftogaz recapitalization
End-March 2015	25,000	17,200
End-June 2015	44,000	26,100
End-September 2015	53,000	28,300
End-December 2015	55,000	28,300

C. Ceiling on Cumulative Change in Monetary Base of the NBU (Base Money) (Indicative Target)

Definition

9. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks, and funds of customers at the NBU.[4] Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A, and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts of groups 323,[5] 3250, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency.

Adjustment mechanism

- Consistent with the NDA target adjustment mechanism (as defined above), monetary base targets will be adjusted upward by the full amount of the cumulative excess in the total amount of NBU loans to the Deposit Guarantee Fund (DGF) as well as total amount of NBU purchases of government bonds issued for the purposes of DGF financing or banks recapitalization, relative to the baseline projection (Table D), and evaluated at the program exchange rate if provided in foreign exchange.

- Consistent with the NDA target adjustment mechanism (as defined above), monetary base targets will be adjusted upward by the amount of hryvnia placed in a commercial bank's account at the NBU, when the People's Bank of China uses the hryvnia. Monetary base targets will be adjusted downward by the amount of hryvnia (both the principal and interest due), when the People's Bank of China repays the used hryvnia.

[4] The definitions set out here will be modified to include any other accounts that may be identified or created in the future in connection with domestic currency issue and the deposit money banks' deposits at the NBU.

[5] Includes accounts of following sectors: 2 – other financial intermediaries and other financial organizations; 6 – regional and local authorities; 7 – government non-financial corporations; 8 – private and foreign-controlled non-financial corporations; 9 – non-commercial organizations serving households.

D. Ceiling on Cash Deficit of the General Government (Performance Criterion)

Definition

10. The general government comprises the central (state) government, including the Road Fund (UkrAvtoDor), all local governments, and all extra budgetary funds, including the Pension Fund, Unemployment Fund, and the Fund for Social Insurance of Ukraine (formerly temporary disability insurance and occupational injury and disease insurance funds). The budget of the general government comprises: (i) the state budget; (ii) all local government budgets; and (iii), if not already included in (i), the budgets of the extra budgetary funds listed above, as well as any other extra budgetary funds included in the monetary statistics compiled by the NBU. The government will inform the IMF staff of the creation or any pending reclassification of any new funds, programs, or entities, immediately. The cash deficit of the general government is measured by means of net financing flows as:

- total net treasury bill sales[6] (in hryvnias and foreign currency) as measured by the information kept in the NBU registry of treasury bill sales (net treasury bill sales are defined as the cumulative total funds realized from the sales of treasury bills at the primary auction and government securities issued for recapitalization of banks and SOEs, less the cumulative total redemption of principal on treasury bills), excluding bonds issued to recapitalize Naftogaz[7] and other SOEs, banks and DGF; plus

- other net domestic banking system credit to general government as measured by the monetary statistics provided by the NBU (this consists of all non-treasury-bill financing in either domestic or foreign currency extended to the general government by banks less the change in all government deposits in the banking system) as well as any other financing extended by entities not reflected by the monetary statistics provided by the NBU; plus

- total receipts from privatization received by the State Property Fund and local governments (including the change in the stock of refundable participation deposits and the net sale of nonfinancial assets); plus

[6] From here on, treasury bills are defined as all treasury securities (including long term instruments or treasury bonds).

[7] These are included in the financing of Naftogaz' cash deficit when they are used (as collateral for a loan, or as an outright sale) by the latter to obtain financing.

- the difference between disbursements and amortization on any bond issued by the general government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus
- the difference between disbursements of foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of foreign credits by the general government (including on lent project loans); plus
- the net sales of SDR allocation in the SDR department; plus
- the net change in general government deposits in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the general government.

11. For the purposes of measuring the deficit of the general government, all flows to/from the budget in foreign currency (including from the issuance of foreign currency denominated domestic financial instruments) will be accounted in hryvnias at the official exchange rate established as of the date of the transaction.

Adjustment mechanism

- The ceiling on the cash deficit of the general government is subject to an automatic adjuster based on deviations of external project financing (defined as disbursements from bilateral and multilateral creditors to the consolidated general government for specific project expenditure) from program projections (Table E). Specifically, if the cumulative proceeds from external project financing (in hryvnia evaluated at actual exchange rates):

a) exceed program projections, the ceiling on the consolidated general government deficit will be adjusted upward by 100 percent of the excess in external project financing; and

Table E. External Financing of General Government Projects—Adjustment

Cumulative flows from January 1, 2015	In millions of hryvnia
External project financing (technical assumption for the adjuster purpose)	
End-March 2015	4523
End-June 2015	11064
End-September 2015	19287
End-December 2015	25274

- The ceilings on the cash deficit of the general government at end-March, end-June, end-September, and end-December 2015 are subject to an automatic adjuster corresponding to the full amount of government bonds issued for the purposes of banks recapitalization and DGF financing, up to a cumulative maximum of UAH 139 billion in 2015. The test date ceilings on the cash deficit of the general government for 2015 will be adjusted upward by any amount of the UAH 139 billion bank recapitalization and DGF financing ceiling under the program that is not used in 2015.

- The ceiling on the cash deficit of the general government is subject to an automatic adjuster on the stock of budgetary arrears on social payments. Budgetary arrears on social payments comprise all arrears of the consolidated budget on wages, pensions, and social benefits owed by the Pension Fund, and the central or local governments. Budgetary arrears are defined as payments not made thirty days after they are due. Wages are defined to comprise all forms of remuneration for work performed for standard and overtime work. Pension obligations of the Pension Fund comprise all pension benefits and other obligations of the Pension Fund. This definition excludes unpaid pensions to individuals who resided or continue to reside on the territories that are temporarily outside the government control.

- The ceiling on the cash deficit of the general government at all 2015 test dates will be automatically adjusted downward by VAT refund arrears accumulated as defined in Section E from January 1, 2015.

- The ceilings on the cash deficit of the general government at end-March, end-June, end-September, and end-December 2015 are subject to an upward adjustment for the full amount of government repaying government-guaranteed part of an external loan to Naftogaz, in case this loan is repaid ahead of schedule and the repayment is recorded as above-the-line transaction. The adjustment will be equal to the actually repaid amount in US$ terms capped at US$500 million, and recalculated in hryvnia at the actual exchange rate at the time of repayment.

12. The ceilings on the cash deficit of the general government at end-March, end-June, end-September, and end-December 2015 are subject to an automatic downward adjuster corresponding to the full savings on the budgetary interest bill resulting from any restructuring or reprofiling of existing government debt to NBU as of end-2014. Such savings will be determined as the difference between the actual and projected payments on government bonds held by the NBU. The projected payments are presented in Table F.

Table F. Projected Payments of Interest on government bonds held by NBU

Cumulative flows from January 1, 2015	In billions of hryvnia
End-March 2015	7.1
End-June 2015	17.4
End-September 2015	27.4
End-December 2015	38.0

E. Ceiling on VAT Refund Arrears (Indicative Target)

13. The ceiling on net accumulation of VAT refund arrears is set to UAH 0 billion. The stock of VAT refund arrears is defined as those claims that have not been settled (through a cash refund, netting out against obligations of taxpayers, payment with a government bond (VAT bond) or an official decision to reject the claim) within a specified time period after the VAT refund claim has been submitted to the State Fiscal Service (SFS). In 2015, this time period is 74 days, allowing for verification of the validity and payment processing of claims. According to this definition, the stock of VAT refund arrears as of December 31, 2014 was UAH 0.697 billion.

F. Ceiling on Cash Deficit of the General Government and Naftogaz (Performance Criterion)

Definition

14. The cash deficit of the General Government and Naftogaz is the cash deficit of the General Government as defined above plus the cash deficit of Naftogaz.

15. Naftogaz is defined as the national joint stock company "Naftogaz of Ukraine." The cash deficit of Naftogaz is measured from below the line as:

- net domestic banking system credit to the company (this consists of all financing in either domestic or foreign currency extended to the company by banks less the change in company deposits in the banking system); plus

- the difference between disbursements of private foreign loans to Naftogaz (including private placements) and the amortization of private foreign loans (including private placements) ; plus
- the difference between disbursements of official foreign credits to Naftogaz (including project loans) and the amortization of official foreign credits (including project loans); plus
- the disbursements of trade credits to import gas; plus
- the difference between disbursements and amortization on any bonds issued by Naftogaz; plus
- the net change in deposits of Naftogaz in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by Naftogaz; plus
- net receipts from sale of financial assets (including recapitalization or other form of treasury securities issued to Naftogaz, irrespective of their issuance date); plus
- any other forms of financing of the company not identified above.

16. For the purposes of measuring the deficit of Naftogaz, all flows in foreign currency will be accounted in hryvnias at the official exchange rate as of the date of the transaction. When there are arrears outstanding as of the test date, the official exchange rate on the test date will apply to their valuation.

Adjustment mechanism

- The ceiling on the cash deficit of the general government and Naftogaz will be adjusted upward by the amount of financing by multilateral institutions and official bilateral creditors disbursed to Naftogaz for investment projects.
- The ceiling on the cash deficit of the general government and Naftogaz will be adjusted downward by the net transfers made by Gazprom (advance transit fee). These transfers are measured on a cumulative basis from the beginning of each calendar year.

G. Ceiling on Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

Definition

17. For the purposes of the program, an external debt payment arrear will be defined as a payment by the general government, which has not been made within seven days after falling due (including grace period, if any). The performance criterion will apply on a continuous basis throughout the program period.

H. Ceiling on Publicly Guaranteed Debt (Performance Criterion)

Definition

18. The ceiling on publicly guaranteed debt will apply to the amount of guarantees issued in 2015 by the central (state) government. The official exchange rate will apply to all non-UAH denominated debt. New state guarantees in 2015 will amount to no more than UAH 30 billion. This ceiling excludes guarantees issued by the Ministry of Finance for NBU borrowings from IMF.

I. Other Continuous Performance Criteria

19. During the period of the Extended Arrangement, Ukraine will not (i) impose or intensify restrictions on the making of payments and transfers for current international transactions; (ii) introduce or modify multiple currency practices; (iii) conclude bilateral payments agreements that are inconsistent with Article VIII; and (iv) impose or intensify import restrictions for balance of payments reasons.

II. Official Exchange Rate

Determination of the official exchange rate

20. The NBU will, on a daily basis, set the official rate calculated as a weighted average of the exchange rates of the interbank market deals on the same day. To calculate the official exchange rate, all deals concluded on the day will be considered regardless of the settlement date. Specifically, tod, tom and spot (T+2) deals will be included. NBU will make public its official exchange rate by no later than 18:00 of the day, preceding the one for which it is set.

III. Reporting Requirements

A. National Bank of Ukraine

21. The NBU will continue to provide to the IMF on a monthly basis, no later than the 25th day of the following month, an aggregate balance sheet for the NBU and a consolidated balance sheet for the deposit money banks.

22. The NBU will provide to the IMF, on a daily basis, with daily data the stock of net and gross international reserves, at both actual and program exchange rates. In addition, it will provide on a weekly and monthly basis, no later than the 25th of the following month, the full breakdown of NBU accounts included in net international reserves (defined in Table A above).

23. The NBU will provide the IMF on a daily basis with information on official foreign exchange interventions. In this context, it will also provide the results of any foreign exchange auctions.

24. The NBU will provide the IMF on a daily basis with information on balances held in the analytical accounts 2900 "Accounts payable per transactions for the foreign exchange, banking and precious metals purchase and sale on behalf of banks' clients."

25. The NBU will continue to provide on its web site the daily holdings of treasury bills at primary market prices, at current exchange rates. The NBU will provide information on daily holdings of treasury bills broken down by type of holders (including state-owned banks and private banks) at primary market prices at the rate fixed on the day of auction information on t-bills sales, including in the foreign exchange, from the beginning of the year at the official rate as of the date of placement, as well as the t-bills in circulation, by principal debt outstanding at the official exchange rate as of the date of placement (OP-2); reports on each treasury bill auction; and provide to the IMF the monthly report on treasury bills, in the format agreed with the IMF staff.

26. The NBU will provide information on daily transactions (volumes and yields) on the secondary market treasury bills (including over the counter transactions).

27. The NBU will provide to the IMF, on a daily basis, the information on the claims on banks provided and liabilities in the format agreed with the IMF staff.

28. The NBU will provide to the IMF its financial statements (income and expenses) for the current and, if available, for the following year, as approved by the NBU's Council. The IMF is to be notified immediately of any update.

29. The NBU will keep providing to the IMF, on a monthly basis, general information on the NBU financing (as well as the refinancing) of the banks of Ukraine, and on the operations of mopping up (absorption) of the liquidity from the banking system (including through the CDs issuance) in the format agreed with the IMF staff. It will also provide, on a weekly basis, bank-by-bank information on the outstanding amount of loans from the NBU, reported by type of lending. In the weekly report, the NBU will include the collateral that has been pledged to the NBU for loans (by bank and loan type as well as by collateral type, haircut and currency). The weekly reporting of NBU loans and collateral will make clear which banks are under temporary administration or liquidation.

30. The NBU will provide to the IMF, on a quarterly basis but not later than 30 days after the expiration of the reporting quarter, the report on the banking sector financial stability indicators in the format agreed with the IMF staff.

31. Every 10 days, the NBU will continue to provide the IMF with the operational monetary survey of the NBU, including any additional information that is needed for the IMF staff to monitor monetary policy and developments in the banking sector.

32. The NBU will provide to the IMF, on a monthly basis, the net domestic assets data based on the monthly balance sheets within three weeks following the end of the month.

33. The NBU will continue to provide to the IMF the daily operational balance sheets of the NBU and commercial banks on a daily basis according to standard reporting forms, including detailed information on loans of the banking sector provided to the general government, with detailed breakdown of this information by indebtedness of the central (state) government and local budgets, including in national and foreign currency, by loan and by security, as well as the information on the balances of the funds of the government held at the NBU, in particular, the balances of the Single Treasury Account denominated in the national currency (account 3240 A) and the funds of the State Treasury denominated in foreign currency (account 3513 A).

34. The NBU will provide to the IMF, on a monthly basis, projections for external payments falling due in the next twelve months. The data on actual settlement of external obligations, reflecting separately principal and interest payments as well as actual outturns for both the public and private sectors, shall be provided on a quarterly basis, within 80 days following the end of the quarter.

35. The NBU will provide to the IMF, on a quarterly basis, the stock of short- and long-term external debt (including arrears) for both public and private sectors.

36. The NBU will provide to the IMF, on a daily basis, data on foreign exchange export proceeds and obligatory foreign exchange sales; data on import transactions for goods and services; data on amounts of foreign exchange transferred from abroad to the benefit of physical persons – residents and non-residents – to be paid in cash without opening an account; data on FX wires from Ukraine abroad for current foreign exchange non-trade transactions on the basis of the orders of physical persons; data on sales and purchases of foreign exchange cash by individuals (incl. through banks, exchange offices, and Ukrposta); data summarizing the implementation of T+2 verification system, namely, the total number and volume of transactions screened and the total number and volume of transactions blocked, with separate information on imports. The NBU will provide to the IMF weekly data on the volumes of non-cash foreign exchange purchases on behalf of banks' clients and banks broken down by reasons (From N 538).

37. The NBU will provide to the IMF, on a daily basis, data on foreign assets and liabilities of the overall banking system (excl. the NBU); data on banks' open foreign exchange positions by main groups of banks; data on deposits on the aggregated basis for the overall banking system (excl. the NBU) broken down by households and legal entities, maturity, as well as by national and foreign currency; data on loans on the aggregated basis for the overall banking system (excl. the NBU) broken down by households and legal entities as well as by national and foreign currency.

38. The NBU will provide, on a daily basis, bank-by-bank data for the largest 35 banks and aggregate data for the Group III and IV banks separately on cash and cash equivalents, available funds in NBU accounts (excl. reserve requirements), correspondent accounts with well-known international banks (excl. encumbered accounts), and deposits. The data will be reported by domestic and foreign currency. In addition, the deposits will be reported by households and legal entities and by maturity (current accounts, saving accounts, and time deposits).

39. The NBU will provide, on a monthly basis, data on the total number and volume of deposits of individuals broken down in groups by deposit size. The data will be reported by bank for the largest 35 banks and on aggregate for the remaining banks.

40. The NBU will provide to the IMF on a daily basis aggregated data on main currency flows, including government foreign receipts and payments by currencies as well as currency breakdown of interbank market operations. The NBU will continue to provide daily information on exchange market transactions including the exchange rate.

41. The NBU will provide to the IMF reports N 381.25; 381.26 with information on reserve requirements.

42. The NBU will provide the IMF, on a two weekly basis, with daily data on the total financing (including refinancing) issued by the NBU to commercial banks, broken down by types of instrument, maturity (average weighted), interest rate as well as transactions to absorb liquidity from the banking system.

43. The NBU will provide the IMF, on a two weekly basis, in an agreed format, data for the entire banking sector as well as on a bank-by-bank basis for Group I and Group II banks on total assets and liabilities; risk weighted assets (for ratio H2 calculation); regulatory and Tier 1 capital; capital adequacy ratios for normative, regulatory (Tier I and Tier II) and Tier 1 capital; deposits (by maturity, domestic and foreign currency, and households and legal entities); insured deposits (by domestic and foreign currency); deposits of related parties (by domestic and foreign currency, and households and legal entities); other liabilities to related parties (by domestic and foreign currency); counterparty names and amounts of the largest 20 deposits of related parties; loans and claims (by households in domestic and foreign currency, legal entities in domestic and foreign currency, banks in domestic and foreign currency, maturity, and by loan classification categories I, II, III, IV and V); collateral for loans and claims (by type of collateral, legal entities in domestic and foreign currency, households in domestic and foreign currency, banks in domestic and foreign currency, and by loan classification categories I, II, III, IV and V); provisions on loans and claims (by households in domestic and foreign currency, legal entities in domestic and foreign currency, banks in domestic and foreign currency, and by loan classification categories I, II, III, IV and V); related party loans (by households, legal entities, and banks); counterparty names and amounts of the largest 20 loans to related parties; large exposures (loans equal to or greater than 10 percent of equity), refinanced loans, and restructured loans (by households, legal entities, and banks); the average interest rate on the outstanding stock of loans to customers (by legal entities and households); amount in accounts at the NBU; accrued interest (by domestic and foreign currency); foreign exchange net open position; securities held for sale with government securities reported separately (by domestic and foreign currency); securities held as investment with government securities reported separately (by domestic and foreign currency); mandatory reserve requirement and assets held at the NBU; cash in vaults.

44. The NBU will provide to the IMF, on a monthly basis, data bank-by-bank and by region loans and provisions (by households and legal entities, and domestic and foreign currency); deposits (by households and legal entities, and domestic and foreign currency); due from banks (by domestic and foreign currency).

45. The NBU will report to the IMF, on a monthly basis, bank-by-bank data on cumulative income statements, including total revenues; interest revenues (from loans to households, loans to legal entities, interbank loans, placements with the NBU, securities); revenues from fees and

commissions; total expenses; interest expenses (on deposits to legal entities, deposits to households, interbank borrowing, borrowing from NBU, securities issued); fees and commissions paid; salaries and other staff compensation; other operational expenses; net earnings before loan loss provisions; loan loss provisions; net earnings after loan loss provisions; taxes paid; net earnings.

46. The NBU will provide to the IMF the existing report containing two-week projections of cash flows for the 35 largest banks. The report will be provided to the IMF with the same frequency as it is produced internally at the NBU.

47. The NBU will report to the IMF on a bi-weekly basis and bank-by-bank the amount by which the Group 1 and 2 banks' regulatory capital has been increased. The report will disclose the instrument or means by which the regulatory capital has been increased (e.g., capital injection, conversion of subordinated debt to equity etc.)

48. The NBU will once a month inform the IMF any regulatory and supervisory measures against banks violating the NBU regulations on capital adequacy, liquidity ration, large exposures, and connected lending, as well as about decisions on declaring a bank as problem or insolvent.

49. The NBU will continue to provide on a monthly basis, no later than 25 days after the end of the month, banking system monitoring indicators in an agreed format. This includes inter alia data on nonperforming loans (III, IV and V category).

50. The NBU will continue to provide detailed quarterly balance of payments data in electronic format within 80 days after the end of the quarter.

51. The NBU will provide data on credit to nongovernment units that are guaranteed by the NBU on a monthly basis no later than 25 days after the end of the month.

52. The NBU will inform IMF staff if the Treasury does not pay interest or principal on domestic government bonds due to the NBU, deposit money banks, or nonbank entities and individuals. In such case, the NBU will provide information on outstanding interest and principal payments.

53. The NBU will inform IMF staff of any changes to reserve requirements for deposit money banks.

54. The NBU will communicate (electronically) to the IMF staff any changes in the accounting and valuation principles applicable to the balance-sheet data and will notify the staff before introducing any changes to the Charts of Accounts and reporting forms of both the NBU and the commercial banks.

55. The NBU Internal Audit Department will continue to provide an assurance report to the Fund, no later than six weeks after each test date, confirming that: (i) the monetary data are in accordance with program definitions and have been verified and reconciled to accounting records; and (ii) that there have been no changes to the chart of accounts or valuation methods that would impact the data reporting.

56. The NBU will continue to provide the Fund with a copy of the annual management letter from the external auditor within six weeks of completion of each audit. As required under the Fund's safeguard policy, this will remain in effect for the duration of the arrangement and for as long as credit remains outstanding.

57. The NBU will provide the Fund with data on the interest income received from the portfolio of government bonds available at January 19, 2015 on a quarterly basis but no later than 15 days from the end of the reporting period,

B. Deposit Guarantee Fund

58. The DGF will report to the IMF on a monthly basis and bank-by-bank the amount of pending payments to insured depositors in banks in liquidation. The report will also contain the amount of resources available in DGF to pay insured depositors in banks in liquidation. The available resources will be reported by type of resource (e.g., cash balance, government bonds etc.)

59. The DGF will report to the IMF on a monthly basis the amount and type of resources that have been provided to DGF from the MoF during the preceding month. The report will also contain a 1-year month-by-month forecast of the amount and type of resources that the DGF expects to receive from MoF, the amount of government bonds the DGF plans to sell to or repurchase with the NBU and the amount that DGF expects to pay out to insured depositors in banks in liquidation (reported bank-by-bank).

C. Ministry of Finance

60. The Ministry of Finance will provide the IMF with the monthly consolidated balances (end-month) of other non-general government entities, including SOEs, holding accounts at the Treasury no later than 25 days after the end of the month.

61. The Treasury will continue to provide to the IMF reports on: daily operational budget execution indicators, daily inflow of borrowed funds (by currency of issuance) to the state budget and expenditures related to debt service (interest payments and principals), weekly balances of Treasury cash flow (outturn and forecast), including data on government foreign exchange deposits,

in a format agreed with IMF staff, 10-day basis data on revenue of the state, local government, and consolidated budgets, monthly data on funds, deposited with the Single Treasury Account, on the registration accounts of the entities which are not included to the state sector, information on the stock of public entities in account #3712 within the Single Treasury Account, on inflow to the State budget from placing Treasury or any other liabilities to households in foreign and domestic currency and their redemption.

62. The Ministry of Finance will continue to provide to the IMF in electronic form monthly and quarterly treasury reports, no later than 25 and 35 days after the end of the period respectively. The Ministry of Finance will continue to provide to the IMF in electronic form the final fiscal accounts at the end of each fiscal year, no later than March of the following year. Inter alia, these reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications. In addition, quarterly reports will contain standard information on budget expenses to cover called government guarantees.

63. The Ministry of Finance will report monthly data on the public wage bill (excluding SOEs) in line with the template agreed with the IMF staff. It will also provide monthly reports on the borrowing (disbursements, interests and amortization) of UrkAvtoDor in line with the format agreed with IMF staff. The Ministry of Finance will report to the IMF on a monthly basis information on municipal borrowing and amortization of debt in format agreed with IMF staff.

64. The Ministry of Finance will report to the IMF on a monthly basis, no later than 15 days after the end of the month, the cash deficit of the general government, with details on budget execution data for privatization receipts of the state and local governments; disbursements of external credits (including budget support and project loans for on-lending) to the consolidated budget and amortization of external debt by the consolidated budget; net domestic borrowing of the general government, including net t-bill issuance, issuance of other government debt instruments, and change in government deposits.

65. The Ministry of Finance will provide data on the stock of all budgetary arrears on a monthly basis, no later than on the 1st day of the second subsequent month, including separate line items for wages, pensions, social benefits, energy, communal services, and all other arrears on goods and services. The Treasury will report monthly data on accounts payable for state and local budgets (economic and functional classification). The Pension Fund will provide monthly reports on net unpaid pensions to the individuals who resided or continue to reside in the territories that are temporarily outside the government control.

66. The Ministry of Finance will provide monthly information, no later than 25 days after the end of each month, on the amounts and terms of all external debt contracted or guaranteed by the central government.

67. The Ministry of Finance will provide to the IMF in electronic form on a monthly basis, no later than 25 days after the end of the month, (a) data on the outstanding stock of domestic and external debt of the state and local budgets (including general and special funds), (b) the standard files planned and actual external debt disbursement, amortization, and interest payments (including general and special funds), broken down in detail by creditor categories as agreed with Fund staff, and (c) the report on external debt amortization and interest payments by days and currencies. The Ministry of Finance will also report the accumulation of any budgetary arrears on external and domestic debt service.

68. The Ministry of Finance will provide to the IMF monthly debt (domestic and external) amortization schedules updated on a weekly basis.

69. The Ministry of Finance will provide data on external and domestic credit to key budgetary spending units as well as nongovernment units (including Naftogaz, State Mortgage Institution, Deposit Guarantee Fund and Agrarian Fund) that is guaranteed by the government (amount of sovereign guarantees extended by executive resolutions and actually effectuated; total amount of outstanding guarantees and list of their recipients) on a monthly basis no later than 25 days after the end of the month.

70. The Ministry of Finance will provide data on the approved budgets and quarterly operational data (daily for the Pension Fund only) on the revenue, expenditures, and arrears, and balance sheets of the Pension Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), the Fund for Social Insurance , Employment Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), and any other extra budgetary funds managed at the state level no later than 50 days after the end of each quarter (each month in case of the Pension Fund). Any within-year amendments to the budgets of these funds will be reported within a week after their approval. The Ministry of Finance will also report the annual financial statement including the final fiscal accounts of those funds at the end of each fiscal year, no later than April of the following year.

71. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central (state) and local budgets, starting from January 2010. After any public sector wage increase, the Ministry of Finance will provide an estimate

of its costs for the current and two subsequent fiscal years, for the state and local government budgets.

72. The Ministry of Finance will provide, no later than 15 days after the end of each month, monthly data on the budgetary costs associated with the recapitalization of banks and SOEs. This cost includes the upfront impact on the cash deficit of the general government of the recapitalization of banks and SOEs as well as the costs associated with the payment of interests.

73. The Ministry of Finance will provide monthly data on their expenditure plans (ROSPIS) for state budget.

74. The State Fiscal Service (SFS) will provide monthly data, no later than 25 days after the end of the month, on tax arrears, inclusive of deferred payments, interest and penalties outstanding, in the following format:

	Beginning Stock				Netting out during month	I. DEFERRALS DURING MONTH	Write-offs (arrears written off during month)	Collections of outstanding debt at beginning of month	New Arrears (tax liabilities becoming overdue during month)	Ending Stock
	Total	Principal	Interest	Penalties						
Tax arrears										

75. The SFS will continue to provide on a quarterly basis, no later than two months after the end of the quarter, a listing of all tax exemptions granted, specifying the beneficiary the exemption provided, the duration, and the estimated subsequent revenue loss for the current fiscal year.

76. The SFS will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund requests; (ii) refund requests paid in cash; (iii) refunds netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock of requests; and (vii) stock of VAT refund arrears according to the definition in paragraph 11 (unsettled VAT refund claims submitted to the SFS more than 74 days before the end-of-period.

77. The SFS will continue to provide monthly reports 1.P0 on actual tax revenue and 1.P6 on tax arrears, no later than 25 days after the end of each month.

78. The SFS will provide on a quarterly basis but no later than 25 days after the end of each quarter information on the number of tax appeals and the associated disputed amounts received by the SFS in each reporting period, the number of internally resolved appeals indicating the number of appeals resolved in favor of the controlling body, in favor of taxpayer and partial satisfaction.

79. After each amendment of the state budget, the Ministry of Finance will provide data on revenue plans (ROSPIS) for state and local budgets.

D. Ministry of Economy, Ministry of Energy and Coal Industry, Ministry of Housing and Municipal Economy of Ukraine, NURC and NERC

80. The Ministry of Economy will provide quarterly information on actual levels of communal service tariffs in all regions for major services (heating, water supply, sewage and rent) and their level of cost recovery. In addition, the Ministry of Economy, the Ministry of Housing and Municipal Economy of Ukraine, and the National Energy Regulatory Commission will provide the methodology underlying the tariff calculations for full cost recovery, including heating and gas.

81. For each month, no later than the 25th of the following month, the government (based on information by the Ministry of Energy and Coal Industry, the Ministry of Economy, SFS/SCS, MoF, NERC, and Naftogaz) will provide IMF staff with information in electronic form (in an agreed format defined as "Ukraine: The Financial Position of Gas Sector") on financial indicators in the gas and heating sectors, including prices and volumes of domestically produced (by production entity) and imported (by sources of imports) gas, sales, tariffs, arrears, payments to the budget, subsidies, and debt. On a monthly basis, Naftogaz will provide to IMF staff updated information on the company's financial liabilities, with a schedule of loan-by-loan interest and principal payments.

82. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information "in electronic form (in an agreed format) on the cash flows and deficit of the company, as defined above. This report will break down the total cash outlays for gas imports from Gazprom by month in a separate table mutually agreed with IMF staff.

83. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information in electronic form in an agreed format on the domestic gas used by Naftogaz for sales to households, heating utilities, budget institutions, and industries, including gas produced by SC "Ukrgasvydobuvannya," and OJSC "Ukrnafta."

84. For each quarter, no later than the 25th of the following month, the Ministry of Housing and Municipal Economy will provide IMF staff with information of the quantity of heating energy meters installed at a building-level measured also as a ratio to the applicable buildings.

85. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information in electronic form on the amount of Naftogaz arrears to domestic suppliers including Naftogaz subsidiaries, Ukrtransgas, Ukrgas vydobuvannya, Ukrnafta 90 days after they are due.

86. For each month, no later than the 25th of the following month, the Ministry of Energy and Coal Industry (based on information by Naftogaz) will provide IMF staff with information in electronic form and in an agreed format with IMF staff the stock of Naftogaz receivables and the amount of receivables paid in prior month.

87. The Ministry of Energy and Coal Industry (based on information by Naftogaz) will report on a weekly basis data on Naftogaz daily market purchases of foreign exchange.

88. The Ministry of Economy will provide on a quarterly basis, but no later than 80 days after the end of each quarter consolidated information from the financial statements of 50 largest SOEs (excluding Naftogaz). Specifically, the information will include data on: (a) gross profit/losses, (b) net financial results, (c) subsidies received from the budget, (d) guarantees granted from the budget, (e) stock of debt, broken down by domestic and foreign (f) taxes and dividends paid, (g) wage arrears and (h) other payment arrears. The report will also include information on the number of all SOE (a) making profits, (b) making loss or (c) balanced with aggregated financial results for each of these groups.

E. State Statistics Service

89. In case of any revisions of gross domestic products the State Statistics Service will provide to the IMF revised quarterly data on gross domestic product (nominal, real, deflator) and their components (economic activities, expenditure, income), no later than 10 days after any revisions have been made.

Annex

Occupations defined in the Law of Ukraine on Pensions that are eligible for early retirement and will be affected by an increase in the retirement age and the qualified period of service:

Occupations allowing early retirement based on the age and the qualified period of service:

Occupations included in Lists 1 and 2 established by the Cabinet of Ministers' Resolution #36, plus:
Tractor drivers
Public transportation drivers
Workers employed in the textile industry
Milkmaids

Occupations allowing early retirement based on the qualified period of service:

Employees of education
Employees of healthcare
Employees of social security services
Athletes
Artists
Aviation workers

INTERNATIONAL MONETARY FUND

UKRAINE

ASSESSMENT OF THE RISKS TO THE FUND AND THE FUND'S LIQUIDITY POSITION

March 6, 2015

Approved By
Andrew Tweedie and Mark Flanagan

Prepared by the Finance and Strategy, Policy, and Review Departments

CONTENTS

INTRODUCTION

1. **This note assesses the risks to the Fund arising from the proposed arrangement under the Extended Fund Facility (EFF) for Ukraine and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.**[1] The authorities are requesting a four-year extended arrangement under the EFF with access equivalent to SDR 12.348 billion (900 percent of quota) and have notified the Fund of their intention to cancel the existing Stand-by Arrangement (SBA). Proposed access is significantly frontloaded, with a first purchase of SDR 3.546 billion (258.45 percent of quota) upon approval, followed by three purchases of SDR 1.182 billion (86.16 percent of quota) each during the remainder of 2015. By mid-March 2016, a year into the program, cumulative scheduled purchases would amount to SDR 7.530 billion (548.9 percent of quota or more than 61 percent of the proposed access). The remaining access is phased in 11 quarterly purchases equivalent to SDR 437.98 billion (31.92 percent of quota), with the final purchase scheduled for mid-December 2018, following the completion of the fifteenth review (Table 1).

Table 1. Ukraine: Proposed EFF—Access and Phasing

			Percent of quota	
Availability	Date 1/	SDR mn	Purchase	Cumulative
2015	February/March	3,546.0	258.5	258.5
	June	1,182.1	86.2	344.6
	September	1,182.1	86.2	430.8
	December	1,182.1	86.2	516.9
2016	March	438.0	31.9	548.9
	June	438.0	31.9	580.8
	September	438.0	31.9	612.7
	December	438.0	31.9	644.6
2017	March	438.0	31.9	676.5
	June	438.0	31.9	708.5
	September	438.0	31.9	740.4
	December	438.0	31.9	772.3
2018	March	438.0	31.9	804.2
	June	438.0	31.9	836.2
	September	438.0	31.9	868.1
	December	438.0	31.9	900.0
	Total	12,348.0	900.0	

Source: Finance Department
1/ Starting in June 2015, purchases will depend on the completion of a review and/or compliance with performance criteria as established under the program.

[1] See paragraph 5 of Decision No 14064-(08/18), adopted 2/22/2008, as amended, and The Acting Chair's Summing Up of the Review of Access Policy Under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy (3/5/03).

BACKGROUND

2. **Ukraine has had an extensive financial relationship with the Fund since becoming a member in September 1992 (Table 2).** GRA credit outstanding to Ukraine currently stands at SDR 3.785 billion (276 percent of quota). Performance under Ukraine's previous programs with the Fund has generally been poor. The 2005 ex-post assessment (EPA) covering 13 years of Fund engagement in Ukraine since its independence singled out lack of political consensus to pursue market-friendly reforms as the main cause of repeated program failures.[2] In the same vein, the 2011 and 2013 ex-post evaluations (EPEs) of the 2008 and 2010 programs under the SBA—approved in November 2008 and July 2010 — also point to weak ownership of policies and weak governance as having led to the failure of these programs. The 2008 two-year SBA-supported program went off track after two reviews and was cancelled in mid-2010. The 2010 29-month SBA-supported program went off-track after completion of one review. Ukraine has met its obligations to the Fund in a timely fashion.

3. **Ukraine's purchases under the current SBA represent less than one-third of the committed amount under the existing program**. In April 2014, the Executive Board approved a 24-month SBA with access equivalent to SDR 10.976 billion (800 percent of quota) to support the authorities' program, aimed at restoring macroeconomic stability, strengthening economic governance and transparency, and laying the foundation for strong economic growth. The fiscal targets under the program were met with a margin. However, despite the authorities' efforts, the program was derailed after completing the first review largely because a key risk identified at the time of the program approval materialized, namely the escalation of the conflict in Eastern Ukraine. Also, progress was made in implementing a number of key structural reforms although some key pieces of legislation were watered down reflecting pressure from vested interests. The purchase associated with the completed review brought cumulative purchases under the existing SBA to SDR 2.973 billion (216.7 percent of quota).

[2] See Ukraine—Ex Post Assessment of Longer-Term Program Engagement (10/18/2005).

Table 2. Ukraine: IMF Financial Arrangements and Fund Exposure, 1994-2029 1/
(In millions of SDR)

Year	Type of New Arrangement		Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Amount Drawn	Number of reviews			Fund Exposure 1/	
							Envisaged	Completed			
1994	STF	2/	26-Oct-1994		498.6	498.6	0	n/a		249.3	
1995	SBA		7-Apr-1995	6-Apr-1996	997.3	538.7	4	3	3/	1,037.3	
1996	SBA		10-May-1996	23-Feb-1997	598.2	598.2	3	3		1,573.3	
1997	SBA		25-Aug-1997	24-Aug-1998	398.9	181.3	4	1	3/	1,780.6	
1998	EFF		4-Sep-1998	3-Sep-2002	1,920.0	1,193.0	12	6	3/	1,985.0	
1999										2,044.6	
2000										1,591.2	
2001										1,520.7	
2002										1,380.0	
2003										1,235.5	
2004	SBA		29-Mar-2004	28-Mar-2005	411.6	0.0	1	0		1,033.7	
2005										830.9	
2006										551.9	
2007										272.9	
2008	SBA		5-Nov-2008	27-Jul-10	11,000.0	7,000.0	8	2		3,057.3	
2009										7,000.0	
2010	SBA		28-Jul-2010	27-Dec-12	10,000.0	2,250.0	9	1		9,250.0	
2011										9,250.0	
2012										7,015.6	
2013										3,359.4	
2014	SBA		30-Apr-2014		10,976.0	*2,973*	8	1	3/	3,941.4	
2015										*10,065.0*	4/
2016										*11,816.9*	4/
2017										*12,939.9*	4/
2018										*13,205.5*	4/
2019										*11,954.0*	4/
2020										*10,699.0*	4/
2021										*9,151.9*	4/
2022										*7,312.9*	4/
2023										*5,254.9*	4/
2024										*3,196.9*	4/
2025										*1,532.9*	4/
2026										*730.0*	4/
2027										*219.0*	4/
2028										*0.0*	4/
2029											

Source: Finance Department
1/ As of end-December, unless otherwise stated.
2/ The Systemic Transformation Facility (STF) was created in April 1993 and allowed to lapse in April 1995.
3/ Completed with delays or waivers.
4/ Figures including transactions under the proposed program are in italics. Fund exposure is derived assuming purchases are made as per the schedule in Table 1 and Ukraine remains current on all its scheduled repurchases.

4. Ukraine's total external debt-to-GDP is now very high, reflecting the sharp GDP contraction in dollar terms observed in 2014 (Table 3). Following a sharp exchange rate depreciation and a deep economic contraction in 2014, total external debt-to-GDP increased to almost 102½ percent in 2014, about 16 percentage points higher than its previous peak reached in 2010. Total external debt is expected to increase further, to 158 percent of GDP in 2015, placing Ukraine at the higher end relative to recent exceptional access cases (Figure 1, Panel A).[3] Private sector debt is projected to represent more than two-thirds of total external debt in 2015. External direct public debt as a share of GDP is projected to increase to 50 percent in 2015, from 26¼ percent in 2014 (Tables 3 and 4).

Table 3. Ukraine: External Debt Structure, 2007–2014 1/

	2007	2008	2009	2010	2011	2012	2013	2014
				(In Millions of U.S. Dollars)				
Total External Debt	79,955	101,659	103,396	117,346	126,236	134,625	140,590	131,138
of which:								
Public	12,346	16,684	24,016	32,491	33,361	32,186	30,208	33,583
Loans	6,174	10,592	18,975	24,308	24,127	18,889	12,567	15,751
Multilateral	3,447	8,209	16,852	20,190	20,268	17,108	11,364	14,665
Of which IMF	431	4,709	10,974	14,371	14,326	10,908	5,121	5,710
Private	67,609	84,975	79,380	84,855	92,875	102,439	110,382	97,555
Short-term	20,677	20,301	19,032	23,541	30,713	31,178	34,775	31,167
Long-term	46,932	64,674	60,348	61,314	62,162	71,261	75,607	66,388
				(In Percent of GDP)				
Total External Debt	53.8	54.0	85.1	86.3	77.3	76.6	78.3	102.4
of which:								
Public	8.3	8.9	19.8	23.9	20.4	18.3	16.8	26.2
Loans	4.2	5.6	15.6	17.9	14.8	10.8	7.0	12.3
Multilateral	2.3	4.4	13.9	14.8	11.3	9.5	6.3	8.2
Of which IMF	0.3	2.5	9.0	10.6	8.0	6.1	2.9	3.2
EU/EIB/EBRD	0.2	0.2	0.5	0.5	0.5	0.6	0.7	1.5
World Bank	1.5	1.6	2.7	2.3	1.8	1.8	1.8	2.4
Other multilateral	0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Bilateral	1.3	0.9	1.1	1.0	0.7	0.6	0.5	0.6
Commercial	0.5	0.3	0.7	2.0	1.4	0.4	0.2	0.0
Bonds	4.1	3.2	4.1	6.0	5.7	7.6	9.8	13.9
Private	45.5	45.1	65.3	62.4	56.9	58.3	61.4	76.2
Short-term	13.9	10.8	15.7	17.3	18.8	17.7	19.4	24.3
Long-term	31.6	34.4	49.6	45.1	38.1	40.6	42.1	51.9

Source: Ukrainian authorities and IMF staff estimates.
1/ End of year unless otherwise indicated.

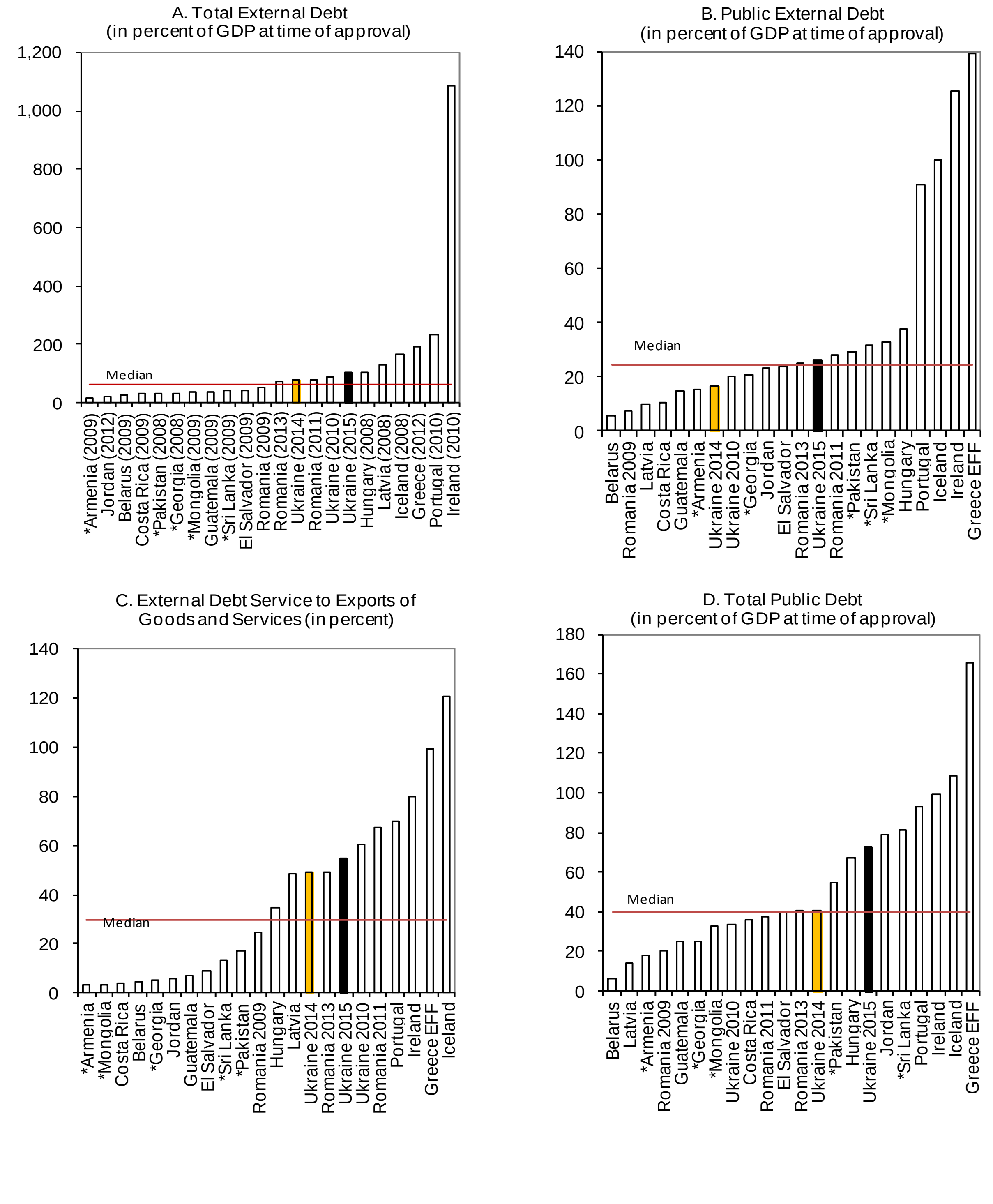
5. Ukraine's external debt service is high, with a relatively small share borne by the public sector. The ratio of total external debt service to exports of goods and services increased significantly in 2009, reflecting the sharp decline in exports associated with the global financial crisis. It peaked at 61 percent in 2009 and fell subsequently, reaching 49½ percent in 2013. It increased again to 54⅓ percent in 2014 as a result of the sharp decline in exports associated with the ongoing

[3] Throughout the paper, recent exceptional access cases refer to arrangements since September 2008.

crisis. In 2015, it is projected to remain almost at the 2014 level. Nonetheless, as was the case at the time of the 2014 SBA, it will be at the higher end relative to recent exceptional access cases, whose median ratio of debt service-to exports at the time of approval of the exceptional access arrangements is almost 30 percent (Figure 1, Panel C). In percent of GDP, Ukraine's total external debt service in 2015 is projected at 39½ , of which nearly one-tenth is borne by the public sector. The burden of private sector debt service will be eased by a variety of voluntary private debt rollovers now under way (see staff report, ¶17).

6. **Ukraine's total public debt is also high and is projected to rise much further by end-2015**. Over the period 2010 to 2013, the public debt-to-GDP ratio was unchanged at about 40 percent. Public gross financing needs increased sharply in 2014, reflecting a significant exchange rate depreciation that also contributed to a rise in quasi-fiscal losses in the energy sector, the ongoing conflict and a weak economy. By end-2015, total public debt is projected to exceed 94 percent of GDP, far higher than projected at the inception of the existing SBA. This debt level is 54 percentage points of GDP above the median public debt at the time of approval of recent exceptional access cases (Figure 1, Panel D).

Figure 1. Ukraine: Debt Ratios for Recent Exceptional Access Arrangements 1/



Source: Ukrainian Authorities and IMF staff estimates, and World Economic Outlook
1/ For arrangements approved since September 2008, estimates as reported in each staff report on the request of the Stand-By Arrangement or Extended Fund Facility. For Ukraine 2014, ratios reflect projected end-2013 data at the time of approval of the 2014 SBA whereas for Ukraine 2015, ratios reflect end-2014 data.

THE NEW ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—RISKS AND IMPACT ON FUND'S FINANCES

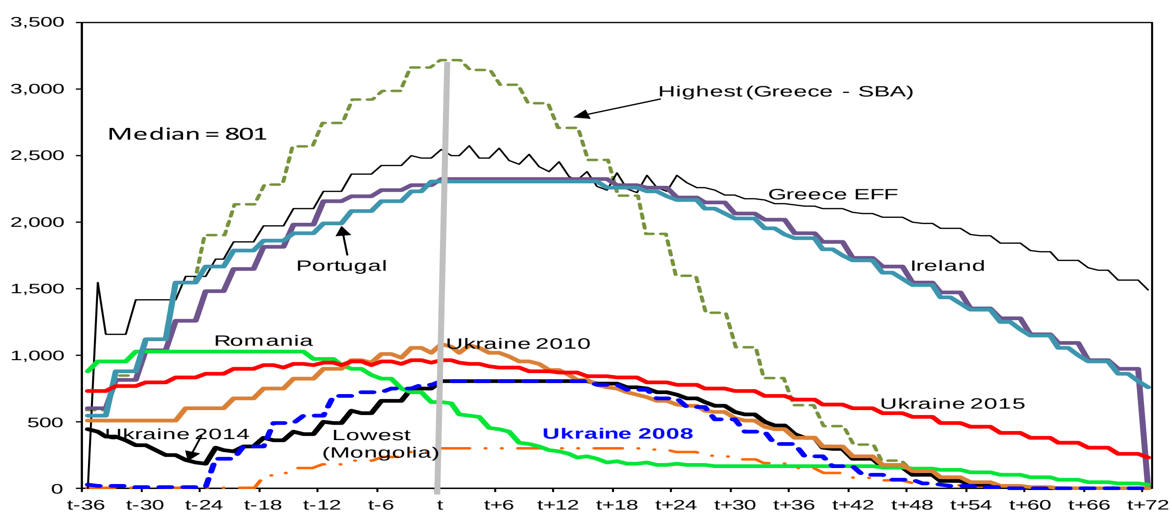
A. Risks to the Fund

7. Access under the proposed extended arrangement would exceed both annual and cumulative access limits and would be among the highest on a number of indicators.

- If all purchases were made as scheduled, Ukraine's outstanding use of GRA resources would rise from about 276 percent of quota at end-February 2015 to peak at 963 percent of quota at end-2018 (Figure 2). This level of access relative to quota would exceed peaks at the time of approval of the 2008 and 2014 SBAs for Ukraine and would be more than 160 percentage points above the median of peaks in recent exceptional access cases. It would however be below recent exceptional access peaks in arrangements with members such as Greece, Ireland, Portugal, Romania, Latvia, and Iceland.

Figure 2. Credit Outstanding in the GRA around Peak Borrowing 1/
(In percent of quota)

Approved Exceptional Access Cases since September 2008 2/

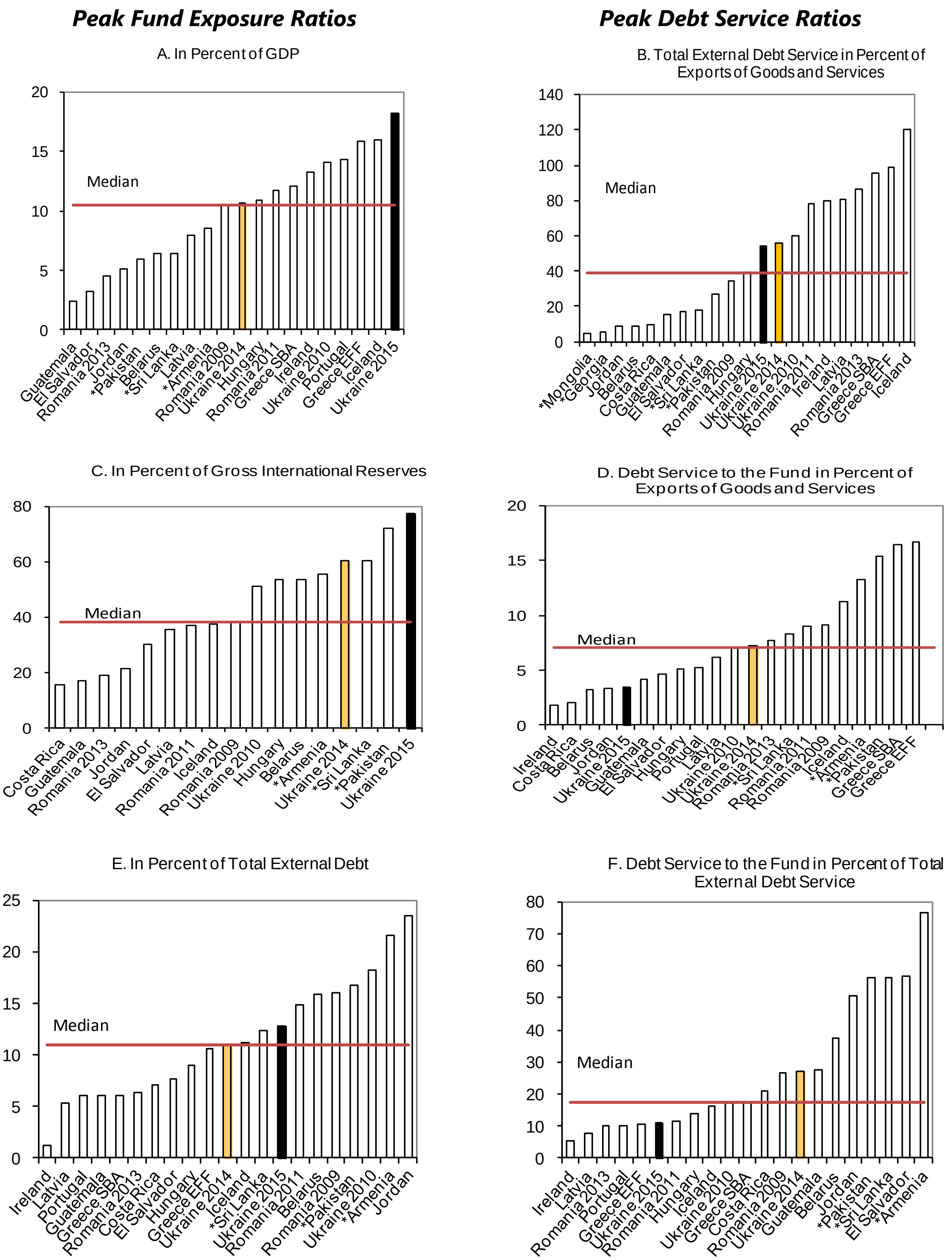


Source: International Financial Statistics (IFS), Finance Department, and IMF staff estimates.
1/ Peak borrowing "t" is defined as the highlest level of credit outstanding for a member. Repurchases are assumed to be on an obligations basis.
2/ Based on post-2008 reform quota. Median credit outstanding at peak is 801 percent of quota; average is 1038 percent of quota.

- If all purchases were made as scheduled, peak Fund exposure to Ukraine would consistently exceed corresponding medians in recent exceptional access cases. Peak Fund exposure relative to GDP would be 18.2 percent, which exceeds all recent exceptional access cases and compares with nearly 10¾ percent under the 2014 SBA (the median of recent exceptional access cases). As a share of gross international reserves, the Fund's exposure to Ukraine would peak in 2015 at 77.3 percent, an exceptionally high figure. This peak exceeds that under the 2014 SBA by almost 17 percentage points and is more than double the median of recent exceptional access cases (Figure 3).[4] As a share of total external debt, peak Fund exposure would be 12.8 percent, compared with 11 percent which is both the median peak of recent exceptional access cases and the peak under Ukraine's 2014 SBA (Table 4 and Figure 3).

[4] The computation of the median of peak Fund exposure in percent of GIR excludes arrangements with members belonging to a currency union: Greece, Ireland, and Portugal.

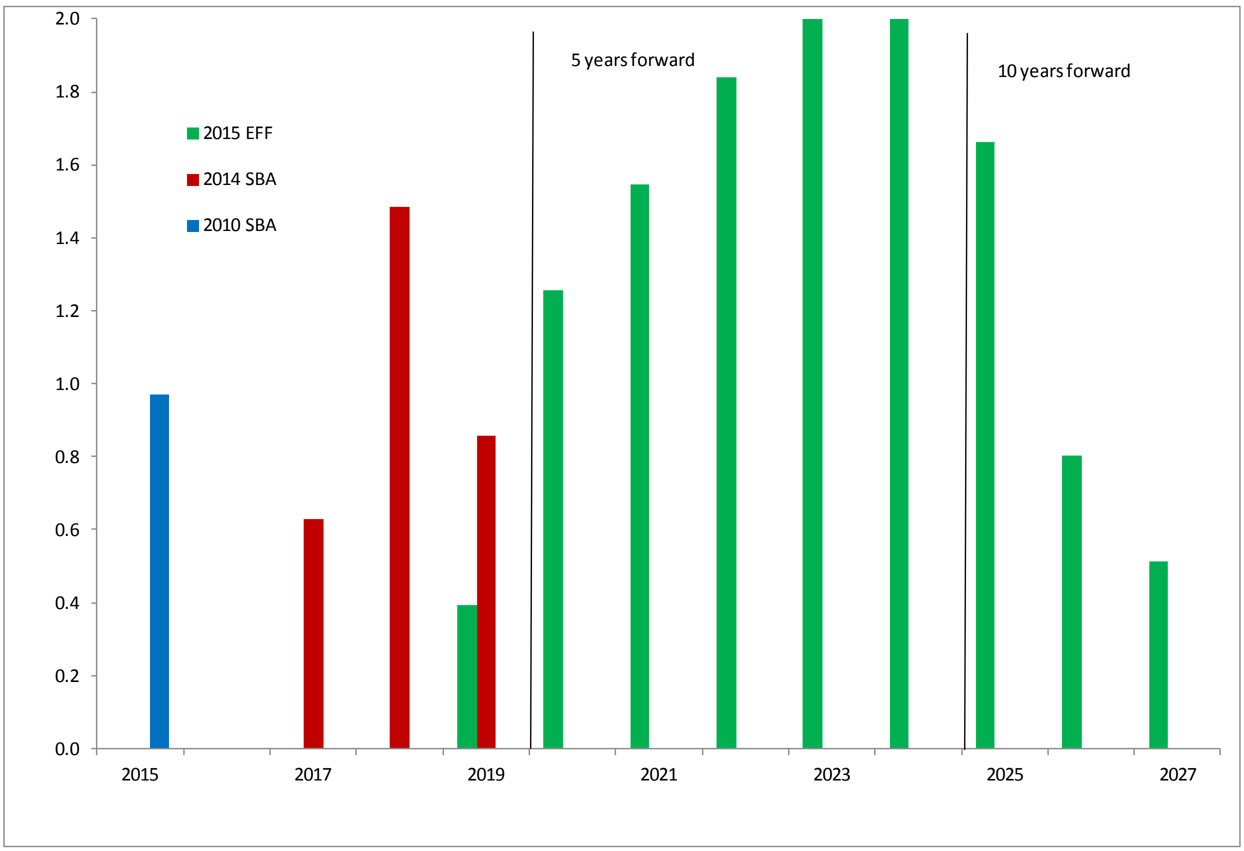
Figure 3. Peak Fund Exposure and Debt Service Ratios for Recent Exceptional Access Cases 1/



Source: Ukrainian authorities and IMF staff estimates, and World Economic Outlook.
1/ Asterisks indicate PRGF-eligible countries at the time of the program.

8. The authorities' intended debt operation could, if successful, help alleviate Ukraine's debt service burden and mitigate risks to the Fund. As indicated in the staff report, the success of the debt operation is critical to reduce financing needs and put public debt on a sustainable path. The proposed arrangement has a longer repurchase period relative to the SBA, with large repurchases falling due during 2020–25 (Figure 4). Given that the operation sets as an objective a limit on gross financing needs during this period, this should help mitigate risks to the Fund.

Figure 4. Ukraine: Projected Repayments to the Fund, 2015-2028 1/
(in billions of SDRs)

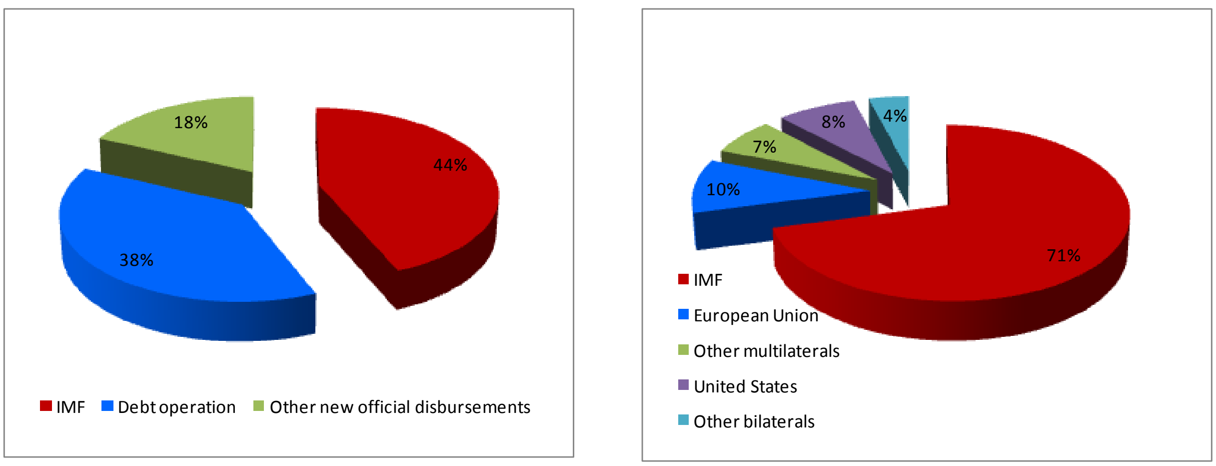


1/ Assuming cancellation of current SBA and approval of a four-year extended arrangement under the EFF in March 2015. Total access under the EFF would be SDR 12.348 billion.

9. While the proposed arrangement is expected to unlock some financial assistance from other official donors and from the private sector, the Fund would remain the largest official creditor to Ukraine's public sector. Since 2008, the Fund has, by credit outstanding, been the top official creditor to Ukraine's government, with an average share of 54 percent during 2008– 14. At end-2014, the share of outstanding Fund credit to Ukraine in total official lending to Ukraine stood at 36 percent. During 2015–18, the projected Fund financing under the proposed arrangement stands out as the largest, representing 44 percent of the total financing to Ukraine from all its creditors and 70 percent of new official disbursements (Figure 5). Accordingly, the Fund's exposure will remain by far the highest among those of all of Ukraine's official creditors. Debt service to the Fund will also be high after the end of the proposed arrangement, averaging 59 percent of total public external service during 2018–24 and peaking at over 80 percent. The high Fund exposure highlights the risks and underscores the role non-Fund external finance to Ukraine should play during the program period and beyond to mitigate risks to the Fund.

Figure 5. Ukraine: Program Financing, 2015–2018 1/

A. Breakdown of Total Financing B. Breakdown of New Official Disbursements



1/ Excludes project financing. The Fund remains the single largest creditor even if project financing is taken into account.

Table 4. Ukraine—Capacity to Repay Indicators 1/

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Exposure and Repayments (In SDR millions)														
GRA credit to Ukraine 2/	10,065.0	11,816.9	12,939.9	13,205.5	11,954.0	10,699.0	9,151.9	7,312.9	5,254.9	3,196.9	1,532.9	730.0	219.0	0.0
(In percent of quota)	(733.6)	(861.3)	(943.1)	(962.5)	(871.3)	(779.8)	(667.0)	(533.0)	(383.0)	(233.0)	(111.7)	(53.2)	(16.0)	(0.0)
Charges due on GRA credit 3/	152.4	245.6	299.1	376.6	390.1	346.3	292.4	226.9	149.6	68.5	28.5	14.6	6.9	2.3
Debt service due on GRA credit 4/	1,121.1	245.6	928.0	1,863.0	1,641.6	1,601.4	1,839.5	2,065.9	2,207.6	2,126.5	1,692.5	817.5	517.8	221.3
Debt and Debt Service Ratios 5/														
In percent of GDP														
Total external debt	158.4	149.5	141.2	134.3	125.0	114.8	109.5	103.3	96.9	90.3	84.4	79.1	74.0	69.5
External debt, public	50.2	51.8	52.0	51.1	46.9	41.9	39.8	36.5	32.7	28.7	25.3	22.4	19.7	17.4
GRA credit to Ukraine	16.6	18.1	18.0	16.9	14.4	11.8	9.5	7.1	4.8	2.8	1.2	0.6	0.2	0.0
Total external debt service	39.6	27.5	21.6	21.3	19.9	19.7	17.7	18.3	18.9	19.1	19.2	19.1	18.9	18.4
Public external debt service	3.8	2.3	2.6	3.4	3.7	3.9	2.3	3.2	3.8	4.1	3.8	4.0	4.1	3.8
Debt service due on GRA credit	1.9	0.4	1.3	2.4	2.0	1.8	1.9	2.0	2.0	1.8	1.4	0.6	0.4	0.2
In percent of Gross International Reserves														
Total external debt	737.4	621.3	503.9	426.3	399.6	399.2	393.4	410.2	446.3	494.8	564.0	588.9	594.9	556.5
External debt, public	233.8	215.3	185.7	162.3	150.0	145.6	142.9	144.8	150.6	157.2	169.2	166.8	158.3	139.6
GRA credit to Ukraine	77.3	75.3	64.4	53.6	46.2	41.4	34.3	28.4	22.3	15.2	8.4	4.2	1.3	0.0
Debt service due on GRA credit	8.6	1.6	4.6	7.6	6.3	6.2	6.9	8.0	9.4	10.1	9.2	4.7	3.0	1.2
In percent of Exports of Goods and Services														
Total external debt service	54.6	38.4	31.0	31.5	30.2	30.6	27.4	28.2	28.5	28.2	27.8	27.0	25.9	24.4
Public external debt service	5.2	3.2	3.7	5.0	5.6	6.0	3.6	4.9	5.7	6.1	5.5	5.7	5.5	5.1
Debt service due on GRA credit	2.6	0.5	1.9	3.5	3.0	2.8	3.0	3.1	3.1	2.7	2.0	0.9	0.5	0.2
In percent of Total External Debt														
GRA credit to Ukraine	10.5	12.1	12.8	12.6	11.6	10.4	8.7	6.9	5.0	3.1	1.5	0.7	0.2	0.0
In percent of Total External Debt Service														
Debt service due on GRA credit	4.7	1.4	6.0	11.2	9.9	9.0	10.8	11.0	10.7	9.6	7.2	3.3	2.0	0.8
In percent of Total Public External Debt														
GRA credit to Ukraine	33.1	35.0	34.7	33.0	30.6	28.3	23.9	19.5	14.7	9.6	4.9	2.5	0.8	0.0
In percent of Total Public External Debt Service														
Debt service due on GRA credit	49.0	16.3	49.9	69.9	53.3	45.9	82.9	63.5	53.8	44.6	36.3	15.6	9.2	3.9

Source: Ukrainian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Assumes full drawings.

2/ Repurchases follow the obligations schedule.

3/ Includes GRA basic rate of charge, surcharges and service fees. Of the 2015 figure, only SDR 141.8 million is for the period subsequent to the Executive Board discussion of the staff report for the request of the proposed EFF.

4/ Includes charges due on GRA credit and payments on principal. Of the 2015 figure, only SDR 954.3 million is for period subsequent to the Executive Board discussion of the staff report for the request of the proposed EFF.

5/ Staff projections for external debt, GDP, gross international reserves, and exports of goods and services, are based on the staff report for the request of the proposed EFF up to 2025 and extended to 2028.

B. Impact on the Fund's Liquidity Position and Risk Exposure

10. The proposed extended arrangement would have a modest impact on the Fund's liquidity but would have a substantial impact on the Fund's credit risk exposure.

- The proposed arrangement would reduce the Fund liquidity by 1.8 percent (Table 5). Taking into account the impact of undrawn balances under the 2014 SBA being cancelled, the proposed arrangement would reduce the one-year forward commitment capacity (FCC) from SDR 235 billion as of February 20, 2015 to SDR 230.7 billion.

- After Ukraine's first purchase under the proposed arrangement, the Fund's exposure to the top five borrowers would increase only marginally (Table 5). With almost 5.9 percent of GRA credit outstanding, Ukraine is the fourth largest user of GRA credit behind Portugal, Greece, and Ireland. The share of the top five borrowers amounts at 88.6 percent. After Ukraine's scheduled first purchase, its share of outstanding GRA credit would increase to 10.6 percent and the share of the top five borrowers would increase to 89.2 percent (Figure 6).

- Potential GRA exposure to Ukraine would represent a significant share of the Fund's current level of precautionary balances (Table 5). The GRA commitment to Ukraine amounts to 97 percent of the current level of precautionary balances. Assuming that all purchases are made as scheduled, Fund exposure to Ukraine as a share of the current level of precautionary balances would rise from 56.7 percent after the first purchase is made to 92.8 percent in 2016 and would peak at 103.7 percent in 2018.

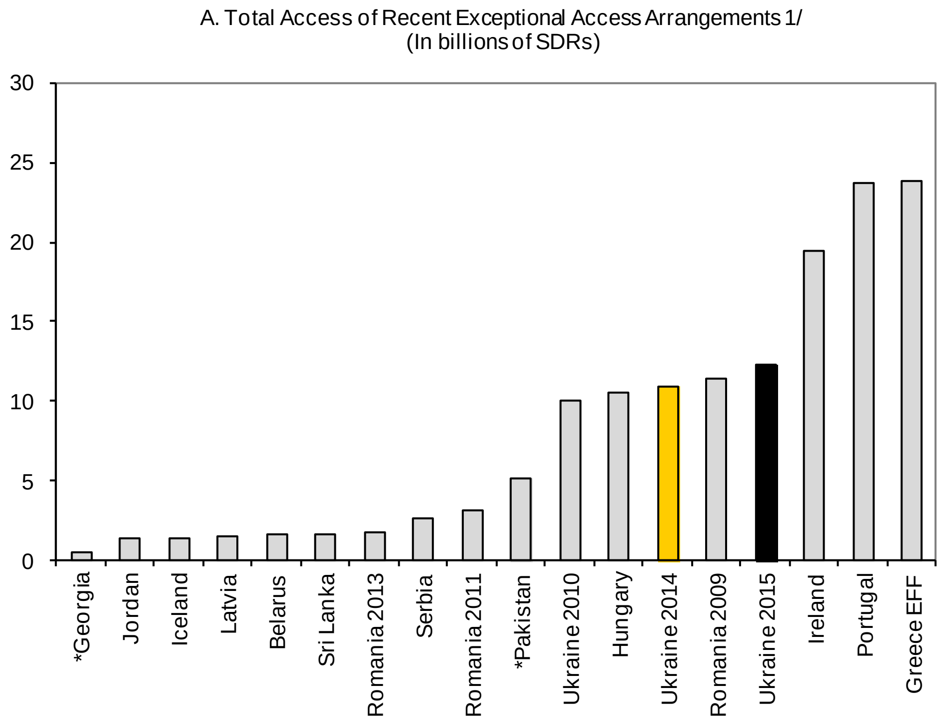
- Were Ukraine to accrue arrears on charges after drawing under the proposed arrangement, the Fund's burden sharing mechanism would be clearly insufficient. In a low interest rate environment, such as the current one, charges for Ukraine, which are projected at SDR 141.8 million for the remainder of 2015, and to average SDR 328 million a year over 2016-2019, significantly exceed the Fund's limited current capacity to absorb charges in arrears through the burden sharing mechanism.

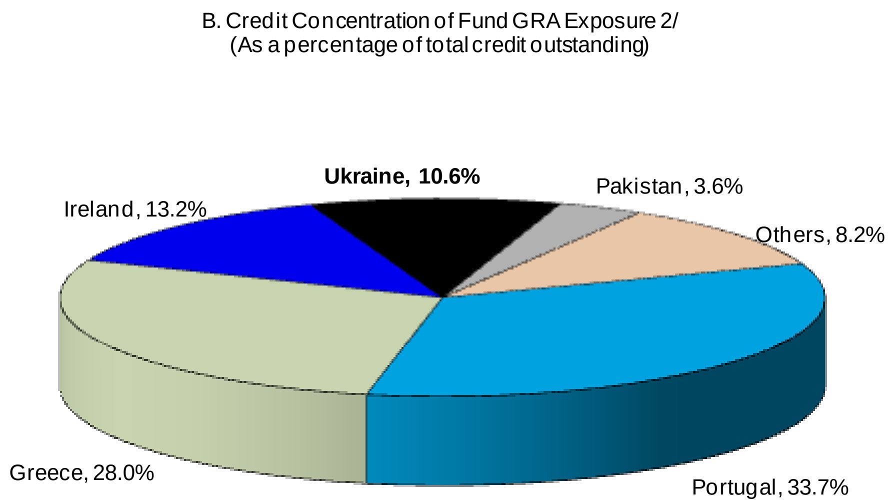
Table 5. Ukraine—Impact on GRA Finances
(millions of SDR unless otherwise noted)

	As of 2/20/2015
Liquidity measures	
Current one-year Forward Commitment Capacity (FCC) 1/	235,023.3
Impact on FCC on approval 2/	-4,344.7
(in percent of current one-year FCC)	-1.8
Prudential measures	
Fund GRA credit outstanding to Ukraine 3/	7,206.2
In percent of current precautionary balances 4/	56.6
In percent of total GRA credit outstanding	11.2
Fund GRA credit outstanding to top five borrowers	
In percent of total GRA credit outstanding	88.6
In percent of total GRA credit outstanding including Ukraine's first post-augmentation purchase	89.2
Ukraine's annual GRA charges in percent of Fund's residual burden sharing capacity for 2014	22,446.2
Memorandum items	
Fund's precautionary balances (FY 2014)	12,730
Fund's residual burden-sharing capacity 4/	0.7

Sources: Ukranian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.
1/ The FCC is defined as the Fund's stock of usable resources less undrawn balances under existing arrangements, plus projected repurchases during the coming 12 months, less repayments of borrowing due one year forward, less a prudential balance. The FCC does not include about US$462 billion in bilateral pledges from members to boost IMF resources. These resources will only be counted towards the FCC once: (i) individual bilateral agreements are effective and (ii) the associated resources are available for use by the IMF in accordance with the borrowing guidelines and the terms of these agreements.
2/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
3/ Projected credit outstanding for Ukraine at time of approval of the proposed arrangement program based on the current repayment schedule and including first drawing.
4/ Burden-sharing capacity is calculated based on the floor for remuneration which, under current policies, is 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

Figure 6. Exceptional Access Levels and Credit Concentration





Source: Finance Department.
1/ Does not include FCL arrangements. Asterisks indicate countries that were PRGT-Eligible at the time of approval.
2/ Credit outstanding as of February 17, 2015, plus expected first purchase under the proposed arrangement with Ukraine (new access).

ASSESSMENT

11. **The program faces exceptionally high risks.** As highlighted in the staff report and in the debt sustainability analysis, the debt trajectory is sensitive to deviations of fiscal adjustment, economic growth, and the exchange rate path from program assumptions. In this context, an escalation of the ongoing conflict in the East, coupled with a long-lasting loss of economic control over Eastern Ukraine and a prolonged disruption of relations with Russia, would undermine confidence, deter investment and exports, and subdue economic activity in a prolonged manner. It is difficult for the program to mitigate this geopolitical risk.

12. **The success of the program will depend critically on forceful implementation of macroeconomic policies, on regaining market confidence, and on sustaining momentum to address deep-rooted structural weaknesses through a wide range of policies, most notably**:

- A decisive and sustained break with the record of generally poor policy implementation under previous programs and a strong political resolve to tackle vested interests. It should be noted here that Ukraine's starting situation is extremely challenging, and that implementing bold front-loaded policies included in the program is absolutely critical for putting the economy on the start of a long recovery path.

- A successful debt operation that would alleviate the debt service burden, ensure that the program is sufficiently financed, and promote debt sustainability.

- The effective restructuring of the banking sector and the unwinding of systemic related party lending without excessively constraining credit to the private sector.

- A relatively rapid and decisive reorientation of economic activity and external trade to make up for severe disruptions in trade with Russia stemming from ongoing geopolitical tensions. This is important to generate the foreign exchange needed to help finance domestic demand and contain gross external financing needs.

- Regaining meaningful market access by the end of the program. This is important to avoid a sharp forced adjustment that would exacerbate or prolong the economic decline posing tremendous risks to the Fund given the large exposure of the Fund in percent of Ukraine's GDP.

13. **If key policies or program assumptions do not materialize, the stabilization of Ukraine's economy would be undermined, perhaps critically, with the likelihood that the debt trajectory would remain unsustainable**:

- Should the restoration of the financial health of Naftogaz— an overarching goal of the program— not materialize, it would undermine the envisaged fiscal adjustment, lead to a deterioration in market confidence, and trigger pressures on the exchange rate. There is a risk that, despite measures aimed at improving collection, the envisaged significant increases in end-user prices may not yield the expected revenues, owing to the confluence of higher unemployment, falling real wages, and a depreciating exchange rate.

- An unsuccessful debt operation could undermine public debt sustainability and also exacerbate the confidence crisis, thereby disrupting the ongoing restructuring of private sector debt (see staff report, ¶ 17). This would adversely affect the availability of foreign exchange in the country, put pressure on corporates, and further destabilize the economy. It could also undermine prospects to regain market access by end-2017, leading to a further depletion of international reserves and exacerbating Ukraine's burden of debt service.

- A less favorable macroeconomic framework relative to the program baseline —and risks are weighted to the downside — would seriously lower the probability of putting debt on a sustainable path. Such a framework could result from policy slippages, more subdued exports and growth paths, a more depreciated exchange rate, or a combination of adverse factors. The projections paths used for Ukraine have been situated in the bottom quartile of previous crisis countries. However, the combination of macroeconomic and political risks now facing Ukraine is exceptional.

14. Overall, there are manifold risks that could adversely affect Ukraine's capacity to repay the Fund, and strict adherence to the program will be critical. The Fund's exposure to Ukraine is already significant and the proposed large and frontloaded access under the extended arrangement would leave the Fund even more highly exposed to Ukraine. As indicated in the staff report, and as noted above, the authorities were able to make some progress on critical reforms under the 2014 SBA-supported program notwithstanding the adverse environment. Their strict adherence to the EFF-supported program and indeed their ability to recalibrate the program in response to adverse shocks would be crucial to help stabilize the economy and facilitate access to private finance. Still, the derailment of the 2014 SBA is a reminder of how challenging it is to mitigate risks stemming from an escalation of a conflict. Accordingly, looking ahead, should a major shock materialize, the willingness of Ukraine's other official creditors to provide concessional financing would be critical to support Ukraine's efforts to stabilize and revive its economy and facilitate access to private finance, which in turn would be crucial to reduce risks to capacity to repay the Fund.

INTERNATIONAL MONETARY FUND

UKRAINE

March 9, 2015

REQUEST FOR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND CANCELLATION OF STAND-BY ARRANGEMENT—SUPPLEMENTARY INFORMATION

Approved By
Thanos Arvanitis and Mark Flanagan

Prepared By The European Department

1. **This supplement provides information that has become available since the Staff Report was circulated to the Executive Board on February 27, 2015**.

Recent Developments

2. **The hryvnia came under significant pressure in the second half of February**. Following the hryvnia's depreciation to around UAH 24–25/US$1 in early February (Ukraine—Request for Extended Arrangement under the Extended Fund Facility and Cancellation of Stand-By Arrangement, ¶7), the currency came under pressure again in mid-February. This was largely triggered by a decline in confidence following developments related to the conflict in the East. Strong demand for foreign exchange against a weak supply resulted in a sharp depreciation by over 20 percent during February 18–25. If left unaddressed, it could have led to significant exchange rate overshooting, with a destabilizing impact on inflation, banks' balance sheets, and the corporate sector.

3. **In response, and with staff assistance, the authorities put in place a package of measures to restore stability in the FX market**. These include:

- **Monetary policy tightening to anchor exchange rate expectations**. The NBU tightened liquidity conditions significantly, increasing its main policy rate (the discount rate) by 1050 basis points to 30 percent to make it positive in real terms on a forward-looking basis, given the high inflation in the coming months. All interest rates on central bank facilities were increased accordingly.

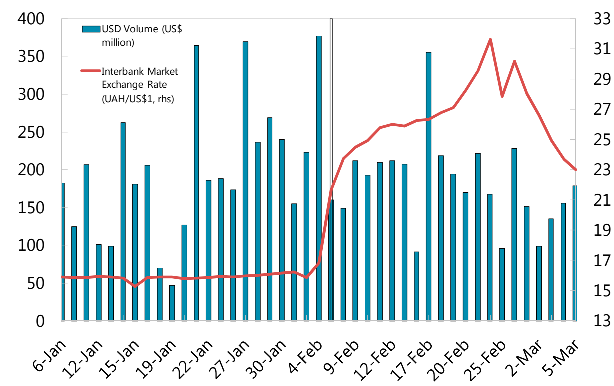
- **Extension of controls on FX demand in response to intensified FX market imbalances**. As the strong FX demand contributed to accelerating depreciation of the hryvnia—despite the significant rise of import prices, and administrative controls—the NBU introduced new administrative measures mainly affecting imports.[1] At the same time, bank lending in hryvnia for purchase of FX was banned and bank's daily FX purchases on the interbank market are limited to 0.1 percent of their regulatory capital as of the previous day.

- **Administrative measures applicable on all FX transactions, regardless of purpose, including**: (i) stricter requirements (e.g., certificate of being current on tax payments) for FX purchase and transfers; (ii) no lending in hryvnia against FX deposit collateral; (iii) expansion of the verification procedure for compliance with NBU regulations ("T+3") to FX transfers abroad made out of own FX funds.

- **Additional measures to reduce capital flight through circumvention of measures on imports and capital transactions, in particular,** (i) broadening of verification measures to limit under-invoicing of exports; and (ii) a ban on transfer of proceeds from non-debt securities traded in the stock exchanges.

4. **The combination of intensified controls and monetary tightening appears to have eased pressures in the interbank foreign exchange market**. The demand for FX has been compressed and, together, with the steady supply of FX from the surrender requirement, has helped the hryvnia fully reverse its post-February 18 slide, while allowing the NBU to buy over US$400 million (text figure). The authorities' communication efforts, suggesting that the current exchange rate appears significantly undervalued relative to fundamentals, have also helped guide market expectations. Still, it is very early to have a definitive assessment of the measures. Over the next few days, banks and their clients are expected to start adapting to the new requirements. However, barring unexpected shocks to confidence, the interbank foreign exchange market is expected to remain broadly balanced without undue pressures on the hryvnia.

Interbank Exchange Rate and Volume



Sources: National Bank of Ukraine

5. **The authorities plan to lift both the existing and new administrative measures once the BOP and financial conditions strengthen**. The NBU will continuously monitor the

[1] The previously adopted two-day verification procedure for requests for FX was extended to include advance import payments and transfers, the threshold for verification was reduced from US$100,000 to US$50,000, and the number of days during which the NBU can verify the bona fide nature of the transaction were increased from two to three (T+3). Furthermore, explicit NBU confirmation of the transactions is required now as opposed to the absence of explicit NBU objection. Also, payments for imports of goods above US$500,000 (other than essential imports) must be paid through letters of credit.

effectiveness of the new measures, including indicators of capital flight and return of confidence. While the authorities stand ready to recalibrate existing exchange restrictions and capital controls as warranted to ensure financial stability, they are preparing a plan for their eventual and gradual removal (MEFP ¶8), conditional on a durable improvement in the balance of payments. A separate supplement will be issued with staff assessment of the jurisdictional implications under Article VIII, Sections 2(a) and 3 of the various exchange system measures put in place by Ukraine, including the measures adopted in the past few days.

6. **On the banking sector, the NBU is moving decisively to resolve insolvent banks**. Three additional banks were declared insolvent and put under the Deposit Guarantee Fund's temporary administration, bringing the total banks resolved to 44. This included the fourth largest bank, representing 4 percent of assets and 4½ percent of deposits.

7. **With regard to the conflict in the East, following the second Minsk accord on February 12, the new cease-fire is now broadly holding**. Despite the intensification of fighting during its early stage, the cease-fire has now become effective with reports indicating the withdrawal of heavy weapons from the frontline.

8. **All outstanding prior actions have been completed**. Legislative amendments on improving Naftogaz collections have been submitted to parliament. On March 2, parliament approved a revised state budget and a package of tax and expenditure legislations consistent with program targets. Parliament also approved legislation introducing unlimited liability of bank owners on related party loans. On March 3–4, the energy regulator adopted and published decisions to raise gas and heating prices, effective April 1.

Staff Appraisal

9. **Staff welcomes the decisive action and the comprehensive set of measures implemented by the NBU in the face of temporary and excessive pressures on the hryvnia**. Tighter monetary policy and enhanced administrative controls were necessary and appropriate to prevent an exchange rate overshooting that would have been destabilizing on confidence and the economy. The combination avoids the need for a very high increase in interest rates that would have had a more adverse impact on the economy, and alone might not have worked under the current circumstances. The quick action by the authorities demonstrates their commitment to achieve macroeconomic stabilization in a very challenging environment.

10. **On the basis of recent developments, staff does not see a need to update the program's macroeconomic framework and program objectives remain attainable**. In view of this, the exceptional access criteria continue to be met. The exchange rate overshooting lasted for a few days and should not have a lasting impact on inflation or the economy. The tighter monetary conditions and administrative measures would not affect growth in 2015, given the already very tight credit conditions. If they are unwound over the near term as the

balance of payments situation improves, including on the back of support from external official financing, the impact on economic activity in 2016 and beyond should be limited and program objectives continue to be attainable. As in all Fund programs, the macroeconomic framework will be revisited during program reviews.

INTERNATIONAL MONETARY FUND

UKRAINE

March 10, 2015

REQUEST FOR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND CANCELLATION OF STAND-BY ARRANGEMENT—SUPPLEMENTARY INFORMATION

Approved By
Thanos Arvanitis and Mark Flanagan

Prepared By the Staff Representatives for EFF Program Negotiations with Ukraine

1. **This supplement provides additional information that has become available since the Staff Report was circulated to the Executive Board on February 27, 2015**. The information does not alter the thrust of the staff appraisal.

2. **Staff has conducted a jurisdictional assessment of the exchange system measures currently in effect in Ukraine that were put in place following the completion of the first review under the Stand-by Arrangement, including the recent measures adopted in March**.[1] Following completion of this assessment, the following measures have been determined to give rise to exchange restrictions and multiple currency practices subject to Fund approval, respectively, under Article VIII, Section 2(a) and 3:[2]

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[1] As reported in Ukraine—Request for Extended Arrangement under the Extended Fund Facility and Cancellation of Stand-By Arrangement—Supplementary Information on March 9, 2015, measures recently adopted include more extensive verification procedures by the NBU to ascertain the bona fide nature of requests for foreign exchange, and requirements to use letters of credit for making certain advance import payments. At this time, staff finds no basis for determining that these measures give rise to exchange restrictions. These measures however, could give rise to exchange restrictions in the future if the implementation of the verification procedures results in undue delays in the availability of foreign exchange for current international transactions, or if letters of credit are not readily available for import payments.

[2] At the first review under the Stand-By Arrangement, staff reported an exchange restriction resulting from a foreign exchange transaction tax applicable to cash and non-cash purchases of foreign exchange. Effective January 1, 2015, the restriction has been eliminated as the tax was amended and limited in application to only cash purchases of foreign exchange by individuals. Non-cash purchases are not subject to the tax.

- Exchange restriction arising from absolute limits on the availability of foreign exchange for certain non-trade current international transactions (NBU Resolution 160, adopted March 3, 2015). Certain individual non-trade transfers abroad in foreign exchange, in particular family and personal remittances, are limited to a monthly cap of UAH 150,000 from foreign exchange accounts and with supporting documents or to a cap of UAH 15,000 daily if effected by residents without supporting documents or without opening a foreign exchange account. These limits had been established under a number of resolutions adopted by the NBU in 2014, but were lifted before completion of the first review under the Stand-By Arrangement. However, the limits were subsequently reintroduced and are currently in place.

- Exchange restriction arising from a ban on the transfer abroad of dividends received by nonresident investors from foreign investments in Ukraine (NBU Resolution 160, dated March 3, 2015). This measure has been in place since September 23, 2014, but its scope was extended to cover dividend from exchange traded securities in March 2015.

- Exchange restriction arising from the requirement to provide a tax clearance certificate evidencing the payments of all taxes, including taxes unrelated to the transaction, before obtaining authorization for making import payments equal to or exceeding US$50,000 (NBU Resolution 160, dated March 3, 2015).

- Multiple currency practice arising from the use of multiple price foreign exchange auctions conducted by the National Bank of Ukraine without a mechanism to prevent (i) a spread deviation of more than 2 percent in the exchange rates at which the NBU sells foreign exchange to successful bidders; and (ii) a spread deviation of more than 2 percent between the auction rates and the market exchange rate. The procedures that allow the NBU to conduct these auctions are long-standing (although they were recently amended) but the auctions had not been in operation until September of 2014, when the NBU reactivated the auctions.

3. **In addition, Ukraine continues to maintain the following multiple currency practices put in place prior to approval of the Stand-By Arrangement, and subject to Fund approval under Article VIII, Section 3**:

- Multiple currency practice arising from the requirement to transfer the positive difference between the sale and purchase price of foreign exchange to the state budget if the purchased foreign exchange is not used within 10 days and is resold.

- Multiple currency practice arising from the use of the official exchange rate for government transactions, including transactions of some SOEs, without establishing a mechanism to ensure that the official exchange rate does not deviate from the market exchange rate by more than 2 percent.

4. **The authorities have requested Fund approval for the retention of all the exchange restrictions and multiple currency practices**. They have committed to prepare by mid-May 2015 a plan for the removal of all these measures as soon as conditions permit. Staff supports the Executive Board approval as the measures are temporary, for balance of payments reasons, and non-discriminatory. A decision is proposed to this effect for consideration of the Executive Board.

Press Release No. 15/107
FOR IMMEDIATE RELEASE
March 11, 2015

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves 4-Year US$17.5 Billion Extended Fund Facility for Ukraine, US$5 Billion for Immediate Disbursement

The Executive Board of the International Monetary Fund (IMF) today approved a four-year extended arrangement under the Extended Fund Facility for Ukraine. The arrangement amounts to the equivalent of SDR 12.348 billion (about US$17.5 billion, 900 percent of quota) and was approved under the Fund's exceptional access policy. The Board also took note of Ukraine's decision to cancel the Stand-By Arrangement (SBA) for Ukraine that was approved on April 30, 2014 (see Press Release No. 14/189).

The authorities' economic program supported by the Extended Fund Facility (EFF) will build on and deepen reforms launched under the SBA. The program aims to put the economy on the path to recovery, restore external sustainability, strengthen public finances, and support economic growth by advancing structural and governance reforms, while protecting the most vulnerable.

The approval of the extended arrangement under the EFF enables the immediate disbursement of SDR 3.546 billion (about US$5 billion), with SDR 1.915 billion (about US$2.7 billion) being allocated to budget support. Further disbursements will be based on standard quarterly reviews and performance criteria.

Following the Executive Board's discussion, Mr. David Lipton, First Deputy Managing Director and Acting Chair, said:

"Notwithstanding a strong policy-led adjustment effort in 2014, the Ukrainian economy continues to be affected by the conflict in the East and the attendant loss of confidence. The deep recession and sharp exchange rate depreciation aggravated existing vulnerabilities, weakened bank balance sheets, and raised public debt.

"Demonstrating strong resolve, Ukraine's authorities have developed a new program to restore macroeconomic stability and address long-standing structural obstacles to growth, including weak governance. The authorities recognize that the resolute implementation of the program is critical to restore confidence and growth, bring inflation to single digits, keep external deficits manageable, and replenish international reserves.

“The authorities recognize that the best support for the hryvnia is the restoration of confidence through strong policies and reforms. To support this new regime, appropriate reserve targets are included in the program. While program policies are taking hold, the authorities plan to maintain monetary policy rates positive in real terms to anchor inflation expectations, and remove capital controls and restrictions at an appropriately calibrated pace as the balance of payments improves.

“The authorities are determined to stabilize the financial system, maintain confidence in banks, and strengthen financial regulation and supervision. To this end, they have made progress toward recapitalizing systemic banks and resolving weak non-systemic banks. The decisive implementation of the banking strategy would be crucial to regain public confidence.

“Recognizing the need for fiscal consolidation, the authorities have launched an expenditure-led adjustment and frontloaded energy price increases to reduce quasi-fiscal losses and set debt on a firm downward path. Policies to underpin the fiscal adjustment include improving the pension system’s sustainability, reforming public employment, and reforming the healthcare and education systems. The planned debt operation would also help secure program financing and restore debt sustainability with high probability. A successful debt operation with high participation will be a key consideration to proceed with the first program review.

“The authorities plan to eliminate the large quasi-fiscal losses of Naftogaz by 2017 by undertaking bold measures to increase tariffs, improve collection rates, and fundamentally restructure the company. Funding to protect the most vulnerable from the impact of the energy price increases will be raised to alleviate social costs and build support for the reforms.

“Addressing deep-rooted structural problems is critical to create an enabling environment for investment and private sector activity. Tackling weak governance and improving the business climate is critical to increase investment and achieve higher growth. A comprehensive strategy to reform state-owned enterprises is important to enhance efficiency and reduce fiscal risks.

“The program is subject to exceptional risks, especially those arising from the conflict in the East, which may affect the country’s ability to sustain the stabilization efforts and deliver the structural overhaul needed to resume growth. On the other hand, the crisis provides an opportunity for the government to make a decisive break from the past and implement reform-oriented and sustainable policies with strong ownership. The authorities' program responds appropriately to present challenges and deserves strong support. The implementation risks are being mitigated by a critical set of measures adopted as prior actions and by securing broad political support for program objectives and policies. These should help unlock sizable international official assistance and private capital inflows."

Annex

Recent Economic Developments

Despite the authorities' policy efforts, the economy fell into a deep recession in 2014. The conflict in Eastern Ukraine had a significant impact on the economy and the financial system, through disruptions in trade and industrial production and loss of confidence, which fueled capital outflows and led to sharp exchange rate depreciation. Banks came under increasing stress, public debt increased, and international reserves fell to low levels. New financing needs emerged.

Under the SBA, the authorities began implementing difficult reforms to tackle unsustainable policies of the past, including fiscal adjustment, greater exchange rate flexibility, and increases in energy prices, as well as simplifying the regulatory environment for business activity and taking steps to improve governance. Despite these efforts, meeting the program objectives became difficult given the size of the new shocks. Restoring external sustainability will now take longer and require even deeper reforms. To address these challenges, the authorities have asked for a cancellation of the SBA and its replacement with a new four year extended arrangement under the EFF.

Program Summary

The authorities' economic program supported by the Fund aims to secure external and financial stability and restore robust economic growth, while protecting the most vulnerable. Specifically, the policies would aim at:

- **Securing financial stability**. This includes (i) a strong monetary policy framework to restore price stability; (ii) exchange rate flexibility to cushion the economy against external shocks; and (iii) a comprehensive strategy to strengthen banks' financial health, through bank recapitalization, reduction of related party lending, and resolution of impaired assets, which are critical to regain public confidence and support economic recovery.

- **Strengthening public finances**. An expenditure-led adjustment will support fiscal consolidation in the coming years. Together with energy sector reforms and the announced debt operation, this would reduce fiscal imbalances and achieve public debt sustainability with high probability. Social protection schemes would be revamped to protect the poorest and alleviate social costs.

- **Advancing structural reforms**. Decisive efforts will help revitalize the business climate, attract investment, and enhance Ukraine's growth potential. This includes governance reforms, including anti-corruption and judicial measures, deregulation and tax administration reforms, and reforms of state-owned enterprises to improve corporate governance and reduce fiscal risks. Broader energy sector reforms, including Naftogaz's restructuring, would increase energy efficiency and foster energy independence.

Macroeconomic Outlook

In the current difficult environment, real GDP is expected to contract by about 5½ percent in 2015. Inflation is expected to spike temporarily in response to the exchange rate depreciation and gas and heating tariff increases, before subsiding to about 27 percent at end-2015. The current account deficit should fall to about 1½ percent of GDP on the back of the exchange rate adjustment and subdued domestic demand. With sizable international assistance, gross international reserves will be gradually re-built, reaching around 3.3 month of imports coverage at end-2015. The currency devaluation and official borrowing are expected to push public sector debt up to 94 percent of GDP and external debt to 158 percent of GDP in 2015.

Ukraine's economic prospects will improve in the medium-term. Real GDP growth is expected to rebound to 2 percent in 2016 and rise to 4 percent in the medium term. Buoyed by restored competitiveness, the current account deficit is projected to stabilize at around 1¼ percent of GDP in 2016–18. By end-2018, inflation will fall to mid-single digits and the NBU will build its international reserves to cover nearly 83 percent of short term debt. Following the debt operation and sustained fiscal adjustment, public debt is expected to decline to around 71 percent of GDP by 2020.

Statement by Menno Snel, Executive Director for Ukraine
and Oleksandr Petryk, Alternate Executive Director
March 11, 2015

The Ukrainian authorities highly value the Fund's continued financial and technical assistance. Performance under the SBA was strong. However, the authorities request its cancellation and continued support under a new four-year Extended Arrangement. The conflict in the East escalated. The economy weakened further and confidence of the economic agents declined. Balance-of-payments needs widened, and official reserves stand at a very low level. For all these reasons, broader and deeper reforms must be implemented over a longer time period of time, for which an EFF provides more adequate support.

To restore stability and economic growth, the President, the government, the National Bank of Ukraine (NBU) and the parliament remain fully committed to a comprehensive economic reform program which will build on the decisive measures that were taken under the SBA. Policies will focus on low and stable inflation within a flexible exchange rate policy, a sound banking system, strong public finances, reforms in the energy sector and other structural reforms which fight corruption and improve the business climate.

Tensions on the foreign exchange market and hikes in inflation called for the introduction of administrative restrictions and measures on monetary regulation. As soon as the situation stabilizes, the National Bank of Ukraine intends to gradually phase out the administrative measures and ease, as appropriate, monetary policy.

All prior actions have—once more—been implemented in time. **This reflects the authorities' continued commitment to the adjustment program**. Since the last review in August 2014 a lot has been achieved. On March 2, 2015 all remaining outstanding prior actions were implemented. A supplement to the state budget was adopted by parliament, which includes pension reforms, tax and expenditure measures. The remaining prior actions on the financial sector and the energy sector were also implemented.

The additional funds committed by international partners are highly appreciated. Together with the scheduled debt operation, the program is fully financed. To facilitate consultations with holders of public sector debt, financial and legal advisors are hired. The debt operation will be guided by program objectives. The authorities are committed to conclude the operation by the time of the first review.

Macroeconomic developments

GDP contraction in 2014 is estimated at 6.9 percent. The conflict in Eastern Ukraine and the build-up of macroeconomic imbalances in previous years largely explain this

setback. The decline in production was observed in almost all basic industries. Industrial output fell by 10.1 percent; construction by 21.7 percent; retail by 8.6 percent; and wholesale trade by 15 percent. The largest contraction in industrial output was recorded in the Donetsk and Luhansk regions, by 31.5 percent and 42 percent respectively. In those regions infrastructure and production capacity has been destroyed to a significant extent. On the positive side, a record high harvest of cereals increased agriculture output by 2.8 percent.

Last year, the current account deficit sharply narrowed to US$6.1 bln, or 4.8 percent of GDP. Low domestic demand and the sharp currency depreciation caused imports to fall by 27.4 percent. However, exports also declined by 14.4 percent because of the destruction of infrastructure and production capacity in Eastern Ukraine, lower commodity prices and much more complicated trade relations with Russia. Due to the unstable geopolitical situation and devaluation expectations, net capital outflow reached US$8.1 bln in 2014.

The banking system faces a sustained outflow of deposits. Currency depreciation, the fall in both disposable household income and corporate profits negatively affect the quality of banks' credit portfolios. In early February 2015, the aggregate capital adequacy ratio dropped below 14 percent from 16 percent six months ago.

The upward trend in inflation continued with a y-o-y headline inflation of 28.5 percent in January 2015. This was mainly driven by the sharp depreciation of the Hryvnia and hikes in administratively regulated prices and increased excise taxes. Even under depressed demand, y-o-y core inflation accelerated to 26.1 percent. Despite the decline in oil prices, fuel prices increased by 60 percent y-o-y due to the significant depreciation of the Hryvnia.

In the second half of February, the Hryvnia came under significant pressure, largely driven by a decline in confidence due to a temporary intensification of the conflict in the East. In one week's time, the exchange rate depreciated by about 20 percent.

In close consultation with the IMF, the NBU introduced a package of measures aimed at restoring stability in the foreign exchange market. These measures include:

- Monetary policy tightening: the main policy rate was increased from 19.5 to 30 percent. NBU's refinance and deposit rates were increased accordingly, by 1050 basis points.
- New temporary administrative measures were introduced to contain FX demand: the verification procedure for FX purchase requests was extended to include advance imports and transfers, the verification threshold was reduced to US$50,000 and the period for verification of the bona fide nature of transactions was prolonged to three days. In addition, lending in Hryvnia for FX purchase has been prohibited and banks' FX non-cash purchases on their own behalf significantly limited.
- Verification requirements for all FX transactions have been tightened.

These measures already yielded positive results. On March 6, 2015 the exchange rate appreciated to 22.5–23 Hryvnia/US$.

Monetary and exchange rate policy

The authorities are committed to the flexible exchange rate regime which is critical to rebuild international reserves and restore competitiveness. Foreign exchange restrictions and capital controls will be removed gradually when circumstances allow. The authorities are convinced that restoring confidence in the fundamentals of the economy through ambitious reforms and strong policy implementation is the best strategy to attenuate and remedy the current pressures.

Monetary policy aims for a low and stable inflation. **Inflation targeting will be adopted when conditions allow**. The inflation targeting framework is expected to help provide price stability in the medium term, eliminate external imbalances, and facilitate the gradual rebuilding of foreign reserves. The NBU has developed a model-based system of macroeconomic analysis and forecasting in the past years in order to do so. Amendments to the NBU Law will be adopted by the end of April (structural benchmark). Under the new law, the NBU will set policy objectives, use its own macroeconomic projections and decides on its monetary policy, irrespective of its effects on the central bank's income position. These measures, together with changes in the structure of the NBU including a downsizing of the Board from 11 to 6 members and the establishment of a Monetary Policy Committee will strengthen the governance, effectiveness and independence of the NBU substantially.

Financial sector

A well supervised, sound and solid banking system is a key objective under the program. The 2014 diagnostic results have led to specific recapitalization and resolution plans for several banks. A comprehensive reform package was supported by parliament by the end of 2014. The authorities enhanced the Deposit Guarantee Fund (DGF) framework. It now has the legal and operational capability to resolve banks and to issue and operate with own and governments' securities to cover gaps between assets and liabilities that are being transferred from insolvent to solvent institutions. This was a prior action completed in September 2014. On March 2, 2015, the parliament approved legislation that holds bank owners responsible for losses on loans granted to shareholders holding 10 percent or more of total voting shares (prior action). Banks need to submit reports of related exposure which will be reviewed carefully. Credible action plans are required from the banks.

Fiscal policy

Despite very difficult circumstances, the 2014 general government fiscal deficit target was met. The Ukrainian Government started with a simplification of taxes and elimination of distortive taxes. The revenue performance was in line with projections under the SBA. Wages, pensions and social benefits were set in nominal terms. The reduction of the public wage bill started. Overall, public expenditures were cut, despite higher military spending and higher public outlays cost by the currency depreciation.

The 2015 budget, adopted in December 2014, includes both expenditures and revenues measures. The tax base will be widened; massive exemptions are eliminated; the tax system will be streamlined by abolishing distortive taxes and simplifying rules. New excises have been introduced as was a tax on luxury vehicles. Tobacco excises, royalties on natural resources and the personal income tax were increased. A temporary import duty surcharge has been adopted for balance of payments reasons. Despite high inflation, nominal wages are frozen at their 2014 level, except for military personnel. The indexation of minimum pensions has been delayed until December 2015. Subsidies to state-owned enterprises are reduced. All explicit subsidies are now means-tested and income-based. Since the start of the SBA, the number of civil servants is reduced by around 25,000.

On March 2, 2015, the parliament approved supplementary measures to the 2015 budget, which was a prior action. The amendments will increase revenues by Hryvnia 22.5 bln while also increasing expenditures by Hryvnia 35.7 bln. As a result the budget deficit will widen from 3.7 percent of GDP to 4.2 percent of GDP. This is mainly because of the increased debt service after the depreciation of the Hryvnia. At the same time, reduced support for Naftogaz and the pension Fund will lower the quasi fiscal deficit from 10.5 percent last year to 7.3 percent of GDP this year. As part of these amendments, the number of budget- paid employees will be reduced by 3 percent in 2015, including a 20 percent decrease of the civil service workforce. Furthermore, several saving measures were undertaken in the pension sector. The retirement age is being gradually increased by five years for women and a number of professions which were eligible for early retirement. Benefits for pensioners who continue working are reduced. Special pensions will be abolished. A third element of the amendment is related to revenues and expenditures in the energy sector. Increases in rental payments by the state gas companies will fund increased subsidies for the poorest people affected by the increase in energy tariffs.

Over the medium-term, the Ukrainian authorities aim for a gradual expenditure-based fiscal consolidation and strengthening of the fiscal institutions. The focus will be on improving the tax collection and tax administration and strengthen expenditure transparency and control, particularly in government procurement.

Energy policy

The authorities undertook important reforms in the energy sector. The gas price and heating tariffs for households were raised in May and July 2014. At the same time, the new targeted social safety net which compensates the poorest for energy price hikes has become operational. Unfortunately, all these efforts were offset by the depreciation of the exchange rate. This, together with reduced gas transit revenues and a prepayment for imported gas for 2015 led to a deficit of 5.7 percent of GDP instead of 4.3 percent of GDP projected at the time of the first review of the SBA.

As a prior action, the energy regulator introduced a resolution on energy prices on March 3, 2015. This includes a price increase for gas of 285 percent and for heating of 67 percent from April 1, 2015 onwards and measures to improve gas payment collection. A new law on the gas market is under preparation. It will pave the way for further Naftogaz restructuring and overhaul the gas market in Ukraine by enabling third party access to the gas infrastructure and the operation of an energy regulator.

Further energy sector reforms focus on reducing fiscal subsidies, increasing the efficiency of Naftogaz and eliminating its deficit by 2017. Gradual but persistent increases in retail gas prices and heating tariffs will be accompanied by further social assistance measures to mitigate the impact on low-income households. Energy efficiency will be pursued. In cooperation with the World Bank, the authorities are finalizing plans to reform the gas sector including splitting Naftogaz's main activities as extracting, transportation, storage and sales.

Structural reforms

Important steps were taken to improve the business climate. In collaboration with the World Bank, the authorities have prepared a law on investors' protection which will be submitted to parliament by the end of March 2015. Parliament adopted a new law on transparency of state procurement and a moratorium on inspections. The number of permits required for business registration was cut from 143 to 85 and the process to get a permit was streamlined. A business ombudsman has been appointed in December 2014.

The establishment of a robust legal framework to fight corruption is underway. An anti-corruption investigation agency was established in 2014. The recommendations of the diagnostic study on governance from July 2014 will be gradually implemented. Specifically, the authorities are working towards establishing the National Anti-corruption Bureau (NAB) by end-April 2015. The NAB Law will be amended to strengthen its external oversight, give it power to investigate former Presidents and ensure it has access to all relevant information. Anti-money laundering efforts are stepped-up by enhancing Ukraine's AML framework. Assets disclosure of high-level officials will be enhanced.

Final remarks

Implementing the ambitious reform agenda in the current challenging context is very demanding. It requires extraordinary political determination. The extended arrangement will provide Ukraine with the necessary breathing space to continue implementing the policies required to meet the program objectives and making progress towards stability and growth. The staff report rightly quotes Prime Minister Jatsenyuk to demonstrate strong ownership of the program for reforms. The authorities are committed to take additional measures that may be needed to meet the program objectives.