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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A PROPOSED REHABILITATION LOAN

IN AN AMOUNT EQUIVALENT TO US$500 MILLION

TO

UKRAINE

NOVEMBER 30, 1994

UKRAINE - REHABILITATION LOAN

Currency Equivalents

Currency unit = Karbovanets

US$1.00 = 78,600 Karbovanets (October 27, 1994)

Weights and Measures

Metric System

Abbreviations and Acronyms

CAS	Country Assistance Strategy
CG	Consultative Group
CPAR	Country Procurement Assessment Report
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ESW	Economic and Sector Work
FIAS	Foreign Investment Advisory Service
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
IAS	Internationally Accepted Standards
IBL	Institutional Building Loan
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDA	International Development Assistance
IFC	International Finance Corporation
IMF	International Monetary Fund
KBV	Karbovanets
MIGA	Multilateral Investment Guarantee Agency
NBU	National Bank of Ukraine
PHRD	Population and Human Resource Development
SOE	Statement of Expenditures
SPF	State Property Fund
STF	Systemic Transformation Facility
UNCTAD	United Nations Conference on Trade and Development
VER	Voluntary Export Restraints
WTO	World Trade Organization

Government Fiscal Year

January 1 - December 31

Table of Contents

UKRAINE - REHABILITATION LOAN

LOAN AND PROGRAM SUMMARY

Borrower: Ukraine

Amount: US$500 million equivalent

Terms: Seventeen years maturity with a five year grace period, at the Bank's standard variable interest rate.

Objectives and Description: The main objective of the loan is to support the Government's economic reform program to stabilize the economy and create the conditions for a resumption of economic growth. Other objectives are to (i) provide foreign exchange for the purchase of critical imports, including for the private sector; (ii) provide budgetary support for the strengthening of the social safety net for the neediest; (iii) improve the functioning of the foreign exchange market; and (iv) provide a framework for financial assistance from other donor agencies. The loan supports policies that: (a) promote the development of competitive markets; (b) result in improved financial discipline and hard budgets for enterprises, farms and banks; and (c) improve the targeting of benefits to the most needy and strengthen the social safety net. Among the key reforms are price and trade liberalization; development of the private sector, and the abolition of the system of state orders; privatization of small, medium and large enterprises, and agricultural land; restructuring of the electricity sector; and improved targeting of benefits to protect vulnerable groups, especially children in poor families and poor pensioners.

Benefits: The implementation of reforms will help restore macroeconomic stability and reverse the decline in economic activity, thus creating new jobs and improving living standards. This objective will also be served directly through the increased availability of foreign exchange to alleviate critical production bottlenecks. The local counterpart funds from the Bank loan will directly benefit the poor insofar as these are used to augment the resources targeted for them.

Risks: The main risks relate to slippage in implementation of reform measures. This can happen either because of effective opposition to the structural reforms in Parliament (especially privatization and agriculture sector reform) or the weak implementation capacity of Government. The first risk is being mitigated by designing the loan so as to address the legitimate concerns of those opposed to reforms. Thus, special attention is devoted to improved targeting of social assistance. The mass privatization program is designed to ensure that every citizen gets a share in state property and the mass publicity campaign will inform the population of the Government's plans and their rights. The Bank is also continuing its public economic education efforts, and maintaining close contact with Parliamentarians including those that oppose reforms. The risk from the weaknesses in implementation capacity will continue to be addressed through technical assistance in

various sectors, as well as by efforts to design policies that minimize the burden on the various agencies. A third risk is the deterioration of economic relations with Russia and Turkmenistan that are also Ukraine's main energy suppliers and creditors. This could lead to an abrupt disruption in supply of energy, forcing the Government to reinstate administrative controls and reverse the liberalization process now underway. This risk is being partly addressed by the policies supported by the loan that enable energy importers to recover the full cost of imported energy from final users, including the liberalization of prices, the unification of the exchange rate, and measures to ensure payment discipline. The participation of the IMF in bilateral negotiations to regularize previous arrears, and the commitment of the Government to prevent the accumulation of new arrears should also reduce this risk. Finally, there is a risk that external funding to the extent required will not be forthcoming, forcing the Government on an adjustment path that is socially hard to sustain. This risk will be mitigated by the Bank's loan, its efforts to attract cofinancing from other donors, and the leadership by the Bank in efforts to mobilize external donor support later in FY96.

Rate of Return: Not applicable

Poverty Category: Poverty focussed. The program includes specific measures to (i) protect low income households from the impact of increases in prices; (ii) strengthen mechanisms to deal with unemployment; and (iii) monitor the impact of adjustment on the poor and the unemployed.

Appraisal Report: Not applicable

Estimated Disbursement:

- US$250 million would be available for disbursement upon effectiveness. US$100 million (20 percent of the proposed loan) could be used to finance retroactively eligible imports procured in the four months preceding effectiveness. Effectiveness is expected on December 22, 1994.

- A further US$250 million is expected to be disbursed after April 1, 1995 on the basis of a satisfactory review of the progress in the overall program.

Map: IBRD No. 24253

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED REHABILITATION LOAN TO UKRAINE

1. I submit for your approval the following report and recommendation on a proposed loan to Ukraine for the equivalent of US$500 million to provide support for the Government's economic reform program. The loan would be at the Bank's standard variable interest rate, with a maturity of 17 years including a grace period of 5 years.

2. Formal contacts between the World Bank and Ukraine began in January 1992. Ukraine joined the IBRD in September 1992, IFC in October 1993, and MIGA in July 1994. The first country economic memorandum (Report No. 11029-UA) was distributed to the Board in June 1993.

PART I. COUNTRY POLICIES AND IBRD ASSISTANCE STRATEGY

I. Recent Economic Developments

A. Background

3. Ukraine, a country with a history that goes back to Kievan Rus in the tenth century, gained its independence from the Soviet Union in August 1991. It has a land mass of 603,700 square kilometers that is the largest in Europe (with the exception of the European part of Russia), and a population of 52 million that ranks fifth in Europe. Per capita GNP is estimated at US$1,910 (1993), placing Ukraine among the lower middle-income countries.[1] Ukraine has a highly educated labor force, fertile agricultural land, and diverse natural resources consisting of raw materials and metals. However, currently more than 50 percent of energy needs must be met through imports, principally from Russia.

4. For 70 years under Soviet control, the economy of Ukraine was shaped by the centrally planned allocation of resources, with the attendant administrative controls over prices and high investment ratios. In 1991, industry accounted for 46 percent of GDP, owing to the predominance of such fields as metallurgy, machine-building, and the military industrial complex in the economy. Agriculture constituted 26 percent of GDP, reflecting Ukraine's position as the "bread basket" of the Soviet Union.

B. Recent Economic Trends

5. Economic conditions in Ukraine, already difficult at the time of independence, have since worsened dramatically. There has been a large drop in officially recorded output, prices continue to rise steeply, and the stock of external debt (including arrears) has mounted significantly. While the growth in the parallel economy

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1/ Atlas methodology. GNP estimates for the economies of the former Soviet Union are subject to more than the usual range of uncertainty, and should therefore be regarded as preliminary and subject to revision.

has helped cushion the impact of the output collapse in the official economy, it remains a source of social tension and undermines the capacity of the Government to perform essential social services.

6. **Real GDP** fell by a total of 38 percent during the period 1990-93, a trend that accelerated in the first half of 1994. During that period, real GDP is estimated to have declined by 27 percent compared to a year earlier and industrial production by almost 40 percent. Particularly hard hit have been the energy-intensive industries and those facing shrinking markets for their products, such as metallurgy, machine-building, and construction materials.

7. On the supply side, the disintegration of long-established supply and customer links, both within Ukraine and with other FSU countries, has hurt many industries. Frequent disruptions in the supply of energy and raw materials have led to growing shortages. As noted above, with domestic production meeting only about half the country's energy needs, Ukraine is heavily dependent on imports, mainly from Russia and to a lesser extent, Turkmenistan. Energy supplies from the FSU have been cut off intermittently in response to the accumulation of payments arrears by Ukraine. Given the rigid specialization of enterprises inherited from the FSU, the declining fortunes of one industry or enterprise has often had a ripple effect throughout the economy. On the demand side, a number of specialized markets have dwindled, notably military equipment, which in 1990 accounted for as much as 10 percent of GDP, and a significant share of exports to the FSU. The large decline in real wages -- in the order of 60 percent in 1993 -- has also contributed to waning demand.

8. Inappropriate economic policies also contributed to depressing economic activity. Throughout the period, the state continued to maintain and tighten a wide range of controls on economic activity, particularly in the area of prices, domestic and foreign trade, and the exchange system. These controls, and ad-hoc and frequent changes in regulations, hampered exports and inhibited the growth of a dynamic private sector that could have cushioned the impact of the declining state enterprise sector. Furthermore, as attested to by the rapid erosion in living standards, these controls failed in their objective: prices continued to rise, an increasing share of the labor force became underemployed, capital flight accelerated and an increasing volume of economic activity went underground, further worsening the external balance of payments and the Government's budget.

9. **Prices** continued to rise rapidly throughout the period since independence. The average inflation rate climbed from 91 percent in 1991 to 1,210 percent in 1992 to 4,735 percent in 1993. And by the fall of 1993, inflation approached rates characteristic of hyperinflation, with prices rising by about 65 percent per month in the last quarter. Following a drastic tightening of credit policies in autumn 1993 and a freeze in adjustment in administered prices, particularly of energy after December, the rate of inflation came down markedly in 1994, reaching 4-5 percent per month in the second and third quarters.

10. The acceleration of inflation was due in large part to loose fiscal and monetary policies. Though the expenditures of the state budget (including directed credits) were sharply reduced in 1993 compared to 1992 (by 20 percentage points of GDP), the need for monetary financing of the deficit still remained excessive (9.7 percent of GDP) in relation to the economy's need for liquidity, given the public's dwindling confidence in the domestic currency. In the first half of 1994, expenditures were cut further by an additional 25 percent in real terms from their level in the second half of 1993, but revenues fell sharply too in real terms, and domestic financing of the general Government budget deficit remained as large as 8.7 percent of GDP. The financing needs of the budget was largely accommodated through credit expansion by the National Bank. Despite the growth of domestic credit so far in 1994, inflationary trends remained subdued. This has been attributed in part to (i) increased demand for money, due to the de-monetization that occurred in 1993 and the positive real interest rates; and (ii) an accumulation of excess reserves by banks in recognition of the poor financial situation of client enterprises, declining demand for credit due to high interest rates, and increased demand for cash probably linked to the growth of the underground economy.

11. The continuing sharp fall in production, combined with the rapid increase in prices has significantly eroded the standard of living of the population, especially of those at the low end of the income distribution. As already mentioned real **wages** fell 60 percent over 1993 and have remained broadly unchanged since. Though officially reported unemployment remains minuscule (0.4 percent of the labor force), it is estimated that as much as 16 percent of the labor force is underemployed in one form or other. While the growth of the informal economy and increased recourse to non-wage payments to workers in the official economy may have moderated the fall in wage incomes of workers, living conditions have no doubt worsened for most of the population. This has been compounded by the deteriorating conditions of hospitals and schools brought about by the need to control Government expenditures. One indication of the deterioration is provided by the increase in mortality rates in recent years: the life expectancy at birth for men has declined from 67 years in 1989 to 64 years in 1992, and from 75 to 74 years for women during the same period.

12. The **external trade** of Ukraine, of which about three quarters was conducted with the FSU, came under serious strain as the prices of traded goods rose to world levels after 1992. Between 1991 and 1993, the ruble price of gas rose by a factor of 570, and that of oil by a factor of 1,055. Despite a large drop in energy import volumes, the share of gas and oil imports shot up from 12 percent of FSU imports in 1991 to above 50 percent in 1993. This sharp deterioration in the terms of trade resulted in a widening of Ukraine's trade and current account deficit. The deficit in merchandise trade with the countries of the FSU increased to about $3 billion in 1993 and an estimated $2.1 billion in 1994. The merchandise trade deficit with the rest of the world was estimated at about $460 million in 1994. Taking account of the surplus on trade in services (mainly from fees for transit of gas), the overall deficit on goods and services rose to $970 million in 1993 and to an estimated $1.8 billion in 1994.

13. Instead of promoting exports and improving energy efficiency, the increase in the cost of energy imports was met partly by compressing non-energy imports, but increasingly through accumulation of payment arrears, particularly for energy imports. **Exports** continued to fall steeply throughout 1992-94, and are estimated to have fallen by 15-16 percent per year in 1993 and 1994. The distortions in the foreign exchange regime and extensive quantitative restrictions on exports were important explanatory factors. The failure to adjust domestic prices of energy to fully reflect the higher import costs and the unwillingness to close down loss-making enterprises resulted in maintaining a low level of efficiency in energy utilization. And while the volume of energy **imports** fell during the period, they fell by less than GDP. On the other hand, non-energy imports declined steeply -- 30 percent in 1993 and by an additional 38 percent in 1994 -- which may have weakened Ukraine's capacity to export.

14. Increasingly, Ukraine accumulated **arrears** on payments for its energy imports. By end of June 1994, the total stock of net arrears, mostly on account of non-payment for energy imports, had risen to $2.2 billion. Most of those arrears are to Russia and Turkmenistan. Since then, payment arrears have continued. Ukraine's total **external liabilities** as of end-September 1994 amounted to $6.5 billion, or about one half of exports of goods and services, and close to 10 percent of GDP.

C. Status of Systemic Reforms

15. As already mentioned, economic policy failed to address the deep macro-economic imbalances brought about by the collapse of the FSU and the deterioration in the terms of trade. In an unsuccessful bid to maintain the existing pattern of production, and prevent the erosion in living conditions that was inevitable in the short run, the Government tightened the administrative management of the economy, thereby preventing an efficient private sector from emerging. When some reforms to loosen the state's role were implemented, these were piecemeal and lacking in coherence. The necessary adjustment of the real economy to external shocks was postponed

largely through increased indebtedness, and these policies failed to prevent a sharp deterioration in living conditions of the population.

16. The state continued to play a dominant role in the economy, with budget expenditures constituting almost 50 percent of GDP. **Price regulations** remained pervasive and took several forms. These regulations undermined budget discipline, created pressure on the external balance of payment, and discouraged the entry and growth of the private sector in production and trade. In addition, the state order system has remained important for major products accounting for 40% of total trade turnover in 1993. This further undermined the signalling role of prices and hampered the development of domestic private trade. Large state monopolies continue to dominate such sectors as the distribution system. With respect to foreign trade, **export quotas** and export taxes were pervasive in 1993. Some liberalization was achieved during 1994 when export duties were eliminated and the list of goods subject to export quotas was reduced by half. Nevertheless, quotas continue to apply for about 30 percent of exports, limiting Ukraine's growth potential. Equally damaging for exports was the **multiple exchange rate** system in place since August 1993. Under this system, exporters were required to surrender a certain portion (initially 50 percent) of their foreign exchange at a relatively appreciated official exchange rate, which constituted a significant tax on their earnings and contributed to capital flight and barter trade.

17. Very limited progress was achieved in **privatization**. Despite the passage of enabling legislation, only some municipalities began privatizing small enterprises and retail outlets, but these have been local initiatives and insignificant for the overall picture. In early 1994, the Central Government announced its intention of accelerating the privatization process for medium and large enterprises as well as for small-scale units, but the entire privatization effort was temporarily suspended by Parliament by mid-year. In agriculture, only a minuscule fraction (11%) of the total land is privately owned. While the land code allows for individual members of collective and cooperative farms to obtain title to an identifiable piece of land on the farm, this has not been implemented.

18. As for the emerging **private sector**, their growth has largely been in the informal economy. The business environment is still subject to frequent changes in regulations and taxes, and too many business decisions remain at the discretion of the central Government or local authorities. The overall tax burden is too high, with payroll taxes alone amounting to about 53 percent of the wage bill. Critical infrastructure such as transport, storage space, retail shops, etc. remain under state ownership and the private sector's access to them is limited. The continuing **soft budget constraint** on state enterprises keeps resources locked up in inefficient activities and denies their use to the emerging private sector.

19. The economic environment in Ukraine has thus provided few incentives for economic agents to respond efficiently to market signals (including changes in the external terms of trade) and to business opportunities, both at home and abroad. Widely fluctuating prices and exchange rate have eroded confidence in the future, and made individuals and enterprises reluctant to save and invest. The state enterprises do not adjust to changing economic conditions in the expectation that the state will bail them out of their financial difficulties.

II. The Government's Economic Reform Program

A. Overview

20. In democratic elections held in July 1994, Ukraine chose a new President, Mr. Leonid Kuchma. In his inaugural speech to Parliament on October 12, 1994, the President called for a radical break from the past in

economic policies. A bold and comprehensive program of macroeconomic stabilization and structural reforms was developed with the assistance of the IMF and the World Bank, with the objectives of reducing the rate of inflation and promoting sustainable economic recovery and better living conditions for the population. A series of difficult and far-reaching measures were implemented up-front to demonstrate the Government's commitment to break with the past. These included the lifting of a majority of price controls, the unification of the exchange rate, the elimination of most export quotas, the sharp reduction in subsidies on bread and other public utilities, the adjustment of imported energy prices to full cost recovery levels, as well as the implementation of a more targeted safety net. On October 26, 1994 the IMF approved a first purchase of SDR 249.325 million (approximately $365 million) under the System Transformation Facility (STF). The Rehabilitation loan from the World Bank supports the implementation of structural reform measures necessary for effective stabilization and to promote economic growth led by a growing private sector.

21. The Government's program calls for accelerating the transition to a market-oriented economy. Within this broad framework, the economic package that the Government has adopted aims to break inflationary expectations and promote a sustained recovery in economic growth and living standards of the population. To this end, the program focuses on four key interdependent elements. First, a **stable macroeconomic environment** is required so that producers and consumers can make sound business decisions without excessive uncertainties about policies and prospects. The stabilization of the economy will rest upon tight fiscal and monetary policies supported by wage restraint. Second, **competition in markets** is essential for an efficient allocation of resources. In an effort to promote free and open markets, the Government will rely upon a variety of policies, namely the liberalization of domestic prices as well as the foreign exchange and trade regime; the dismantling of the state order system; and demonopolization. It will also promote activity in the emerging private sector, much of which has been forced into unofficial channels because of burdensome controls. Third, the **hardening of enterprise budget constraints** will encourage enterprises to respond to the new market forces. This shift in enterprise behavior is to come about through privatization, the enforcement of bankruptcy laws, and an overhaul in enterprise management. A strict financial policy (including the elimination of directed credits and credits to settle inter-enterprise arrears) and reform of the financial sector will serve to support the changes at the enterprise level that are envisaged under the program. Finally, the **social safety net** is to be strengthened and made sustainable, primarily through better targeting, in order to protect the population groups most vulnerable to the adjustments associated with the structural transformation of the economy, and to fulfill its legitimate role in a market economy.

B. The Stabilization Program

(i) Fiscal Policy

22. The authorities recognize that a stable macroeconomic environment is essential for promoting investment in the economy and generating economic growth. It is also recognized that in the past inflation was fueled by the large Government budget deficit which had to be financed through credit expansion by the central bank. To bring about a lasting reduction in inflation, the Government is committed to implementing tight fiscal and monetary policies. Consistent with the objective of reducing the monthly rate of inflation to less than 5 percent by end 1995, the deficit of the consolidated state budget, including directed credits and the Pension Fund, is to be limited in 1994 to no more than 10 percent of expected GDP. Given the limited scope for increases in tax revenues in this period, the reduction in the deficit is expected to come from expenditure cuts equivalent to 2 1/2 percent of GDP compared to the level of expenditures in the first half of 1994. These cuts comprise reductions in subsidies on coal, housing and communal services, cuts in net credit and support for agriculture, reduced expenditures on commodity reserves and steep cuts in other expenditures as well. To protect the most vulnerable groups of the population, a program of targeted assistance has been developed and adequate resources have been

budgeted. In 1995, the ratio of the general Government deficit to GDP is to be reduced to at least half the level of 1994, through improvements in the tax system as well as further cuts in expenditures.

(ii) Monetary Policy

23. The Government will continue to rely on tight monetary policy. Consistent with the targeted rate of inflation, the increase in net domestic assets of the NBU is to be limited and the growth of money supply restricted to 40 percent in the fourth quarter of 1994 (when nominal GDP growth is estimated at 58 percent) and 21 percent in the first quarter of 1995 (when nominal GDP is projected to grow by 25 percent). Because of the large credit needs of the Government, no increase in credit to the non-Government sector is expected to be possible in the fourth quarter of 1994. As a temporary measure, the outstanding stock of credit of each bank to the non-Government sector has been frozen during the fourth quarter under a system of credit ceilings. As the Government's financing needs diminish in 1995, direct credit controls are to be relaxed and increased reliance placed on indirect instruments of monetary policy.

24. To increase the attractiveness of deposits in local currency (relative to foreign exchange or goods), in end October 1994 the NBU raised its refinance rate from 11.5 percent per month to 25 percent and intends to maintain it at a level that is positive in real terms with respect to expected inflation. Also as of end October, the NBU ceased issuing directed credits, and all refinance credits are allocated partly in proportion to the banks' capital and increasingly through auctions. The NBU is committed not to issue credits to settle inter-enterprise arrears. All ceilings on interest rates of banks were eliminated as of end October 1994.

(iii) Income Policy

25. During 1993-94, the growth of wages was limited because of the difficult financial situation of enterprises. However, as a safeguard against an unsustainable growth in wages, a ceiling is being applied on the wage bills of state enterprises for the fourth quarter of 1994 when the wage bill will not be allowed to increase by more that 80 percent of the programmed rate of inflation.

C. The Structural Reform Program

26. The Government's structural reform program has three main components. First, measures will be taken to promote competition by letting markets function and removing the inhibiting role of the state towards the private sector. Second, policies will be implemented that will harden the budget constraint on enterprises, farms and banks through privatization, elimination of subsidized credit and other transfers to loss-making enterprises, and the restructuring of state enterprises into commercial entities. And third, the social safety net will be strengthened for the most needy groups of the population through improved targeting of benefits. All these measures are necessary to promote a more efficient use of resources and to create the conditions for a stable and sustainable improvement in the living conditions of the population.

(i) Creating a Competitive Environment

Price Liberalization

27. Until recently, with few exceptions, price regulations were pervasive and took several forms. These included: (i) administrative setting of prices for housing, communal services, and public transport; (ii) limits on profit margins for selected commodities such as some types of bread, baby food, and other "essential" consumer goods; (iii) required approval of local authorities for price increases of commodities identified as "socially

significant"; (iv) limits on trade mark-up; (v) required approval by Government of price increases by industrial enterprises that are 'monopolists' including in particular enterprises producing fertilizers, chemical products and agricultural machinery; and (vi) allowing enterprises to deduct only 'justified' costs for tax purposes. Most commodities fell under one of these regulations. These regulations had a direct adverse impact on the economy. Thus, maintaining administered prices too low in relation to cost recovery levels led to increased subsidies from the budget and contributed to inflationary pressures. Limits on profit margins and trade mark-up discouraged entry of the private sector, and weakened the incentive to reduce cost. The different degrees of price controls for different commodities and sectors has also distorted relative prices. Thus, for example, it is estimated that the average price of agricultural inputs rose 38 times in 1992 while output prices rose only 15 times, resulting in a significant deterioration in agricultural terms of trade.

28. The overall goal in the area of pricing is to significantly reduce (central and local) Government intervention in setting and regulating prices. This will not only promote efficient resource allocation, including in particular of scarce energy imports, but will also strengthen the budget. At end October 1994, through a decree of the Cabinet of Ministers the Government abolished a majority of state interventions in price setting, including direct price controls, most ceilings on profit margins, as well as advance notification/approval for prices including for goods produced by "monopolies".

29. At the producer level, price controls remain only for natural monopolies (electricity, gas, central heating, water supply and sewage), public transport, rents, and for a small and declining number of artificial monopolies. In two steps, on October 25 and November 5, 1994, the domestic price of imported natural gas for industrial and agricultural users and Governmental organizations was raised by a factor of 3 and 1.5, respectively.[2] In 1995, natural gas prices for these consumers will be periodically adjusted to maintain a level that fully covers import plus domestic transmission and distribution costs valued at the market exchange rate. On November 5, 1994, the price of domestic coal was raised by 90 percent to reduce subsidies to no more than 20 percent, from 60-65 percent before. The Government intends to liberalize coal prices as of January 1, 1995 except for coal for household use. Electricity prices were also raised 2.5 times on October 1 and again in November 1994 to reflect fully recent increases in fuel costs, and a system of periodic price adjustments has been put in place to compensate for additional changes in fuel and other basic input costs. The Government intends to liberalize electricity prices for producers by late-1995 when a competitive wholesale electricity market is established (see para. 60).

30. Retail prices of most foodstuffs and other commodities were liberalized as of October 21, 1994. At the retail level, price controls remain only on bread, public utility charges, fares for public transportation, fuel for households, and housing rents. Bread prices were raised by 4 to 5 times in October 1994 in order to achieve full cost recovery at the 1994 procurement price for grain.[3] However, as a temporary measure, ceilings were maintained on profit margins for bread products, baby food and flour. The control of bread prices and the profit margin ceilings on bread products, baby foods and flour are to be abolished as of January 1, 1995. Public utility tariffs and housing rents were also increased in late October sufficient to increase the proportion of costs that is recovered from about 5 percent to 20 percent. This led to a 7-fold increase in housing costs. Fares for public transport were raised 6 times in October 1994 to cover 20 percent of cost (from 2-3 percent cost recovery before).

31. The Government is committed to further liberalization of prices in early 1995, and to essentially complete its process by the end of the year. The domestic prices of coal and bread are to be liberalized on January 1, 1995

2/ In the first half of 1994, the average wholesale price of natural gas was 25 percent of the border price at the market exchange rate.

3/ Consumer subsidies covered 75-80 percent of the cost of bread in mid-1994.

and the list of artificial monopolies subject to price controls sharply reduced. Limits on profit margins for crude oil and oil products will be eliminated as of January 1, 1995. Household electricity prices are to be increased in January 1995 to cover at least 40 percent of costs and increased further in June 1995 to cover at least 60 percent of costs. Housing rents and other public utility charges are also to be raised significantly.

32. To protect the most vulnerable groups from the full impact of these large price increases, the Government is implementing a program of targeted assistance, using in part the savings generated by eliminating the untargeted consumer subsidies that goes to the better-off population (see paras. 74-80).

Private Sector Development

33. The Government recognizes that the rapid development of the private sector provides not only the main source of growth in the economy, but is also a source of competition for existing state enterprises. Consequently, economic policy seeks to encourage more rapid growth of the private sector and to bring the informal economy into the mainstream. Implementation of the program to stabilize the economy and to liberalize prices and the external regime will go a long way in establishing an environment favorable to the private sector. A series of more specific measures to promote private enterprise are also planned. First, the Government has already adopted the Law on Entrepreneurship, simplifying the process of licensing and registration for new businesses. Guidelines on the application of the revised procedures have been issued to local authorities. These guidelines will impose mandatory deadlines of five days within which city authorities must respond to new business applications. Entry is allowed in all branches of economic activity, including transport and distribution of goods. Second, rapid implementation of mass- and small-scale privatization programs will increase the availability of former state owned enterprises' assets to the private sector. State owned enterprises are already free to sell their assets through public auction up to a book value of 2000 minimum wages without permission of the State Property Fund (SPF) or line Ministry. Third, the Government is undertaking a thorough review of the taxation system, with a view to reducing the overall tax burden on economic activity and eliminating discrimination, if any, against private sector activity. Finally, a high level task force has been established to develop a comprehensive plan to create a legal framework conducive to private sector development.

34. The Government recognizes the importance of foreign direct investment to facilitate and speed up the process of creating an efficient and competitive private sector. Foreign investors will not only bring capital, but also technology, management skills, and access to foreign markets. The economic reform program will significantly improve the prospects for attracting serious long term investors. The Government is aware that changes should only be adopted cautiously, and never retroactively, as stability and predictability of laws and regulations are crucial to the confidence of investors,

35. With the improved overall framework in mind, the Government considers it no longer a priority to create special incentives for foreign investors, nor will efforts be continued to guide foreign investors to "priority areas". The Government is planning to abolish tax holidays and other tax exemptions in the context of the broader tax reform effort, as well as other special incentives. The leading principle will be to ensure equal treatment of local and foreign investors.

Liberalization of Domestic Trade

36. State orders (purchases financed out of enterprise's own revenues, but intermediated through the state) and state contracts (intermediated by the state and financed out of budgetary funds and directed credits) continued to be in place in 1994. But both have declined significantly since 1990, and accounted for 40 percent of domestic trade turnover in 1993 (compared to 70 percent in 1990). State orders and contracts remain significant for fuel, exportable industrial products and agricultural crops. The continued use of state orders and state

contracts hinders the role of markets and free prices in resource allocation, and maintains a role of the state in the economy that is not consistent with a market economy.

37. The wholesale storage bases formerly under the Ministry of Trade have been largely abandoned as storage centers for goods traded through the state system. Part of these storage areas are leased out to commercial companies, but much of their capacity currently is idle. Grain silos are also underutilized as many farms choose to store grain on farm (under inadequate conditions) rather than sell it to the state which rarely makes timely payment. The operations of retail stores, some of which have been leased out to workers' collectives, are tightly restricted by local regulations, including profile restrictions. The lack of access of the private sector to this infrastructure is an important constraint to the development of private trading activity.

38. Consistent with the Government's policy of liberalization, and to promote private sector activity, the system of state orders is to be dismantled as of January 1, 1995 and replaced by ordinary contractual obligations. From January 1, 1995 purchases by the state will be confined to goods and services necessary for the activities of budgetary organizations (these include the armed forces, schools, hospitals, agencies and other organizations which are wholly financed from the budget). These goods will be procured through competitive tenders within the resources allocated in the budget for this purpose. With the removal of formal obstacles and informal impediments to wholesale and retail marketing (see below), intra-regional and inter-regional trade will be allowed to develop along commercial lines.

39. Also as of January 1, 1995 the earlier Presidential decree that imposed a maximum ceiling of 55 percent on mark-ups over producer cost in domestic trade is to be repealed and all central and local Government ceilings on mark-ups will be eliminated. The ceilings inhibited the growth of wholesale trade as enterprises' ability to recoup the costs of transporting, storing, and retailing goods was severely limited. An expert group is to be formed in the Ministry of Foreign Economic Relations (MFER) to receive complaints about regional and local Governments' attempts to regulate or otherwise interfere with inter-regional trade. The tax on profits from intermediary activities is also to be lowered to 30 percent by end of 1994, which is more in line with profits tax in other sectors. This will serve to reduce the discrimination against intermediary activity and greatly increase the incentive to develop commodity markets and private wholesaling activities.

40. The Government recognizes that the above measures will be most effective in generating dynamic private sector trade if the supporting infrastructure is available. Wholesale storage bases and trucking enterprises will be included in the Government's mass privatization program for 1995, and privatized rapidly. The first pilot auctions, beginning in the first quarter of 1995, will include these facilities. Grain silos and elevators will be included in the privatization program for 1995. Retail stores, including food stores, will be privatized quickly under the small scale privatization program.

Reform of the External Regime

41. The removal of exchange and trade restrictions is a critical element in the Government's strategy to introduce a rational structure of relative prices, promote exports and use the foreign exchange earnings to ease domestic shortages, and to expose monopolist producers to import competition.

42. Until recently, the external regime was highly complex and restrictive. Through most of 1993-94, 50 percent of foreign exchange earnings had to be surrendered to the authorities, most (or a large share) of it at a highly appreciated official rate. The share of foreign exchange turned over to the Government was channeled through the Tender Committee, which allocated this foreign exchange to priority imports, mostly energy. The remaining 50 percent of the foreign exchange earnings could be kept in foreign exchange accounts or sold at the

foreign exchange auctions run by the NBU (or sold to the NBU at an administered rate when the auction market was terminated in November 1993).

43. The controls on foreign trade applied mainly to exports as the Government sought to prevent the outflow of goods for which domestic prices were lower than world market prices. In the case of key commodities, an intricate system of controls was anchored by licenses, and consisted variously of quotas (which enterprises obtained for the most part by signing state orders and state contracts), a "special regime", and export taxes. With a Presidential decree issued in May 1994, the scope of export control was substantially narrowed. Export taxes were eliminated. Licenses and quotas were limited to slightly more than 100 products accounting for about one third of total export value, down from 240 goods equivalent to almost two thirds of total export value in December 1993; and the special regime was replaced by a system of quarterly auctions of quotas. To prevent capital flight, a system of indicative prices is also used to ensure that export prices conform to world market levels. Imports are free from quotas, and licenses are required only for a few products for health and safety reasons. The average import tariff in 1993 was about 12 percent, but tariffs are widely dispersed, with the maximum rate in excess of 300 percent.

44. To promote exports and open up the Ukrainian economy to international trade and competition, the Government has moved decisively to reform the external regime. On October 5, 1994 the interbank auction market for foreign exchange was re-opened. The official rate for the surrender of foreign exchange was abolished on October 26, the exchange rate was unified, and the rate is now determined in the inter-bank market. The inter-bank market is being progressively opened to all licensed banks and bids are being processed, and the exchange rate determined without administrative interference. The allocation of foreign exchange through the Tender Committee was abolished at end October and a high degree of current account convertibility of the karbovanets was re-established, with full convertibility for all trade and related activities.

45. All export quotas and licenses, with the exception of ferrous and non-ferrous scrap metal, cast iron, coal, grain, and goods subject to voluntary export restraints (VER) and other contingent international agreements were abolished as of November 1, 1994. All export quotas and licenses are to be removed by January 1, 1995 except for goods subject to VER and other contingent international agreements. With the unification of the exchange rate and the elimination of quotas, the rationale for indicative prices to monitor and control exports no longer exists. Consequently, indicative prices will no longer be used for purposes of obtaining MFER's approval of export contracts and licenses expect for goods subject to VER and other contingent international agreements.

46. The Government is committed not to impose any quantitative import restrictions, except for the licenses that are currently in place for health and safety reasons. The import tariff regime will be modified to maintain low and uniform rates. This is to be achieved by reducing the maximum tariff rate to 30 percent by January 1, 1995 and by lowering it further by end of the 1995. Tariffs may be temporarily raised above the maximum rate in strict conformity with GATT/WTO norms. However, the share of goods whose import tariffs can exceed the established maximum rate will be limited to 1 percent (measured on the basis of 1993 import shares). The excise duties on imported and domestically produced goods are to be unified by March 1995. The Government intends to avoid frequent revisions to the tariff structure.

(ii) Hardening of Enterprise Budget Constraints

47. Economic liberalization will be most successful in transforming the economy if flanking reforms that make households, enterprises, and commercial banks responsive to market signals are implemented. The Government considers three areas to be of special importance, i.e. privatization; stricter financial disciple and improved corporate governance; and reform of the financial sector.

Privatization

48. The state sector dominates activities in Ukraine: there are roughly 100,000 small-scale enterprises and 20,000 medium and large-scale enterprises, and only a minuscule number have been privatized. The legal and institutional framework for privatization has been established and a range of laws on ownership, the privatization of state-owned companies, small-scale privatization, etc. have been adopted. In 1991, the State Property Fund (SPF) was given the mandate to prepare and execute a privatization program. However, progress has been disappointingly slow. The slow pace of privatization reflected numerous obstacles, including a lack of political sponsorship and the widespread phenomenon of leasing with a right to buy out. Against this backdrop, the Government has expressed its commitment to accelerating the process of privatization.

49. *Small-Scale Privatization.* During the spring and summer of 1994, small scale privatization accelerated but by the end of June 1994, only about 5000 small enterprises were privatized. The Government intends to complete at least 6000 transactions by the end of 1994 and to complete the privatization of 90 percent of all small scale enterprises by end 1995. To meet this objective the State Property Fund has instructed local privatization bodies to implement the program and has mounted an extensive public information campaign to promote small scale enterprise auctions and buy-outs. This will be backed up by a system of incentives and penalties for enterprise directors and officials of local Government bodies. A system of incentives/disincentives for the rapid privatization of leased enterprises is also to be set up.

50. *Mass Privatization.* Very limited progress has been achieved in the privatization of medium and large enterprises. As of mid-1994, only about 1000 enterprises had been privatized, mostly by transfer of ownership to the workers' collective. The Government is determined to accelerate the privatization program for medium and large enterprises. To enable this, the procedures for mass privatization have been greatly simplified and the Government has announced its intention of privatizing in 1995 at least 8000 medium and large enterprises including freight trucking companies, warehouses and storage facilities. Public auctions using paper privatization certificates are to start in the first quarter of 1995. Simplifications to the procedures included the merging of the formerly separate corporatization and privatization processes into a single track, the appointment of a single board for each enterprise which now exercises the role of all the various commissions required by the legislation, the bottom-up preparation of streamlined standard documentation packages for privatization by the enterprises themselves, and approval of the completed packages according to tight deadlines by the State Property Fund. According to the new procedures, the book value and most recent inventory are to be taken as the standard valuation for each enterprise, there will be automatic allocation of blocks of shares to the public auction process, and a simple bidding system in the auctions that will allow proportional allocation of shares to all bidders.

51. By mid-December, 1994 the Government intends to distribute paper privatization certificates to the population in five pilot oblasts and by January 1995 regional bidding networks will have been created in these oblasts. Distribution to the population in all remaining oblasts will begin in January, 1995. A national public information program is already underway explaining the mass privatization program to the public with the emphasis on the benefits of the program, the use of certificates, and the new streamlined privatization procedures. The first certificate auctions following the new procedures will take place in February-March 1995 with sales of shares in at least 200 enterprises. These will include freight trucking enterprises and wholesale storage bases. The auctions will be extended to the entire country by April, 1995 and between January 1 and June 15, 1995 around 1000 medium and large enterprises will have been privatized through the mass privatization program. The process will accelerate further in the second half of 1995. Grain silos and elevators are to be privatized in 1995.

52. Over 50 private investment funds have already been created and they will be encouraged within the established regulatory framework to participate in the certificate auctions as a means of concentrating share

ownership and enhancing corporate governance of privatized enterprises. Shares in all privatized enterprises will be immediately tradable and secondary securities markets infrastructure is being developed.

53. *Privatization in Agriculture.* Only a very small share (11%) of total agricultural land is privately owned and cultivated. The Land Code of March 1992 specifically allows for private as well as state and cooperative ownership of agricultural land. It also stipulates that collective and state farm members and those providing social services in villages (as well as pensioners who previously worked in agriculture) are entitled to receive equal average shares of the available agricultural land at the local level. The official right to farm or otherwise exploit these land plots is obtained, according to the Land Code, only after the plot has been surveyed and a document issued certifying the property right. Plots can then be farmed, leased, used as collateral, given as a gift, or bequeathed. However, they can only be sold after six years of possession.

54. The development of private farming and an agricultural land market is being constrained by the failure to distribute identifiable land shares to the members of the state and collective farms which can be registered and mortgaged, and by the six year moratorium on land sales. To promote the development of a land market, the Government will seek to amend the Land Code to achieve three goals: (i) provide physically identifiable average land share to eligible beneficiaries using clear and implementable procedures; (ii) reduce the moratorium on sale to two years after receiving possession, or January 1, 1996, whichever occurs first and (iii) enforce lease payments by farmers for land received above the local average land share, or transform these leases into purchases from the land reserve. Land from the reserves is to be made available to all buyers, and its resale thereafter will be subject to the same limited moratorium period. The procedures for land mortgage (and other encumbrances) will be clarified in the amendments to the Land Code as well. The amendments to the Land Code and a draft Law on Registration of Land and Other Real Estate is to be submitted to Parliament by January 1, 1995. The draft Law on Registration of Land and Other Real Estate will explicitly specify the procedures for registering both urban and rural land and other real estate.

Enterprise Management and Restructuring

55. Notwithstanding privatization and growth of the private sector, state enterprises will remain important in the near term. Strengthening their economic performance will be critical to the improvement in the Government's fiscal position, to the recovery of output, the development of the private sector, and the viability of the banking system.

56. Financial discipline in enterprises will be strengthened by measures outlined above that increase competition and promote macro-economic stability, including in particular the liberalization of prices and trade, and the elimination of directed credits and subsidized loans from NBU and commercial banks. The NBU will continue not to provide credits to settle inter-enterprise arrears.

57. In order to deal specifically with the problem of non-payment by budgetary organizations and enterprises to energy suppliers, the Government has established an inter-departmental Commission to initiate actions to reduce payment arrears for gas, electricity and heat. The utilities would report non-payment to the Commission, which would explore mechanisms to ensure payment to the supplier, or if no such arrangement can be made, authorize the utility to reduce or discontinue service.

58. Additional measures will be taken to enforce financial discipline. The enterprise sector will be exposed to the provisions of the Bankruptcy Law and the state will not block the implementation of bankruptcy proceedings by the courts. To demonstrate the Governments' firm commitment in this area, and to signal the change in regime, a number of large non-viable state owned enterprises will be liquidated by mid-March 1995.

The impact of these measures on enterprise behavior will be reviewed during the course of 1995 and other measures will be implemented as necessary.

59. The Government has identified 20 large state enterprises that have either huge losses, or arrears, or receive large budgetary support, and has instructed them to prepare restructuring plans by mid-March 1995. These plans will include partial or complete privatization, partial or complete closure, splitting up of large monopolies, divestment of social assets etc. The Government has also established a mechanism by which it can control the flow of subsidies to these and other large enterprises, making transfers conditional on meeting restructuring targets. As a means of improving their corporate governance, the Government will also begin corporatizing all state enterprises that will not be subject to privatization.

60. The Government is committed to a radical restructuring of the electricity sector with the aim of establishing a competitive market for electricity in 1995. In line with Decree 244/94 of the President of Ukraine "On Market Transformation Measures in the Electricity Sector of Ukraine" and the Government's Action Plan, a National Electricity Regulatory Commission was established in December 1994. The functions of the Commission, which are to be fully defined by the end of the year, may include the issue of licenses to electricity generating, transmission and distribution companies, monitoring of compliance with the licenses, and promotion of the development of competition in electricity production and supply. The Government has also initiated the corporatization of hydropower plants.

Financial Sector Reform

61. The Government recognizes that financial sector reforms are critical for enforcing financial discipline, increasing domestic financial saving and for ensuring that credit is allocated to the most efficient users. The elimination of directed credits from the NBU and its commitment not to interfere with the credit decisions of banks are important steps towards making banks truly commercial entities. The maintenance of real positive interest rates on refinance credits, and the elimination of ceilings on interest rates of banks should allow a more vigorous mobilization of saving and a more efficient allocation of credit. In order to further develop the financial sector, the Government has presented proposals to Parliament to lower the presently high tax rate on banks to 40 percent of profits. The new rate, which will become effective by end of the year, is more in line with profit tax rates in others sectors.

62. In addition to these urgent macro-financial reforms, there are a wide range of structural and institution building reforms in the financial sector which are also essential for the effective operation of a successful market economy.

63. The legal basis to underpin the operations of banks and the NBU is changing rapidly and in a direction which has rapidly removed the "administrative guideline" basis which characterized the legal arrangements of the former centrally planned economy, to a system which is more appropriate to the oversight of a system of voluntary private contracts. Particularly important is draft legislation which, if passed, would establish the NBU in a more independent and powerful role at the pinnacle of the processes involved in monetary management and financial sector development. This would relate in particular to control over lending for budgetary purposes and to the manner in which the NBU can provide temporary support to the commercial banks.

64. Problems persist since neither this draft law nor the parallel law relating to commercial banks has yet been legislated through Parliament. In spite of this, and through a gradual strengthening of its own internal orders and regulations, the NBU has succeeded in tightening many procedures and in particular those relating to the establishment of new banks. However, in the absence of Parliamentary discussion and approval of the new law,

the authority which the NBU ultimately requires if it is to enforce tighter discipline on the sector is less than complete. Progress in this area is expected in the coming months.

65. The Government recognizes that the commercial banking and other financial institutions adapted from the old Soviet system are in a distressed state and in other ways are poorly equipped to support the needs of an emerging private sector. Equally it is well understood that as enterprise budgets are hardened and other pressures from macroeconomic and price reform emerge, the presently hidden losses of the former state banks in particular will become increasingly visible and transparent. Thus in addition to the corporatization of the former state banks which has already occurred, and the upgrading of some of their payments and other systems which has been carried out with World Bank and other donor support, a major restructuring program, including possible re-capitalization and break-up, for the banks may be required. This will have unavoidable feed-back effects on the budget as well as other macroeconomic variables.

66. As a first step, by March 15, 1995 the Government will complete a study, with technical assistance from the World Bank, which will define, cost and evaluate alternative restructuring proposals for the former state banks. These proposals will form the basis for developing concrete restructuring plans by mid-June 1995 for subsequent implementation. Restructuring proposals for the banks will be closely integrated with the restructuring of major loss-making enterprises.

67. As regards the subset of new private "commercial" banks which have proliferated during the past three years (there are now 235 in total), the actions needed and proposed are rather different. For the larger, better managed and capitalized of these banks, accelerated action is already underway to upgrade the organization and presentation of accounts to Internationally Accepted Standards (IAS). Among other things this will enable at least some of these banks to benefit quite soon from internationally financed lines of credit -- an early example is the EBRD credit line expected to benefit six banks from early 1995. The NBU is engaged in a program which will extend this accounting and other upgrading to the other new commercial banks to create new banking structures that can conform to international standards in all major banking functions.

68. A crucial element in this involves the ongoing strengthening and upgrading of the National Bank of Ukraine's department of Bank Supervision and Inspection as well as more stringent standards applied by the separate Bank Registration Department. Much progress has already been made to better define and also implement the framework for prudential supervision during the past two years including:

- far stricter procedures and requirements to register new banks including a minimum capital requirement now set at ECU 3 million. While this will stop the reckless establishment of banks which was evident from 1991 onwards, it is not yet being extended to banks established under the previous and more lax arrangements;

- the prompter closure, management removal or merger of banks persistently in breach of regulatory requirements;

- the introduction of control of banks assisted by the electronic transfer of information;

- the regionalization of the NBU's regional networks which now enables closer supervision of the branches of the regional banks;

- the establishment of a separate audit division within Bank Supervision which is providing the NBU with some ability to assess the quality of the external audits of the commercial banks;

69. One problem is the apparent lack of coordination between the processes for licensing new banks and the separate processes for licensing insurance companies and various other non-bank financial institutions. While progress has been made with the establishment in 1993 of the first prudential regime for insurance companies and an Insurance Supervisory Committee now exists, coordination with bank registration and supervision still seems relatively limited. This is worrisome given the weak capitalization of many banks and their potential ability to transfer their own risks to the providers of insurance. More generally the whole matter of the risks in the financial sector and the associated techniques for managing risk need to receive far more prominence than thus far has been the case.

(iii) Social Safety Net and Labor Markets

70. Resolute execution of the reform program described above will generate sustainable economic growth in the medium-term and allow living standards in Ukraine to improve. Rapid and decisive action in implementing this economic package is the best possible way to avoid and alleviate poverty in Ukraine; social protection measures in the absence of a vigorous adjustment program can only redistribute poverty. Effective stabilization policies will dampen inflation and restore confidence of investors, domestic and foreign, in the currency. This will promote investment, and economic growth and employment. The de-regulation of prices and exports will also stimulate business activity in the private sector, thus providing good jobs, especially in the export industries. Privatization of small shops, medium and large enterprises, agricultural land and housing constitutes a direct transfer of potentially productive assets to the population, and if used well could be an important source of income.

71. Yet the benefits from Ukraine's stabilization and adjustment programs will be neither instantaneous, nor available to all. The Government recognizes that there will be social costs during the transition and social needs over the longer term for which provisions must be made. Spending on social programs in Ukraine has been relatively high, 25.4 percent of GDP in 1993, and also unfocused. Moreover, these expenditures are financed by a very high payroll tax (53 percent), which damages Ukraine's international competitiveness and inhibits growth and job creation. Considerable efforts are needed to restructure the major social programs and target them to the most vulnerable groups, thereby increasing their effectiveness within the overall goal of limiting the state budget deficit.

72. In the short term, the most immediate concern is to deal with the consequences of the significant increases in prices of key goods and services that were a necessary component of the stabilization program. Before the recent price adjustments, the consumer prices of bread and housing (including housing-related services such as water/sewer and energy) reflected only a small fraction of production costs. Consumer subsidies were a major source of macroeconomic imbalance, and the low prices encouraged wasteful consumption (and smuggling of bread). Large increases in these prices have placed a particular strain on certain groups within the population. It is the Government's intention to assist needy groups rather than to continue to fund new programs aimed at subsidizing the consumption of specific goods and services by all population groups. The goal is to raise benefits for the truly needy, financing the increases with decreases in general consumer subsidies and other improvements in targeting. Not everyone can be fully protected against changes in relative prices -- that would defeat the purpose of the changes, and in any case it would be unaffordable. Yet substantial protection must be provided to the groups most likely to fall toward the bottom of the income distribution. Three groups are of particular concern: low income families with children, low income pensioners, and the unemployed. The first two groups are already subject to means test and an adequate delivery system exits. A comprehensive system of assistance for the unemployed also exits, though it has been largely unutilized thus far.

Children

73. Studies in neighboring countries have shown that children are disproportionately represented among the poor, and that the incidence of poverty among families with children (especially more than three) is very high. Survey research in Ukraine will probably reveal the same pattern.

74. To protect poor families with children, in October 1994, the Government increased the eligibility threshold and benefit levels for the means-tested child allowances to reflect inflation since December 1993. The Government will continue to ensure that the eligibility cut-off and benefit levels are adjusted monthly to at least keep pace with inflation. Because the real average wage may decline during the initial phase of the adjustment program, this approach could lead to an increase in the number of eligible families and in the amounts that they receive. Under these circumstances, the overall balance between means-tested and non-means-tested benefits would improve, and the overall structure of benefits would become more progressive (i.e. more effective in its targeting).

75. In the past, the eligibility cut-off for means-tested family allowances (and also for supplemental pension benefits) was based on the value of a particular consumption basket. Studies in other FSU countries indicate that such baskets tend to reflect social desiderata instead of absolute subsistence minima. For example, in Russia, poverty lines based on these baskets proved to be so high that more than half the population had fallen into poverty by 1992. Such high standards are of little use in framing social policy or targeting benefits. Hence, the Government plans to move toward a concept of eligibility for means-tested benefits that reflects fiscal realities.

76. As part of its efforts to enhance targeting in social programs, the Government will strengthen means-testing procedures. Under current practice, only income from employment in budgetary agencies or state-owned enterprises is captured. Economies of scale in household size are ignored; income in kind is not fully taken into account; and rural/urban and regional differences in the cost of living are ignored. Survey research will help overcome these deficiencies.

77. In addition to the allowances presented here, many other benefits are available to large, needy families. Rents may be cut in half, or waived entirely, and vouchers can be provided for food and clothing. These benefits, which are administered in a decentralized fashion by local social protection offices, will continue. Measures will be considered to assure their even application over all geographic areas.

The Elderly

78. Preliminary indications are that pensioners, as a group, are actually a bit better off than the general population in Ukraine. However, some pensioners are among the poor and the large increases in certain administered prices, for example for housing, could significantly increase their numbers.

79. The pension system, which is the largest component of the social benefit system other than consumer subsidies, provides old-age, disability, survivors', and "social" pensions to eligible workers or their families as well as certain allowances to children under the age of 18 months. There are 14 million pensioners in Ukraine, about 27 percent of the population. The Pension Fund, which is financial by a 33 percent payroll tax, is facing both short-term and long-term difficulties. In 1993, the Pension Fund posted a deficit equivalent to 3 percent of GDP (covered by a transfer from the state budget) because (i) the lag between increases in the minimum wage, to which benefits are tied, and the average wage to which contributions are linked; (ii) the number of workers receiving taxable wages declined, mainly on account of shorter working hours and unpaid leave; and (iii) some enterprises may have delayed their payment of pension contributions. The minimum wage was last raised in

November 1993, and the average wage has now adjusted. Accordingly, the pension system has been approximately in balance so far in 1994.

80. In the short term, the financial vulnerability of the Pension Fund seems manageable since the economic reform program should lead to a decline in the real minimum wage that is more rapid than the corresponding decline in the average wage. The resulting contraction in benefits will affect all pensioners in proportion to the size of their pensions. Without corrective action, this contraction in real benefits would push poor pensioners deeper into poverty, and some pensioners into poverty for the first time. To protect the living standards of pensioners in the face of increasing prices, all pensions were doubled as of October 1, 1994. The bread allowance for pensioners was also increased from KBV 44,000 to KBV 170,000. To protect the poor pensioners, the Government will continue to provide means-tested supplements to the pensions of low-income pensioners. In October 1994, the eligibility criteria and the existing means tested supplementary payment were increased to reflect inflation since December 1993. For the future, these will be indexed on a monthly basis to the targeted rate of inflation. As a result, more pensioners will become eligible for supplementary benefits, and the amounts for which they are eligible will rise. Overall, a shift from the untargeted portion to the targeted portion of the pension bill will take place. While this will weaken the link between contributions and benefits, that link is not strong now and this step is necessary in the short term to protect the poorest pensioners. This step will open up scope over time for private pensions. The Government proposes to ensure that eligible pensioners are aware of their rights to the supplement and that enough resources are available in every Ministry of Social Protection office to administer and pay the supplement in a timely fashion.

81. In the long term, the Pension Fund will be burdened by rapid growth in the number of pensioners and slow growth in the number of workers on whose behalf contributions are made to the system. Therefore, it will be necessary to take measures designed to reduce the dependency ratio as well as the ratio of average benefits to the average wage. The normal pension age, currently 55 for women and 60 for men, is not sustainable over the longer term since the required contribution rate is already very high and there are clear limits to reducing the average pension in real terms. The increase in retirement age to levels typical of other European countries will have to be phased in over several years, starting as soon as possible. Actuarial studies that will serve to elevate public awareness and focus discussion are in progress now. In addition to changing the retirement age, the Government will seek to remove special pension supplements from the public pension system. Under current arrangements, many categories of workers, such as coal miners, bus drivers, and other protected workers receive public pensions under especially favorable rules; for example, workers in some industries are entitled to retire before the normal pension age, while others receive generous supplements to the standard pension. This system provides an unwarranted subsidy to production in favored industries and imposes an excessive payroll tax on workers in the less favored industries. In the future, such enterprises will have to pay the extra compensation either directly in wages or in benefits such as a voluntary supplemental pension. Other system features, such as treatment of working pensioners, must also be re-evaluated.

82. Informal assistance to the elderly is provided by family members, just as it is everywhere in the world. This assistance takes the form of cash transfers, housing, or other services, but very little is known about it. Survey research will be undertaken with the objective of designing social assistance policies that complement rather than crowd out existing informal mechanisms. However, there are elderly people who are "solitary" (without close relatives) or whose relatives are also poor. With this in mind, the Government intends to strengthen the local social protection offices which, under the current system, are funded to provide limited amounts of ad hoc social assistance to such individuals.

The Unemployed and Disguised Unemployed

83. Despite the contraction of the economy, open unemployment has remained negligible. At end-July 1994, there were only 92,000 registered unemployed (less than 0.4 percent of the labor force). Yet by mid-1994, it has been estimated that as many as 4 million workers (about 16 percent of the labor force) were subject to some form of underemployment.

84. The Employment Fund was established in March 1991 with a mandate to provide benefits and job placement assistance to the unemployed. In both 1992 and 1993, it posted comfortable surpluses, while consuming a high level of resources to serve the very small numbers of openly unemployed workers. A limited share of the Employment Fund's resources, obtained from a 3 percent payroll tax, has gone to pay unemployment benefits or provide training. Most of it has been spent on administration and infrastructure as well as credits to enterprises -- many of them state-owned -- that promise to create jobs. Under the economic package adopted by the Government, the focus of the Employment Fund will be redirected to respond to the needs of the unemployed whose ranks will increase as industrial restructuring takes place.

85. This reorientation could go in several directions. At present, the training financed by the Employment Fund seems designed to prevent the jobless from becoming officially unemployed and registering for benefits, rather than to prepare them to compete for jobs in a market economy. The Employment Fund could consider replacing the present training arrangements with a training voucher scheme. Individuals already unemployed, or threatened with unemployment, would be given vouchers, financed by the Employment Fund, that could be used to purchase training either at state-run training institutions or at private training facilities. Individuals, not the state, would dictate the kind of training that was offered.

86. With respect to job creation, until recently, the Employment Fund financed investments in enterprises promising new jobs. Although cooperatives were included among the entities receiving loans, the loans went predominantly to large state enterprises. This practice has been stopped. The Government believes that the Employment Fund should not extend credits to enterprises promising to create jobs, a task best left to financial institutions that possess the capacity to weigh credit risks. These savings may be deposited in banks to earn real positive returns, to be utilized when unemployment increases. Another option the Government may consider is to cut the payroll tax by a corresponding amount, which will promote economic growth and job-creation. Alternatively, the Employment Fund might strengthen its program for "social works". At present, the Employment Fund may finance the costs associated with the organization of social works, leaving continuing costs to regional authorities. Restricting the Employment Fund to organization costs has prevented the social works program from getting off the ground. It might be more effective to permit the Employment Fund to finance a social investment fund whose clients would be municipalities who competed for limited resources with locally-generated and controlled project proposals. Another use of social works resources might be support for a work cadre to insulate schools and public buildings. The point here is that the Employment Fund's job creation efforts should be directed to areas of legitimate state intervention.

87. In order to strengthen its ability to pay cash benefits further, the Employment Fund may have to consider gradually eliminating unemployment insurance for voluntary quits, school leavers, and other new entrants to the labor force. At the same time, the coverage of unemployment insurance benefits to those who are laid off by bankrupt firms may have to be expanded. Under current law, separated workers are entitled to collect 3 months' wages as severance pay from the enterprise that dismissed them; two months' wages are paid immediately upon separation. Unemployment insurance benefits, which last for nine months, do not begin until workers have been separated from their last employer for 3 months plus 10 days. The Government is studying the possibility of integrating the severance and unemployment compensation systems by shifting responsibility for severance pay, at least in part, to the Employment Fund.

Social Insurance Fund

88. The Social Insurance Fund, financed by a 4.44 percent payroll tax, provides benefits that do offer some protection to the poor even though they are untargeted. In 1993, approximately two-fifths of insurance outlays went to pay for wages lost to sickness and temporary disability; another two-fifths to provide allowances for workers and their families to receive care in sanatoria and holiday homes; and the remaining one-fifth to finance pregnancy, childbirth, and maternity allowances.

89. The operations of the Social Insurance Fund have been in surplus in the past two years, but this surplus fell in 1993. For the short term, the authorities have identified some programs that are poorly targeted and not cost-effective in providing benefits (such as expenditures on vacation homes and sanatoria). The Government will review the expenditures of the Social Insurance Fund and propose measures to cut untargeted spending by the Fund.

Comprehensive Reform of Social Assistance and Social Insurance

90. The measures listed above, in general, represent incremental changes that can be implemented quickly. There is a need for deliberate, comprehensive reform of Ukraine's social assistance and social insurance systems, reform that extends well beyond the horizon of the present Rehabilitation Loan. The Government will launch this reform in two ways. First, measures are underway to improve the quantity and quality of data that is available on living standards and other topics germane to social assistance and social insurance. The World Bank is supporting surveys on employment, unemployment and disguised unemployment, on household income and expenditure, and on pensioners. These studies are intended to complement studies such as the recent ILO labor force flexibility study and also the efforts of the Ministry of Statistics. Second, the Government is undertaking comprehensive reviews of social assistance and social insurance that will evaluate the efficiency and effectiveness of existing policies, programs and institutions and recommend thoroughgoing reform. This work is expected to be completed by March 15, 1995 and will form the basis for comprehensive reforms that will be initiated later in 1995.

Labor Mobility

91. In a market economy, labor must be free to respond to wage differentials among regions and occupations. Labor mobility is especially important during the transition when inefficient activities will close and new activities will emerge. At present, labor mobility is constrained primarily by the shortage of housing, caused in large part by the absence of an active private market for housing. The Law on Privatization approved by Parliament on June 9, 1992 allows occupants of apartments in buildings owned by state enterprises, collective enterprises and municipal or district councils to become owners, either without charge or by paying for excess space. Yet, progress in privatization has been very slow and less than 13 percent of dwellings eligible for privatization have been privatized so far. With the objective of creating a private market for housing, the Government will identify obstacles to rapid privatization and take measures, such as increasing rents, to accelerate privatization. In 1995, the Government also plans to take steps to eliminate the use of propyska as a requirement for applying for a job. This means that propyska, the system of regulations governing the movement of workers between regions, will no longer be an obstacle to labor mobility.

III. Macroeconomic Prospects and External Financing Requirements

92. The economic program described in Section II should have a far-reaching impact on the Ukrainian economy when the policies are implemented. This section describes the macroeconomic outcomes of these policies in the short and medium term. Caution is however warranted given the high degree of uncertainty. Nonetheless, some basic elements of an indicative scenario for the period 1994-2003 can be identified. After an initial jump in prices associated with the implementation of the reform program, inflation is expected to be brought down to low single-digit levels by end 1995. Following a moderate decline in GDP in 1995, real growth will resume in 1996, led by strong export growth and the growth of small and medium enterprises in the private sector. The improvement in living standards would occur only gradually and it is only after the end of the decade that the level of per-capita private consumption would reach that of 1992. Even this modest recovery requires substantial external financing in the coming years. Without such assistance, the reform program could be jeopardized.

A. Inflation and Output

93. After a temporary surge in the price level at the start of the program when prices are freed, administered prices are raised and the exchange rate unified, the monthly rate of inflation would be brought down by year-end. Prices are expected to rise again at the beginning of 1995 when a new round of adjustments in administered prices occurs. Continuing fiscal restraint and tight monetary policies should bring down the monthly rate of inflation to low single digits by end 1995.

94. Real GDP is projected to fall by about 23 percent in 1994, reflecting the 27 percent decline that has already occurred in the first half of 1994 and continuation of inappropriate policies for most of the year. Indeed, even in 1995, with satisfactory implementation of the economic reforms, the best that could be achieved would be to slow the decline in production. A number of factors are expected to produce a further contraction in economic activity. The market for Ukrainian products will remain depressed given tight domestic demand policies and slow growth of neighboring markets. In addition, substantial cuts in Government subsidies and consumption spending, and an end to directed credits will adversely affect some sectors and induce structural adjustment, while the positive supply response will occur only with a lag. Economic growth should resume in 1996, and could accelerate to 6 percent per annum by the end of the decade. On the demand side, the pick-up in the economy would reflect the growth in domestic investment demand, and in exports to the FSU and the rest of the world. On the supply side, it would rest upon improvements in productivity and resource mobilization. The main source of recovery should be small and medium-sized enterprises, mostly in the private sector, and particularly in construction and services; these activities would absorb some of the labor set free in such sectors as heavy industry.

95. Recent years have witnessed a very substantial reduction in the rate of investment in the economy. The private sector has not invested because of economic instability, uncertainty over the legal, institutional and policy framework, and formal and informal restrictions on its activity. Likewise, the public sector has not invested because of shortfalls in revenues and large budget deficits. As the commitment to policy reform is maintained, and there is increased confidence among domestic and foreign investors, these trends will be reversed. Public investment would also expand in order to create the human and physical infrastructure necessary to support the growth of the private sector. The recovery in public sector investment would, however, be much slower, reflecting the continuing need to cut Government spending from its already high levels, the gradual expansion of the tax base, and the progressive improvement in the capacity to identify and implement good public investment projects.

96. Financing the growth of investment would require increasing the rate of domestic savings. This implies that private and Government consumption would have to be restrained now in order to boost efficient investment and permit rapid growth in consumption in the future. Thus, despite the decline in private consumption expenditures that has already taken place since independence (the index of private consumption fell from 140 in 1992 to 100 by 1994), private consumption is projected to stop falling only in 1996. And despite steady growth thereafter, the level of private consumption in year 2003 would remain below the level in 1991. Government consumption would continue to decline throughout the decade, and by the year 2003, it would be about 25 percent less in real terms than in 1993.

B. External Sector

97. A rapid expansion of exports is essential to finance both the higher levels of imports required during the economic recovery and the increasing burden of debt service. The recovery of exports is also likely to provide a major demand side impetus to growth in the next few years as domestic demand will remain compressed.

98. Because of extensive production and trade linkages between Ukraine and other FSU economies, a large share of total exports (and imports) in the short term will continue to be directed to and from these countries. However, as the competitiveness of Ukrainian products gradually increases, the growth rate of exports to the rest of the world should outstrip the growth in exports to the FSU. Thus, as of 1997, exports to the FSU countries can be expected to grow at an annual average rate of 5.5 percent in real terms, while exports to the rest of the world, starting from a low base, could increase at an average annual rate of 7 percent.

99. Economic recovery would require a large increase in imports to satisfy not only the need for inputs and raw materials, but also for equipment and capital goods that has been severely constrained in the last several years owing to the breakdown in trade and the shortage of foreign exchange. Consequently, imports are likely to expand as soon as there is greater availability of foreign exchange, and trade and payments arrangements improve. After growing at an average annual rate of 3.5 percent in 1995-96, import volumes are projected to increase at an average annual rate of 5.5 percent during the period 1997-2003, i.e. at a slower pace than exports.

100. The overall current account deficit is projected to widen initially from an estimated US$1.8 billion in 1994 to US$ 2.2 billion in 1995. The deficit peaks at 2.8 percent of GDP during 1996-97 and declines steadily thereafter to 1.3 percent by year 2003. It is worth noting that the current account deficit would be easier to finance over time as foreign investors and creditors become increasingly confident about policy-making and economic prospects in Ukraine. In these circumstances, it may be expected that foreign direct investment will pick up, and Ukraine will regain access to voluntary lending by commercial sources. Overall, the deficit on current account with the FSU is projected to fall, while that with the rest of the world would increase. This pattern reflects increased interest payments on foreign debt as well as growing imports of modern equipment and technology from the rest of the world that are more suited to a modern market economy.

C. External Financing Requirements and Debt

101. Ukraine will need considerable external capital inflows to finance its transition to a market economy. In the fourth quarter of 1994, a financing gap of $1 billion was financed through the assistance of the international financial community. This assistance took the form of debt rescheduling, as well as balance of payments financing from international financial institutions and other donor countries. In 1995, Ukraine's current account deficit is projected to increase to $2.2 billion. With amortization payments due of about $1 billion, and assuming

a modest accumulation of foreign exchange reserves, the total financing requirement is close to $4.0 billion[4]. This gap will also have to be financed largely through borrowing from official bilateral and multilateral sources, and debt rescheduling arrangements.

102. During the period 1994-2003, total financing requirements are projected at about US$3.9 billion annually on average. This amount would be necessary to finance an average annual current account deficit of US$1.1 billion; a modest build up of reserves, with the reserve cover increasing from less than 1 week of imports in 1994 to about 2 months from 1997 on; and amortization payments coming due. These calculations assume that Ukraine and Russia agree to the "zero option" treatment of the foreign liabilities and assets that Ukraine inherited from the FSU.

103. In the next one to two years, as Ukraine seeks to regain commercial creditworthiness, the bulk of external resources would have to come from official sources. A good portion of official multilateral assistance would take the form of balance of payments support aimed at financing critical imports and mitigating the decline in living standards. Of the financing requirements between 1994 and 2003, official financing is projected to meet 38 percent of total need, with 27 percent coming from bilateral sources and 11 percent from multilateral institutions. As noted above, more financing options should become available as confidence in the Ukrainian economy grows and the external position strengthens. Thus, the weight of official sources in the financing package would gradually diminish. Concomitantly, financing from private creditors and foreign private investors is expected to become important. Its share in the financial resources made available to Ukraine would increase from an average of 20-30 percent in the 1990s to 70 percent by 2003. At the end of the period, debt owed to the multilateral institutions -- mostly to the World Bank -- would represent 27 percent of total debt outstanding.

104. While Ukraine's external debt is projected to increase significantly, the debt burden would remain within manageable limits. External debt as a percent of GDP would increase from 7.3 percent in 1994 to around 20 percent during 2000-2003, which is below the average for middle-income countries. The overall debt service ratio is projected to increase from 8.6 percent in 1994 to a peak of 15.1 percent in year 2001, and decline thereafter. Even if export growth is much slower than projected, the debt service ratio remains within prudent limits.

4/ If Ukraine were to repay all its external payment arrears, which is estimated at $3.3 billion by end 1994, the financing gap would be about $6.4 billion in 1995.

Key Macroeconomic Indicators (in Percentage)

	1993 Actual	1994 Estimated	1995	1996	1997-2003
			----------Projected----------		
Real Growth Rates					
GDP at Factor Cost	-14.0	-23.0	-5.0	1.5	6.5
Exports	-16.0	-18.0	0.3	5.3	5.9
Imports	-23.4	-17.4	2.7	4.3	5.5
Private Consumption	-10.0	-22.4	-4.5	1.7	4.4
(index: 1994=100)	127.2	100.0	95.5	96.6	108.5
As % of GDP					
Domestic Savings	7.0	2.7	4.9	7.3	12.9
Gross Domestic Investment	8.0	5.0	7.5	10.0	14.5
Total Consumption	93.0	97.3	95.1	92.7	87.1
Resource Balance	-1.0	-2.3	-2.6	-2.7	-1.6
General Budget Balance	-9.7	-9.3	-4.3	-1.7	-1.2
Total Debt Outstanding	4.9	7.3	11.3	14.8	20.7
Inflation (Annual Avg)	4735.0	842.0	210.0	19.6	8.3

Sources: Ukrainian authorities and staff estimates.
Note: The underlining monthly rate of inflation drops to 5 percent in March 1995, and to a low single digit by the end of the year. In 1996, the average rate of inflation is projected to be 1.5 percent per month.

External Financing (in millions of US Dollars)

	1993 Actual	1994 Estimated	1995	1996
			----------Projected---------	
Gross Financing Needs	1,197	3,935	3,945	3,862
Balance on Goods and Services	970	1,800	2,220	2,228
Amortization	130	1,505	975	784
Changes in Reserves[a]	97	630	750	850
Assumed Identified Financing	1197	2,970	-2,480	1,200
Official Transfers	120	200	200	250
Foreign Direct Investment	50	90	120	200
Medium/Long-term Credit[b]	774	420	500	750
Other[c]	253	2,260	-3,300[d]	0
Financing Gap	0	965	6,425	2,662
Covered by				
Net IMF Purchases	0	365	1,575	1,000
Other[e]	0	600	4,850	1,662

Sources: Ukrainian authorities and staff estimates.
a/ Official reserves are projected to increase to about one week's imports in 1994, to one and a half month imports in 1996.
b/ The medium and long-term credit in 1995 includes mainly disbursements from a World Bank rehabilitation loan of US$500 million.
c/ Net of changes in payment arrears. Also includes short-term capital flows, reduction in monetary liabilities, and use of correspondent accounts.
d/ The total amount of payment arrears, mainly energy arrears with Russia and Turkmenistan, is estimated to reach US$3.3 billion by the end of 1994. It is assumed that all of it will be repaid in 1995.
e/ Includes new money and debt rescheduling.

IV. The Bank Group's Assistance Strategy

A. Background and Objectives

105. The proposed Rehabilitation Loan has been prepared on an accelerated schedule to respond to the rapidly evolving economic and political events in Ukraine. A Country Assistance Strategy (CAS) will be finalized by the second half of 1995. A limited CAS is described below.

106. The overriding objective of the World Bank's assistance strategy is to help Ukraine in reversing the present economic crisis, and to facilitate the transition to a market-based economy for sustained economic growth. The World Bank will support the Government's stabilization program and the emerging agenda of structural reforms and assist in building the necessary institutional capacity through lending, economic and sector work (ESW), policy dialogue and an active role in resource mobilization and aid coordination. It will support sector-specific reforms and investments that build productive capacity in critical infrastructure sectors such as energy. The Bank will assist the authorities in strengthening the safety net and in developing human resources commensurate to a modern market economy.

107. The launching of an IMF-supported stabilization program in October 1994 paved the way for increased assistance from the Bank. The proposed Rehabilitation Loan supports the first steps in the Government's reform program.

B. The Legacy of the Past

108. In formulating the Bank's assistance program, it is necessary to recognize constraints that have prevented a more active role in the past. While some constraints have been relaxed, others remain likely to condition the magnitude, composition and pace of the assistance program. The Bank must consider the possibility of policy reversals, and be prepared to respond to changing conditions.

109. The most important impediment in the past was the lack of commitment to market-oriented reforms, at the level of the overall economy as well as in the sectors. Reservations at the top mirrored hostility to change at the level of the bureaucracy. President Kuchma, who was elected in July 1994, and key members of the Cabinet now are firmly committed to reforms; but resistance to change remains strong in Parliament and parts of the Cabinet and the bureaucracy. A second constraint was the absence of an effective framework for decision-making. Confusion about who was authorized to make decisions slowed project preparation and implementation. A third issue was weak institutional and technical capacity for developing and implementing reforms. Technical assistance by the World Bank and donors has achieved improvements in this regard, but capacity building has still a long way to go.

110. These constraints prevented the Bank from executing an assistance program suitable to the size and importance of Ukraine. So far, only one loan was approved-- the Institution Building Loan (IBL) in the amount of US$27 million. The IBL provides technical assistance for enterprise reform, financial sector reform, and public financial management. After initial difficulties, now there is some improvement in the implementation record following institutional rearrangements and the changed policy environment.

111. The Bank responded to these unfavorable conditions by preparing a minimum "core" program of assistance that would be viable even in an unstable macro-environment. At the same time, a larger lending

program was identified and some preparatory work was done in case positive developments occurred. The Bank's economic and sector work was designed to provide up-to-date information on the economy and the underpinnings for reforms at the macro- and sectoral levels. In 1993, the Bank produced a Country Economic Memorandum, a social sector report, a report on the power sector, and a comprehensive energy review. In 1994, an agricultural review and a report on the environment were finalized, as was an informal report updating the foreign trade regime. Informal studies in the municipal water and waste water sector, the financial sector, and local Government finances are under way. Based on this work, a document called "Ukraine Policy Notes" was prepared, which was made available to the participants of the informal donor meeting in Paris on July 13, 1994. The document spelled out the major reforms required for a comprehensive reform program, and has formed the basis for the design of the structural reform program that is supported by the proposed Rehabilitation Loan. The document was also useful for the reformers within the Government in their internal deliberations.

112. The Bank has provided support for the dialogue between the G7 and the Ukrainian Government in the nuclear area, relating to improvement in nuclear safety, including the future of Chornobyl. In close collaboration with the EBRD, the Bank has helped develop a strategy which could provide the basis for international assistance to Ukraine's power sector taking account of nuclear safety. Although the Bank would not provide financing for nuclear energy, lending support for energy development, through promoting conventional power generation and policy reforms, would be a key component of the strategy. The Bank is participating in the establishment of an international Task Force to work on the implementation of an Energy Action Plan recently agreed between the Ukrainian Government and the G7. Implementation of the Plan would include energy policy reform, energy efficiency, investments in conventional and nuclear power (including safety upgrades) and the phased closure of capacity at Chornobyl. The financing of the Plan would need to be addressed, as well as the support of the international financial institutions.

113. Important assistance has been provided by the Bank's Resident Mission in Kiev, established in the fall of 1992. The mission has helped in the preparation and implementation of World Bank operations, monitored Ukraine's economic and financial situation and developments and helped build up the policy dialogue. A key responsibility has been to assist in aid coordination efforts of the Government, including help in the identification of external assistance and borrowing priorities. The mission also has undertaken a program of economic education in Ukraine, carrying out seminars, conferences, courses and weekly economic roundtable with Government officials, Parliamentarians, academicians, and journalists.

C. A New Relationship

114. The reform commitment of the new Government led by President Kuchma, and the bold stabilization measures recently implemented with support from the IMF's Systemic Transformation Facility allow the Bank to expand lending to Ukraine. The Government also has entered into discussions with the IMF about a Standby Arrangement in early 1995.

115. The proposed Rehabilitation Loan is designed to support the most urgent reforms and prepare the ground for additional reforms in the next 12 months. The policy conditionality of the proposed loan seeks to ensure that expenditure adjustment, credit constraint, price and trade liberalization, and privatization and financial sector reform extend to the critical sectors of the economy, in particular energy and agriculture. This also will provide a stronger basis for expanding our lending program in these areas. Furthermore, the proposed loan seeks to ensure that key structural reforms that inevitably require time to be fully implemented (such as privatization) are initiated sufficiently boldly and unambiguously to make later reversal difficult. The loan was prepared quickly in the belief that firm and timely support is vital for the success of the reform program.

D. The Lending Program

116. The Bank's lending strategy has been calibrated to Ukraine's development priorities, and the constraints and risks summarized elsewhere in this report. Three scenarios are envisaged. The High case is characterized by a continuing commitment of the Government to stabilization and structural reform policies, and good implementation. In this scenario, and in the context of a broader international effort, lending from the World Bank would amount to around $800 million per year. In FY95, three loans are envisaged in addition to the Rehabilitation loan: respectively, for seeds development ($31 million), health ($50 million) and rehabilitation of hydropower plants ($100 million). If progress in implementation of reforms remains satisfactory, subsequent operations in the High case will include a mix of balance of payments loans (possibly including a SAL, and an Agriculture Sector Adjustment Loan in FY96), other sector adjustment loans (possibly in energy, financial sector and the social sectors), and investment loans that finance a time-slice of the investment program in critical infrastructure sectors such as energy, transport, telecommunications and municipal services. Given the prospective financing gap of Ukraine in the coming years, and the need for deepening the reforms, lending for balance of payment support will constitute the greater share of total Bank lending in early years. As reforms take hold, the share of investment lending will increase.

117. The base case corresponds to a scenario where there is satisfactory implementation of a stabilization program, but structural reforms are not implemented vigorously across sectors. In this case, lending from the Bank would be of the order of $400-500 million a year. The adjustment operations that are to be included of course depend on which sectoral authorities are moving ahead with reform programs. Based on current trends, relatively rapid reforms in privatization, energy and the social sectors may be expected, with the greatest difficulties likely to be encountered in agriculture. The base case also assumes two investment operations a year, with the major focus being on insuring that public infrastructure is maintained in areas such as energy, urban transport, telecommunications, health and education. Other investment operations will be designed to further reform efforts in sectors where the policy environment enables the Bank to proceed with adjustment lending as well.

118. The low case would be characterized by a return to the policy drift of the last years. Lending from the Bank would then be on the order of US$100-200 million per year. No adjustment lending would be considered, but investment lending for infrastructure would go ahead, so that the Bank can maintain its dialogue with the Government, provided that institutional and policy conditions exist for successful project completion.

119. The triggers which would lead the Bank to move to the low case are evident: a failure to sustain budgetary discipline leading to the resumption of hyperinflation; the resurrection of administrative controls on allocation of foreign exchange, prices of key commodities and domestic credit; the slowing down of the privatization program and the restructuring of the energy sector; and the failure to target social transfers to the neediest sectors of the population. It is equally evident that the Government's success in building on the current set of intentions will move the Bank program to the high case.

120. The assumptions underlying the base case are more difficult to spell out. The opposition to stabilization and reform policies comes of course from groups likely to lose influence as a result of the implementation of these policies. An important group in this regard consists of enterprise directors (both in industry and agriculture). This group, which is substantially over-represented in Parliament continues to oppose reforms that dilute the power of current management: that is, controlling the flows of credit to financially-troubled enterprises, sovkhozes and kolkhozes; and genuinely privatizing such units. The base case assumes that the visible disarray caused by

high inflation enables the Government to win the stabilization battle with the Parliament, but at some cost to the Government's ability to pursue privatization across all fronts including agriculture. As indicated above, in such a case the Bank would limit its overall support, but focus selected adjusted operations to those sectors where progress was taking place with follow-up investment activities in those sectors as well.

E. Implications for World Bank Exposure

121. As discussed before, Ukraine will need substantial external capital inflow during the next several years to finance its growing import needs, replenish reserves and meet its debt service obligations on time. Consequently, in the High case it is estimated that Ukraine's total debt outstanding will increase to close to $21 billion (21 percent of GDP) by the year 2003, which is well below the average for middle-income countries (see table). Ukraine's debt service ratio is projected to increase to 14 percent by year 2003, which is also lower than average for middle-income countries. Starting from virtually zero, the World Bank's share in total debt will increase to about 14 percent by 1996 and to 22 percent by the year 2003. The share of debt owed to the World Bank in total debt owed to official creditors (multilateral and bilateral) will reach 27.5 percent in 2003. The debt service on World Bank loans is projected at only 1.8 percent of total exports by year 2003. This value is well within the Bank's exposure guidelines. Bank exposure will be monitored closely and cofinancing with other donors will be incorporated into design of the loans.

Projected Creditworthiness Indicators- *high case lending* (percentage)

	1993	1994	1995	1996	2003	Middle Income Countries (1992)
Total DOD/GDP	4.9	7.3	11.3	14.8	21.1	34.2
Total DOD/Exports of GNFS	27.3	32.2	46.3	59.6	71.9	148.2
IBRD DOD/Exports of GNFS	...	0.2	3.4	8.0	15.6	
IBRD DOD/Total DOD	0.0	0.7	7.4	13.5	21.7	
Debt Service/Exports of GNFS	1.0	8.6	9.0	7.8	13.7	18.4
of which: IBRD	...	...	0.1	0.3	1.8	
IBRD Debt Service/Debt Services on public Guaranteed Debt		...	...	0.2	3.2	

Source: Table pp. 23 and Annex 1.

F. Resource Mobilization and Aid Coordination

122. In July 1994, the Bank hosted the first international donor meeting on Ukraine to establish a clearer understanding on the part of the international community of Ukraine's financing needs, and on the part of the Ukrainian authorities of the key indicators of progress which donors would be watching. The meeting was supplemented by in-country coordination activities organized by the Bank's Resident Mission. This provided a good basis for subsequent aid coordination efforts. Given the size of Ukraine and the scale of these efforts, we have proposed that the IMF take charge of working with donors to fill the immediate balance of payments financing gap, while the Bank will focus the CG process on mobilizing the required financing to meet the investment needs of the country.

G. Economic and Sector Work Program

123. The ESW program is designed to strengthen the intellectual basis for the Bank's policy dialogue, assist aid coordination and underpin future lending. Four broad areas are: macroeconomic stability and growth; public sector efficiency; private sector development; and the social safety net and human resource development. In the macro area, the Bank will be relying more than in the past on IMF analysis of the current situation, while preparing brief policy notes on an annual basis to update the structural reform needs and to put them into a medium-term framework. On public sector efficiency, a review of public expenditure is planned in FY96 which is intended to provide the documentation for a donor coordination meeting and also provide key inputs into the lending program in the infrastructure area. A poverty assessment will also be undertaken in FY96 which will be used to try to mobilize and coordinate international support. As far as the private sector is concerned, the Bank will carry out an assessment in FY97 which will in turn provide the basis for coordination of international efforts in this area. The above reviews and assessments are intended to contribute to the adjustment operations in the areas of privatization and financial sector development; agriculture; energy; the social safety net; and the investment operations for the environment. In addition, sector policies, including investment programs, and the institutional investment framework for the sector will be analyzed as part of the project preparation process.

H. IFC and MIGA Activities

124. Ukraine joined IFC in October 1993. Since then, IFC has been active in the areas of small-scale privatization and selected infrastructure, such as telecommunications. IFC is currently operating in twelve cities. Its first investment, a US$2 million equity financing for the Ukraine Fund, is a venture capital fund targeted at emerging private companies in Ukraine. The Foreign Investment Advisory Service (FIAS) has prepared a report on the climate for foreign direct investment in Ukraine.

125. Ukraine became a member of MIGA in July 1994. To date, there have been no investment guarantees issued.

PART II. THE PROPOSED LOAN

I. Background and Rationale for IBRD Involvement

126. As described above, Ukraine is making the transition to a market economy while experiencing a substantial trade shock and disruptions in supplies, not only of energy and raw materials, but also of equipment and capital goods. The market for Ukraine's products will remain constrained in the short term given the close economic ties between Ukraine and FSU countries and the economic decline that the FSU is suffering. Moreover, the increase in the competitiveness of Ukrainian products necessary to allow rapid export growth to the rest of the world will occur gradually. In addition, considerable time will be required for the conversion of the large military industrial complex, which must deal with the almost total collapse of its traditional market for military goods. The proposed loan of US$500 million would support the initial stages of Ukraine's transition to a market-based economy. The proceeds from this loan would assist Ukraine in financing critical imports needed to stem the decline in output and improve living standards of the population.

127. The Government's program of structural reform to be supported by this Rehabilitation Loan is outlined in Part I and in the attached Memorandum of Economic Reform Policies (see Annex 3). This program complements the macroeconomic stabilization program as supported by the IMF's Systemic Transformation Facility.

II. Project Objectives and Description

128. The loan supports the implementation of the Governments' economic reform program that is outlined in the Memorandum of Economic Reform Policies. The Memorandum defines policy actions which will be undertaken over the coming 12 months. If implemented successfully, these reforms will serve as the basis for the World Bank's future lending program to Ukraine. Other objectives of the proposed loan are to finance critically needed imported inputs, provide budgetary support for the strengthening of the social safety net for the neediest, provide a framework for financial assistance from other donor agencies, and support the development of a market based foreign exchange allocation system. In view of the urgent need for foreign exchange, it is expected that the proceeds of the loan will be disbursed within a short period of time. The closing date of the loan will therefore be June 30, 1996.

129. The interbank auction market for foreign exchange was reopened on October 5, 1994, and a single, unified exchange rate determined in the inter-bank market applies to all official and commercial foreign exchange transactions. The Government intends to expand the volume of transactions taking place through the inter-bank auction market so as to further strengthen the role of market forces in allocating foreign exchange. The inter-bank foreign exchange market has been opened to 50 of the registered banks, and will progressively be opened to all licensed banks (currently an additional 20). Dollar auctions are currently held once a week.

130. The proposed loan will contribute to the Government's objective of developing the private sector. Public and private commercial production enterprises will have equal access to the foreign exchange market through their commercial banks. As discussed in Part I of this report, the policy program supported by the proposed Rehabilitation Loan will reduce the ability of existing public enterprises to gain preferential access to credit. Measures agreed under the stabilization and structural reform programs will widen market-based credit allocation

through credit auctions, reduce over time the availability of preferential credit, and subject state enterprises to greater financial discipline.

131. On this basis, the proceeds of this loan will be disbursed upon evidence that imports of eligible goods have taken place during the period. Non-eligible imports would comprise only those goods on the World Bank's standard negative list. As agreed with the Government, disbursements will be made through the NBU and an account of the Ministry of Finance at the NBU will be credited with the karbovanets equivalent at the market exchange rate as determined on the interbank exchange market; the Government will thereby receive non-inflationary budget support. The foreign exchange receipts of the loan will be sold by the NBU in the interbank exchange market or will be held in reserve in accordance with the objectives of monetary policy.

III. Environmental Safety

132. As an adjustment operation, this project has been assigned to Category U (unrated) for the purposes of Operational Directive 4.01, which does not require an environmental assessment.

IV. Project Implementation and Key Measures for Disbursement

133. The Rehabilitation Loan supports a substantial program of structural reform measures. Some significant steps have already been taken in the past weeks, particularly those addressing price liberalization and the establishment of the social safety net. Other important measures are due to the taken in the months ahead including some of the key steps to implement the privatization program and liberalize foreign trade. The macroeconomic stabilization program is also at a very early stage of implementation and it will be crucial that the bold initial measures are sustained in the months ahead.

134. To support the implementation of some of the key measures according to a realistic timetable, the proceeds of the proposed loan will be disbursed in the following manner: US$250 million will be available on effectiveness. US$100 million (20 percent of the loan amount) can be disbursed for imports procured in the four months preceding effectiveness. A further US$250 million will be made available after April 1, 1995 on the basis of a satisfactory review of progress in the overall program.

135. The following measures were implemented prior to the presentation of the proposed loan to the Board:

- Presidential decree was issued outlining simplified procedures for mass privatization program, including the merging of corporatization and privatization processes.

- Chairman of the State Property Fund announced the list of sectors to be included in the mass privatization program for 1995, including trucking, warehouses, storage and distribution. The statement confirmed that the MPP for 1995 would include at least 8000 medium and large enterprises.

- Presidential decree was issued repealing ceiling on trade mark-ups as of January 1, 1995.

- Electricity prices were raised to fully reflect recent increases in fuel costs. A system of periodic price adjustment to compensate for additional changes in fuel and other basic input costs was established.

- In accordance with the Government's action plan for restructuring the electricity sector, an Electricity Regulatory Commission was established.

- In the context of the Government's overall reform of corporate income tax, proposals were submitted to Parliament to reduce the tax on profits of banks to 40 percent and intermediaries to 30 percent.

- A national campaign to publicize the Government's plans for mass privatization, including the use of streamlined procedures, and the distribution of paper certificates to the population was launched.

- Instructions were issued to 20 large enterprises to prepare restructuring plans by mid-March 1995.

- The extension of credit from the Employment Fund to finance job creation in enterprises was abolished.

- Preparation was initiated of strategic policy papers on (i) social assistance and (ii) pensions and unemployment compensation, to be completed by March 15, 1995.

136. It is envisaged that the second part of the disbursements under the loan will be made available after April 1, 1995 depending on satisfactory review of the implementation of the reform program outlined in the Memorandum. Some of the key measures that will be reviewed include the following:

- Satisfactory implementation of macro-economic stabilization policies.

- Discontinue existing system of state orders as of January 1, 1995. Introduce competitive methods (bids, tenders) for state procurement, including for grain, to meet the requirements of budgetary organizations, within the resources allocated in the budget for this purpose.

- As of January 1, 1995, abolish all export quotas and licenses, with the exception of goods subject to voluntary export restrictions and other contingent international agreements.

- Lower the maximum import tariff to 30 percent by January 1, 1995, allowing for some temporary exceptions limited to no more than 1% of total imports (measured on the basis of 1993 import shares).

- Implement auctions in 5 oblasts for at least 200 medium and large enterprises, including freight trucking enterprises and wholesale storage bases, according to new simplified procedures. Privatize some grain silos.

- By January 1, 1995, present to Parliament (i) amendments to the Land Code to (a) ensure right of state and collective farm members to identifiable agricultural land and assets; (b) reduce the moratorium on land sales to two years after receiving possession, or January 1, 1996, whichever occurs first; and (c) enforce lease payments by private farmers for land received above their entitlement of the average land share, or transform the leases into sales from the land reserves; and (ii) draft Law on Land and Other Real Estate Registration specifying the procedures for registering urban and rural land and other real estate.

- Close down selected large state enterprises identified as chronic loss-makers.

- Complete the study defining, evaluating and costing alternative restructuring plans for the former state banks.

- Complete reviews of social assistance programs and the study on pensions and unemployment compensation that will provide the basis for reforms in these areas starting later in 1995.

- Implementation of appropriate social safety net measures, including indexation of means tested child allowances and supplementary pension payments for low income pensioners.

137. The Government has set up a Council on Economic Reform under the chairmanship of the First Deputy Prime Minister to oversee, coordinate and monitor the implementation of the Government's reform program. Within the Council, a committee chaired by the Deputy Prime Minister for Finance and Banking and consisting of all the ministries and agencies concerned, including those of Finance, Economy, Energy, Agriculture, Labor, Social Protection, the State Property Fund and the NBU will monitor and coordinate the implementation of policies under the proposed loan.

138. Overall coordination of project activities and general loan administration will be the responsibility of a project manager, located in the office of the Deputy Prime Minister for Finance and Banking. The candidate's qualifications and terms of reference have been agreed upon with the Bank. The project manager will work solely on the implementation of this project, and be responsible for preparing applications for disbursement of World Bank funds, maintaining project accounts and arranging for their timely audit, monitoring overall loan implementation, and preparing monthly progress reports. On the basis of the information from the various agencies involved in the implementation of this loan, the project manager will prepare Ukraine's contribution to the Project Completion Report within six months of the closing date.

139. Training of the staff, responsible for procurement and disbursement matters has been initiated with the assistance of World Bank staff and will continue during project implementation. Although Government officials have had relatively little experience and need time to develop expertise in project implementation (including competitive procurement and disbursement procedures), it is not deemed necessary to recruit an international procurement expert or firm. The design of this project, with all proceeds being provided based on evidence that imports of eligible goods have taken place, will simplify procurement procedures significantly. However, external financing will be sought if expert assistance is to be provided to assist the project manager in setting up an appropriate project account system for loan management.

V. Procurement

140. Procurement under the project will follow standard procedures as spelled out in the "Guidelines for Procurement under the IBRD Loans and IDA Credits". Given the size of Ukraine and the size of the loan, the threshold for simplified International Competitive Bidding (ICB) has been set at US$3 million. As it is expected that the proceeds of this loan will be used exclusively for the import of goods procured by enterprises in the commercial sector, all contracts under this ceiling will be carried out directly by the importers, following established business practices. The Bank's experience of commercial and public procurement practices in Ukraine revealed that these practices are generally in line with the requirement that enterprises, in both public and private sectors, obtain multiple quotations from multiple countries. Contracts larger than US$3 million will be subject to the procedures for simplified ICB processes, and prior review requirements will be followed. Subject to prior approval of the Bank, commonly traded commodities may be procured through organized international commodities markets or other channels of competitive procurement. The standard negative list has been agreed with the Government. In an effort to improve institutional building capacity with respect to procurement, technical assistance is being provided by UNCTAD/GATT, to prepare an operational program for international competitive bidding in the practice of foreign economic relations of Ukraine. Preparation of a public procurement law constitutes part of this program. The Bank plans a strategy paper on procurement to be followed by a CPAR in FY96.

VI. Disbursement

141. The Bank will finance 100 percent of foreign expenditures for directly imported goods. Imports eligible for reimbursement will be subject to the World Bank's standard negative list. The funds will be provided on the basis of (a) statements of expenditures (SOE) prepared by the project manager in accordance with the Bank's simplified documentation requirements for adjustment operations (i.e., based on customs certificates) showing that eligible goods at least equal in value to the amount requested from the Bank have been imported into the country during the period of consideration for contracts each valued at less than US$3 million, or full documentation (i.e., contract supplier's invoice, evidence of shipment, customs certificate, and evidence of payment) for contracts each valued at US$3 million or above, respectively; and (b) a statement by the Government that the imports presented for World Bank financing have not been financed by another loan or grant, or imported under barter arrangements. Contacts valued at less than US$5,000 will not be eligible for financing. Pre-shipment inspection will not be required: the low level of import tariffs for the bulk of imports will limit the probability of tax evasion through under-invoicing, while macroeconomic stabilization has diminished the incentives for capital flight through over-invoicing. The project manager will prepare the withdrawal applications and will keep photocopies of the customs documents on which the applications are based. The original customs documents will be retained by the Customs Department until three years after the closing of the project, and will be made available to Bank supervision missions and to the auditors, as requested.

142. Goods imported within four months before the expected date of loan signing are eligible for retroactive financing under the loan up to a maximum of US$100 million, equivalent to 20 percent of the loan amount, in view of the policy reform actions already undertaken to date and the substantial balance of payments needs of the country.

VII. Reporting, Accounting, and Auditing

143. The project manager will maintain all project accounts, which will be audited annually by independent auditors acceptable to the World Bank in accordance with the World Bank's guidelines on auditing and financing reporting. Audit reports will be submitted to the World Bank not later than six months after the close of each fiscal year, or the date of final disbursement. The project manager will also prepare monthly progress reports detailing the status of all procurement transactions, commitments, and disbursement requests.

VIII. Agreements Reached

144. At negotiations, understandings acceptable to the World Bank were reached on: (a) the attached Memorandum of Economic Reform Policies, outlining the Government's reform program and the timing of implementation; (b) the functions of the Committee established to oversee, coordinate and monitor the implementation of the reform program; (c) the standard negative list of goods precluded from financing under the proposed loan; (d) details of the terms of reference for the project manager; and (e) accounting and auditing arrangements and technical assistance requirements.

IX. Program Benefits and Risks

145. The potential benefits to be derived from a successful reform program are enormous. With its highly educated labor force, fertile agricultural land, and significant mineral deposits, Ukraine has the potential to join the world's rich societies. Provided that the Government maintains its recent approach to reforms, and implements these vigorously, Ukraine will be able to reverse the declining trend in production and begin its long delayed economic recovery. The proposed loan would contribute to economic recovery by increasing efficiency in resource use through market-oriented policy reform. The balance of payment support would finance imports critical to economic recovery, and the local counterpart funds will strengthen the capacity of the Government to provide an adequate safety net for the poor. The disbursement mechanism of the loan will also support development of the foreign exchange market.

146. The main risk to the proposed loan is of policy reversal due to lack of political or social consensus. Though the Government has taken important actions to demonstrate commitment to market-oriented reform, there exists considerable opposition to change within the cabinet of ministers, among the bureaucracy, in Parliament, and among large sections of the population. This opposition is based as much on ideological grounds as it is on myths and misapprehensions. The opposition can be effective, as was demonstrated in recent months by Parliament's repeated efforts to block the Government's privatization program and its reluctance to endorse any significant proposals for reform in the agriculture sector. While the Government has largely succeeded so far in obtaining Parliamentary support for its economic program, the relationship between Parliament and Government in the development and implementation of radical economic reforms is not yet established. Until this is done, the risk that Parliament would stop or delay important parts of the Government's structural reform program cannot be ruled out. The fact that there remain conservative forces within the Government further aggravates this risk. To some extent this risk can be reduced through the judicious interventions of the international community in general and the World Bank in particular. Timely assistance to the reforms, in the

form of technical support and generous financial assistance would lessen the pain of adjustment and alleviate some of the fears of the population. It would also demonstrate directly the benefits from reforms and thus strengthen the position of the reformers in the Government and in society. Opposition could also be diluted by explaining the rationale behind the design of the reform program. In this regard, the emphasis on the social safety net, privatization as a means of asset redistribution in favor of the entire population, the development of the private sector, etc. directly address some of the concerns of those opposing reforms. The efforts of the Bank in engaging Parliamentarians, conservative and radical, in the policy debate should pave the way for later stages of reform.

147. The second risk is that policy implementation will slip because of inadequate implementation capacity within the Government and other executing agencies. This is particularly so in the early stages, when reforms need to encompass a very broad range of areas in order to be successful. While the situation is much better than it was even a few months ago, and is improving very rapidly, in part through the IBL, the design of policies should recognize the need for simplicity and easy implementation. Given the enormous policy agenda that the Government is committed to, there is little doubt that there will be slippage. However, if some of the key measures are implemented during the period of the loan, they are likely to become difficult to stop, and the benefits of the program would materialize. In this regard, the progress in the mass privatization program and the reforms in energy and agriculture are particularly important.

148. A third risk is the deterioration of relations between Ukraine and its neighboring countries, leading to further disruption in economic ties, especially with Russia. Given Ukraine's heavy dependence on imported energy, this could lead to interruptions and cut-off in energy supplies, which would have an adverse impact on production and delay economic recovery. A severe disruption in energy supplies could force increased state intervention in the allocation of energy, and slow down the liberalization of the economy supported by the loan. Moreover, the slowdown in economic recovery could be (wrongly) attributed to reforms themselves, and undermine future reform effort. This risk is being addressed, first by efforts mediated by the IMF to regularize payment of existing inter-state arrears and securing the Government's commitment to prevent any new arrears. The adjustment of domestic energy prices to fully reflect costs, and the unification of the exchange rate will improve the utilization of energy and reduce the country's dependence on imported energy. It will also strengthen the capacity of the energy supplier to meet its foreign payment obligations. Other reforms to strengthen domestic payment discipline, including for payment of energy, will also alleviate the problem. More broadly, economic reforms will improve the country's export prospects and creditworthiness and thus mitigate the risk of non-payment to neighboring countries and other creditors/suppliers.

149. Finally, there is the risk that timely external financial assistance of the magnitude required will not be forthcoming. As discussed, even if the program is fully funded and policy implementation is good, the economic recovery is likely to be gradual and per-capita consumption would recover to the level it achieved in 1992 only by the end of the decade. A shortfall in external financial assistance would force a much faster face of domestic adjustment, which may threaten the fragility of the social consensus in favor of reforms. To address this problem, the Bank will not only be prepared to provide solid financial support, but it will also assist Ukraine in mobilizing other resources through the Consultative Group process and other donor coordination efforts.

PART III. RECOMMENDATION

150. I am satisfied that the proposed loan would comply with the Articles of Agreement of the World Bank and recommend that the Executive Directors approve it.

Lewis T. Preston
President

Washington, D.C.
November 30, 1994

Attachments

Ukraine

KEY MACROECONOMIC INDICATORS

(in percent unless otherwise stated)

	1993 Actual	1994 Estimated	1995	1996	1997	1998	1999	2000	2001	2002	2003
			Projected								
Growth Rates											
GDP at factor Cost	(14.0)	(23.0)	(5.0)	1.5	3.0	4.0	5.0	6.0	7.0	7.0	7.0
Private Consumption	(10.0)	(22.4)	(4.5)	1.7	2.1	3.0	4.0	4.2	4.6	4.7	4.9
Debt Service/XGS	1.0	8.6	8.9	7.0	7.0	8.1	8.5	7.8	8.3	8.8	9.1
Debt Service/GDP	0.2	1.9	2.2	1.7	1.9	2.3	2.4	2.3	2.4	2.6	2.7
Gross Investment/GDP	8.0	5.0	7.5	10.0	11.0	12.0	13.0	15.0	17.0	19.0	20.0
Domestic Savings/GDP	7.0	2.7	4.9	7.3	8.4	9.9	11.2	13.5	16.0	18.4	19.8
Government Revenue/GDP	42.4	41.5	41.5	41.2	40.5	39.4	37.9	36.5	35.2	34.6	34.1
Government Expenditure/GDP	52.1	51.5	46.4	42.9	41.8	40.6	39.4	38.3	36.3	35.2	34.7
Deficit (-) or Surplus (+)/GDP	(9.7)	(10.0)	(4.9)	(1.7)	(1.4)	(1.2)	(1.5)	(1.8)	(1.1)	(0.7)	(0.7)
Export Growth Rate	(16.0)	(18.0)	0.3	5.3	5.8	5.8	5.8	5.8	5.8	5.8	5.8
Exports/GDP	17.9	22.5	24.3	24.8	26.4	27.4	28.2	28.5	28.9	28.9	29.1
Import Growth Rate	(23.4)	(17.4)	2.7	4.3	5.2	5.7	5.6	5.6	5.5	5.5	5.6
Imports/GDP	18.9	24.8	26.9	27.6	29.0	29.5	30.0	30.1	29.9	29.4	29.3
Current Account (in US$ million)	(970)	(1,800)	(2,220)	(2,228)	(2,189)	(2,101)	(2,088)	(2,089)	(1,889)	(1,669)	(1,402)
Current Account/GDP	(1.1)	(2.7)	(3.4)	(3.2)	(3.2)	(2.9)	(2.7)	(2.6)	(2.2)	(1.8)	(1.4)
Annual Average Inflation Rate	4,735.0	862.0	210.0	19.6	16.1	12.7	6.2	5.0	5.0	5.0	5.0

Source: Ukrainian authorities and staff estimates.

UKRAINE - Balance of Payments
(US$ millions at current prices)

	1993 Actual	1994 Estimated	1995	1996	1997	1998	1999	2000	2001	2002	2003
			Projected								
Exports of GNFS	15,850	15,090	16,010	16,784	18,268	19,850	21,445	23,170	25,027	27,039	29,203
Imports of GNFS	16,760	16,640	17,710	18,630	20,033	21,398	22,851	24,427	25,932	27,589	29,373
Resource balance	(910)	(1,550)	(1,700)	(1,846)	(1,765)	(1,548)	(1,405)	(1,257)	(905)	(550)	(171)
Net factor income	(60)	(250)	(520)	(382)	(424)	(553)	(682)	(832)	(984)	(1,119)	(1,231)
Curr. A/C Bal before Off. Grants	(970)	(1,800)	(2,220)	(2,228)	(2,189)	(2,101)	(2,088)	(2,089)	(1,889)	(1,669)	(1,402)
Official Transfers	120	200	200	250	350	300	200	0	0	(0)	(0)
Long-term Capital Inflows	947	1,265	(3,655)	166	1,289	1,287	1,366	1,893	2,145	2,365	2,554
Direct investment	50	90	120	200	300	400	500	750	1,000	1,250	1,500
Net LT Borrowing (DRS)	644	(1,085)	(475)	(34)	989	887	866	1,143	1,145	1,115	1,054
Other LT Inflows (net)	253	2,260	(3,300)	0	0	0	0	0	0	0	0
Total Other Items (Net)	0	600	4,850	1,662	907	848	777	699	630	643	544
Net credit from IMF	0	365	1,575	1,000	558	384	(314)	(838)	(768)	(524)	(175)
Reserve changes n.e.i.	(97)	(630)	(750)	(850)	(916)	(718)	58	335	(118)	(816)	(1,521)
Reference Items											
GDP (billion of current US$)	88.5	67.0	65.8	67.6	69.2	72.5	76.2	81.2	86.6	93.7	100.3
Foreign Exchange Reserves:											
International Reserves (US$ million)	193	823	1,573	2,423	3,339	4,057	3,999	3,664	3,782	4,598	6,119
In months of imports	0.1	0.3	1.0	1.5	2.0	2.3	2.1	1.8	1.8	2.0	2.5
Exchange Rates											
Nom. Off. Ex. Rate (Ann. Avg)	7,629	63,224	170,803	186,418	196,842	216,186	223,703	228,936	234,290	239,771	245,379
Atlas conversion factor	1,734	15,600	42,693	51,044	59,250	66,764	70,882	74,426	78,147	82,055	86,157

Sources: Ukrainian authorities and staff estimates.

ANNEX 2

UKRAINE - REHABILITATION LOAN

Timetable of Key Events

1.	Time taken to prepare:	4 months
2.	Project prepared by:	Government of Ukraine, with assistance of IBRD staff[1].
3.	Preparation mission:	September 15-30, 1994
4.	Negotiations:	November 16-22, 1994
5.	Planned Board presentation:	December 22, 1994
6.	Planned effectiveness:	December 22, 1994
7.	Expected program completion:	June 30, 1996
8.	Appraisal Report:	Not applicable

1/ The main mission comprised Chandrashekar Pant and Sandra Bloemenkamp (EC4C2), Bernard Drum and Ana Goshko (EC4PE), Tom Hoopengardner (EC4HR), Laszlo Lovei (EC4IN), Mark Lundell (EC4NR), Anders Zeijlon and Aleksander Kaliberda (EC4KI). Wafik Grais is the managing Division Chief and Basil Kavalsky the Department Director for the operation.

ANNEX 3

КАБІНЕТ МІНІСТРІВ УКРАЇНИ

м. Київ

«30» листопада 1994 р. № 27-2083/9

Пану Льюісу Престону
Президенту Міжнародного банку
реконструкції та розвитку,
Вашингтон

Стосовно Реабілітаційної позики

Шановний пане Престон!

Направляю Вам Меморандум про політику економічних реформ, який описує програму структурної реформи в Україні.

Україна прагне впровадити в життя всеохоплюючу програму структурних перетворень, яка є продовженням програми макроекономічної стабілізації, і спрямована на досягнення стабільного макроекономічного становища, сприяння економічному зростанню й зайнятості.

Здійснення економічної політики передбачає зокрема: запровадження фінансових та монетарних обмежень, підтримуваних відповідною податковою політикою; лібералізацію цін на внутрішньому ринку, а також режиму зовнішньої торгівлі та валютних операцій; відмову від системи державних замовлень; розвиток приватного сектора та лібералізацію внутрішньої торгівлі; активне започаткування процесу приватизації, застосування ліквідаційних процедур та положень законодавства про банкрутство; запровадження реальних позитивних процентних ставок і здійснення заходів з метою зміцнення платіжної дисципліни. Для захисту груп населення, найбільш вразливих до змін, пов"язаних із структурною перебудовою економіки, буде створено мережу цільового соціального захисту.

Ми просимо про підтримку цієї програми з боку Світового банку за допомогою Реабілітаційної позики у сумі, еквівалентній 500 млн. доп. США.

Разом з Вашими фахівцями ми плануємо систематично переглядати стан виконання умов, означених в Меморандумі про політику економічних реформ та протоколі переговорів між Урядом України і Міжнародним банком реконструкції та розвитку. Перший перегляд умов відбудеться не пізніше 31 березня 1995 року. Розраховуємо, що успішне виконання умов програми дозволить нам отримати другу частину Реабілітаційної позики

З повагою

В.Пинзеник,
Перший віце-прем"єр-міністр

ANNEX 3

Unofficial translation from Ukrainian

30 November, 1994
27-2983/9

Mr.Lewis T.Preston

President of the International
Bank for Reconstruction and Development
Washington, D.C.

RE: Rehabilitation Loan

Dear Mr. Preston,

I am sending herewith the Memorandum on Economic Reform Policies, which describes the program of structural reform in Ukraine.

Ukraine is determined to implement a comprehensive program of structural reforms, which is continuation of the program of macroeconomic stabilization, and is aimed at achieving of stable macroeconomic conditions, promotion of the economic growth and employment.

Economic policy envisages inter alia: introduction of the financial and monetary restraint, supported by appropriate taxation policy; liberalization of the domestic prices as well as foreign trade and exchange regime; dismantling of the state order system; development of the private sector and liberalization of domestic trade regime; active initiation of the privatization process, enforcement of the liquidation procedures and provisions of the bankruptcy laws; introduction of real positive interest rates and measures to enforce payment discipline. In order to protect the population groups most vulnerable to the adjustment associated with the structural transformation of the economy, the system of targeted safety net would be set up.

We ask for the support of the mentioned program from the World Bank by means of the Rehabilitation Loan in the amount equivalent to the 500 million US dollars.

Together with your experts we are planning to periodically review the status of implementation of the conditions set in the Memorandum on Economic Reform Policies and in the Minutes of negotiations between the Government of Ukraine and the International Bank for Reconstruction and Development. The first review is to take place no later than March 31, 1995. We hope, that the successful implementation of the policy measures, outlined in the program, would allow us to receive the second part of the Rehabilitation Loan.
Regards,

V.Pynzenyk
First Vice-Prime Minister

November 22, 1994

Memorandum on Economic Reform Policies

1. Ukraine is striving to overcome the decline in economic activity and high inflation which were characteristic for its economic situation in the last two years. To this end the Government is determined to implement a comprehensive program of macroeconomic stabilization and structural reforms aimed at creating a market-based economy. The objective of these policies is to establish stable macroeconomic conditions and promote economic growth and employment.

2. The program for radical economic reform in Ukraine focuses on four key interdependent elements. First, macroeconomic stabilization will be based on fiscal and monetary restraint supported by appropriate taxation policy. Second, efforts to promote competition will envisage actions in several strategic areas, namely the liberalization of domestic prices as well as the foreign exchange and trade regime, the dismantling of the state order system, development of the private sector and liberalization of domestic trade regime. Third, the hardening of enterprise budget constraints is expected to come about through privatization, the enforcement of liquidation procedures and bankruptcy laws, and an overhaul in enterprise management. A strict financial policy (including the elimination of directed credit, real positive interest rates and measures to enforce payment discipline), as well as reform of the financial sector will serve to support the changes at the enterprise level that are envisaged under the program. And finally, a targeted social safety net must be set up in order to protect the population groups most vulnerable to the adjustments associated with the structural transformation of the economy. The key elements of the comprehensive program including the timetable of actions, are described below and also summarized in the attached policy matrix.

I. Stabilization Program

3. To bring about a lasting reduction in inflation rates, tight fiscal and monetary policies will be implemented. The deficit of the consolidated state budget, including directed credits and the Pension Fund, will be limited to 10% of the expected GDP in 1994 and the ratio of the deficit to GDP will be reduced by at least half in 1995. This is consistent with the objective of reducing the monthly rate of inflation to less than 5% by the end of 1995. These targets will be achieved through large cuts in Government expenditures, including subsidies for coal and bread, housing and communal services, as well as subsidies to the agricultural sector. A program of targeted assistance to the most vulnerable strata of the population will be implemented in the short term (See para. 38). However, the best guarantee for improving the living conditions of the population and protection of the poor is the resolute implementation of radical economic reforms, which will promote a stable increase of budget revenues, economic growth and creation of new jobs.

4. The National Bank of Ukraine and the Government will continue to conduct a tight monetary policy. This is considered necessary to prevent a price jump associated with the liberalization of domestic prices and unification of the exchange rate from developing into an inflationary spiral, as well as to achieve the desired goal of lessening monetary financing of the budget deficit to a level consistent with lowering inflation. Taking into account the large credit needs of the Government in the fourth quarter or 1994, no increase of credit to non-Government establishments is likely to be possible in this quarter. As a temporary measure, in the last quarter of 1994 the outstanding stock of credits of the commercial

banks has been frozen. Direct credit control will be relaxed from January 1, 1995, and increased reliance placed on indirect monetary policy instruments. An increasing share of NBU credits to commercial banks will be allocated through credit auctions; besides this, the NBU has ceased issuing directed credit. The NBU refinance rate was raised to 25 percent per month at the end of October, and will be regulated with respect to expected inflation to ensure that it remains positive in real terms. All lending by the NBU, including to the Government, will take place at a rate no lower than the refinance rate. All ceilings on interest rates of commercial banks were removed at the end of October 1994.

5. At the initial stage, until financial discipline has been strengthened, the Government intends to restrain the growth of wages by setting a ceiling on wages paid by state enterprises. The increase in the wage bill will not be more than 80% of the programmed rate of inflation in the fourth quarter of 1994.

6. The Government will closely monitor the impact of the stabilization policy on key economic variables (inflation, commodity output, balance of payments, exports) and if necessary take corrective actions to restore the macroeconomic balance.

II. The Structural Reform Program

7. The leadership of the country is fully aware that sustained stabilization and economic growth require fundamental structural reforms of production designed to transform the economic system that incorporates elements of administrative planning to a market-oriented one based on a vibrant private sector. Some measures have already been undertaken to promote competitive markets, but this process has not gone far enough. Moreover, in the absence of hard budget constraints, there cannot be a positive supply response on the part of the producers. Economic restructuring has also been hampered by the lack of an adequate social safety net. The program of radical economic reforms of the President contains measures for solving all the addressed issues.

A. Creating a Competitive Environment

Liberalization of Prices

8. The overall goal in the area of pricing is to significantly reduce Government intervention (both at the level of central government, and local bodies of power) in setting and regulating prices. This will not only promote efficient resource allocation, including in particular scarce energy imports, but will also strengthen the state budget. At the end of October 1994 the Government abolished the majority of state interventions in price setting, including direct price control, most ceilings on profit margins, and required advance declaration of price changes, including for commodities produced by monopolists.

9. At the producer level the state control remains for natural monopolies (electricity, gas, central heating, water supply and sewage), public transport, rents, as well as for a small and declining number of artificial monopolies. In two steps, on October 25, 1994 and November 5, 1994, domestic prices of imported natural gas for industry and agricultural consumers and government organizations were raised by factors of 3 and 1.5, respectively. In 1995 natural gas prices for these consumers will be periodically adjusted to maintain a level that fully covers import, domestic distribution, and transportation costs at the unified exchange rate. The price of domestic coal was raised by 90% starting November 5, 1994, to reduce state subsidies to no more than 20 percent, and we intend to liberalize coal prices by January 1,

1995, except for coal for household use. Electricity prices were also raised to reflect fully the recent increases in fuel costs, and a system of periodic price adjustment was introduced to compensate for additional changes in the cost of fuel and other basic input costs. It is planned to liberalize electricity prices for the industrial sector by the end of 1995, when a competitive wholesale electricity market will be established (See para. 32). Limits on profit margins for crude oil and oil products will be eliminated and the number of artificial monopolies subject to price controls will be significantly reduced effective January 1, 1995.

10. Retail prices of most foodstuffs and other commodities were liberalized as of October 21, 1994 by decree of the Cabinet of Ministers. Retail price controls remain only on bread, municipal services, public transportation, household fuel and housing rent. Bread prices were increased 4 to 5 times in October, in order to achieve full cost recovery at the new harvest price for grain. However, as a temporary measure, ceilings were also maintained on profit margins for bread products, baby food and flour. The control of bread prices and the profit margin ceilings on bread products, baby foods, and flour will be abolished as of January 1, 1995.

11. Municipal service tariffs, public transportation fares and housing rents were also raised in October 1994 to increase recovery of expenses from 5% to 20% for housing and municipal services and from 3-4% to 20% for public transportation. The cost recovery ratio for household electricity will be increased to 40% in January 1995 and 60% in June 1995, and will be substantially increased for housing and other municipal services. To protect the most vulnerable strata of the population from the full impact of these large price increases, the Government is implementing a program of targeted assistance (See para. 38).

Private Sector Development

12. The rapid development of the private sector provides not only the main source of growth of the economy and increase in the number of jobs, but also a source of competition for the existing state enterprises. However, the growth of new private ventures has remained below potential; and most new enterprises operate in the informal sector, avoiding tax and other obligations, such as health and safety standards. The Government will encourage more rapid development of the private sector and its integration into normal economic processes by addressing the main obstacles. First, registration procedures have been simplified for the setting up of new enterprises and shorter deadlines have been imposed on registration bodies. Entry has been allowed in all branches of economic activity, including transport and distribution of goods. Second, with the acceleration of privatization access to the means of production will be made easier. The hard budget constraint for state enterprises will also force the latter to sell or lease real estate or other property. State enterprises are free to sell their assets up to a value of 2000 times the minimum wage provided the sale is done through open competitive methods. Third, a thorough review of the taxation system is being undertaken to reduce the overall tax burden on economic activity and uproot discrimination against the private sector where it exists. Finally, a high level task force has been established to develop a comprehensive plan to create a legal framework conducive to private sector development.

13. The Government recognizes the importance of direct foreign investments for facilitating and speeding up the process of creating an efficient and competitive private sector. Foreign investment will not only bring Ukraine capital, but technology, management skills and access to foreign markets as well. The program of radical economic reforms will significantly improve the prospects for attracting serious

long term foreign investors. Insofar as the main condition of their confidence is stability and predictability of laws and other regulations, the Government is aware that changes to them should be introduced cautiously and never retroactively.

14. Taking into account the planned improvement of the overall framework of foreign investments, the Government considers it is no longer a priority to create special incentives for foreign investors, nor will efforts be continued to guide foreign investors to priority sectors. It is planned to abolish tax holidays and other tax exemptions, as well as other special incentives. The leading principle will be to ensure equal conditions for local and foreign investors.

Liberalization of Domestic Trade

15. In line with the Government policy for the liberalization of trade and to promote the development of the private sector, the system of state orders will be eliminated as of January 1, 1995 and replaced by ordinary contractual obligations. The Decree of the President of Ukraine "On State Contract for 1995" and a Draft Regulation of the Cabinet of Ministers of Ukraine "On the Procedure of Formulation, Placement and Fulfillment of State Contract for 1995" are currently under elaboration. They envisage limiting state purchases as of January 1, 1995 to goods and services necessary for the activity of budget organizations (including the armed forces, schools, hospitals, ministries and departments, and other organizations which are wholly financed from the budget). These goods and services will be procured through competitive tenders, within the resources allocated in the budget for these purposes. With the removal of formal and informal obstacles to wholesale and retail marketing (see below), intra-regional and inter-regional trade will be allowed to develop along commercial lines.

16. Also as of January 1, 1995, the Presidential decree (of November 3, 1993) imposing a maximum ceiling of 55% on marketing mark-ups will be repealed and all central and local government ceilings on marketing mark-ups will be eliminated. The tax on profits from intermediary activities will be brought down to 30 percent by the end of 1994, which is more in line with profits tax in other sectors. This will serve to reduce the discrimination against intermediary activity and greatly increase the incentive to develop commodity markets and private wholesaling activities.

17. The above measures will be most effective in generating dynamic private sector trade only if a supporting infrastructure is available. Wholesale storage bases and trucking enterprises will be included in the mass privatization program for 1995 and privatized rapidly. The auctions beginning in the first quarter of 1995 will include these facilities. Besides this, grain elevators and silos will be included in the privatization program for 1995. Retail stores, including food stores, will be privatized quickly under the small scale privatization program (See para. 22).

Reform of the External Trade Regime

18. To promote export and open up the Ukrainian economy to international trade and competition, the Government has taken decisive steps to reform the external regime. Re-opened on October 5, 1994 was the interbank currency auctions. The official rate for the surrender of foreign exchange to the State was abolished on October 26, and the exchange rate is now unified and is being determined in the interbank auction. All licensed banks will be gradually allowed to take part in the currency auctions, and their bids will be processed without administrative interference. The allocation of foreign exchange

through the Tender Committee has been abolished. A high degree of current account convertibility of the karbovanets was re-established, with full convertibility for trade and related activities.

19. The Government has also taken action to liberalize foreign trade. All export quotas and licenses, with the exception of non-ferrous and ferrous scrap metals, cast iron, coal, grain and goods subject to voluntary export restraints (VER) and other contingent international agreements were abolished on November 1, 1994. All export quotas and licenses will be removed by January 1, 1995 except for goods subject to VER and other international contingent agreements. Under these conditions, indicative prices will be published to provide information to exporters.

20. As for imports, the Government will not impose any quantitative restrictions, except for licenses currently in place for health and safety means, envisaged by GATT/WTO norms and principles. The Government is to introduce an economically substantiated system of the tariff regulation of imports. This will be achieved by reducing the maximum tariff rate to 30 percent by January 1, 1995, and by further reducing the maximum rate later in 1995. The possibility remains to temporarily raise custom duties on separate types of goods in strict conformity with GATT/WTO norms. However, the share of import goods whose tariff rates can exceed the established maximum rate will be limited to 1% of total imports (measured on the basis of 1993 import shares). The excise duties on imported and domestically produced goods will be unified by March 1995. The Government will avoid frequent revisions to the tariff structure.

B. Hardening of Enterprise Budget Constraints

21. Economic liberalization is the most effective means for transforming the economy, if it is accompanied by other reforms which force households, enterprises and commercial banks to respond to market signals. Of special attention will be the fulfillment of the following three tasks: privatization, introduction of strict financial discipline and improvement of corporate governance, and reform of the financial sector.

Privatization

22. The Government is committed to accelerating privatization. Though the process has been disappointingly slow so far, the basic legal and institutional framework has largely been established. With respect to small scale privatization, the Government intends to privatize 6,000 small (Group A) enterprises by end 1994 and 90 percent of such enterprises by end-1995. To meet this objective, the State Property Fund (SPF) has instructed its regional departments and offices to implement the program, and mounted an extensive public information campaign to promote small-scale enterprise auctions and buy-outs. These instructions will be backed up by the system of appropriate incentives and penalties for enterprise directors and officials of local government bodies. Besides, it is planned to set up a system of incentives/disincentives for the rapid privatization of leased enterprises.

23. With respect to medium and large enterprises the Government will implement the mass privatization program. The process is to be launched in 1995 with stock auctions of at least 200 enterprises by March 15, 1995 and rapidly expanded to include 8,000 enterprises by the end of 1995. To achieve these targets, the decree and other regulations necessary have been issued to streamline and simplify the mass privatization process. The measures covered by these decrees and regulations include

the following (a) merging of the privatization and corporatization processes with SPF as sole founder of all corporatized enterprises to be included in the State Privatization Program; (b) preparation of simplified standard documentation packages to participate in the privatization/corporatization process (by chairmen of commissions on preparation of enterprises for privatization and/or heads of enterprises); (c) submission of these documents to state privatization bodies for approval according to tight deadlines; (d) book value and most recent inventory to be automatically taken as the valuation of the enterprise; (e) standard allocation of blocks of shares to the auction process; and (f) a simplified bidding system in the auctions that will allow proportional allocation of shares to all bidders.

24. The Government has set forth a list of all sectors to be included in the State Privatization Program in 1995. The list includes freight trucking enterprises, warehousing, and storage and distribution facilities and is accompanied by an official statement by the Chairman of the SPF confirming that stocks of at least 8,000 enterprises are to be offered to the nationals of Ukraine at certificate auctions in 1995.

25. A comprehensive large scale public information campaign on the initiation of state enterprises privatization for paper privatization certificates was launched in November 1994. This campaign publicizes the details of the streamlined mass privatization methodology and the distribution of certificates to the population. Privatization certificates will be printed and distributed to the population in five pilot oblasts through the Savings Bank by mid-December 1994. In January 1995, regional bidding networks in five pilot oblasts will be created and the first pilot certificate auctions will be carried out in February 1995. These auctions will be extended to the entire country by April, 1995, and between January 1 and June 15, 1995 at least 1,000 medium and large enterprises will have been auctioned through the mass privatization program. The creation of investment funds and other financial intermediaries will be encouraged by the government as a means of concentrating share ownership. Shares of all privatized enterprises will be immediately tradable and secondary securities markets will be created for this purpose.

26. In agriculture, the Land Code specifically allows for private and state and collective ownership of land. It also stipulates that collective and state farm members and those providing social services in villages as well as pensioners who previously worked in agriculture are entitled to receive an average land share free of charge. However, land can be sold only after six years of possession. To promote the development of a land market, the Government will seek to amend the Land Code to achieve three main goals: 1) the provision of physically identified average land shares to eligible beneficiaries through clear and implementable procedures; 2) the reduction of the of the moratorium of land sale to two years after receiving possession, or January 1, 1996, whichever occurs first; and 3) enforcement of lease payments by farmers for lands received above the local average land share or the transformation of these leases into purchases from the land reserves. Land in the reserves will be made available to all buyers, and its resale thereafter will be subject to the same reduced moratorium. The procedures for land mortgage (and other encumbrances) will be clarified in the amendments to the Land Code as well. The amendments to the Land Code and a draft Law on Registration of Land and Other Real Estate will be submitted to the Parliament by January 1, 1995. The draft Law on Registration of Land and Other Real Estate will explicitly specify the procedures for registering both urban and rural land and other real estate.

Enterprise Management and Restructuring

27. Notwithstanding privatization and growth of the private sector, state enterprises will continue to occupy a large part of the economy in the near term. Strengthening their economic performance will be

critical to the improvement in the Government's fiscal position, to the recovery of output, the development of the private sector, and the viability of the banking system.

28. Financial discipline in enterprises will be strengthened by measures outlined above that increase competition and promote macro-economic stability, including in particular the liberalization of prices and trade, and the elimination of directed credits and subsidized loans from NBU and commercial banks. The NBU will continue not to provide credits to settle inter-enterprise arrears.

29. In order to reduce payment arrears for gas, electricity and central heating, an interdepartmental commission has been created by the government to deal with arrears of enterprises and budgetary organizations. The utilities report non-payment to the commission which reviews the cause of non-payment and proposes measures. If the problem is not solved, the commission authorizes the utility to reduce or discontinue the supply of energy.

30. Additional measures will be taken to enforce financial discipline and demonstrate that the state will not bail out uneconomic activities. In this regard the enterprise sector will be exposed to the provisions of the Bankruptcy Law and the Government will not block the implementation of bankruptcy proceedings by the courts. It is expected that a number of large non-viable state enterprises will be closed down in 1995.

31. The Government has instructed 20 large state enterprises that have either huge losses, or arrears, or receive large budgetary support to develop action plans for restructuring by mid-March 1995. These plans will include partial or complete privatization, partial or complete closure, splitting up of large monopolies, divestment of social assets, etc. The Government will establish a mechanism by which it can control the flow of subsidies to these and other large enterprises, making transfers conditional on meeting restructuring targets. As a means of improving the corporate governance, the Government will also begin corporatizing state enterprises that will not be subject to privatization.

32. Radical reform of the electricity industry has been approved with the aim of establishing a competitive market for electricity. According to the Government Action Plan for implementing Presidential decree #244/94 "On Market Transformation Measures in the Electricity Industry of Ukraine", a competitive electricity market will be established in 1995. On December 1, 1994, an electricity regulating commission will be created, and the corporatization of hydro-power plants initiated.

Financial Sector Reform

33. The NBU recognizes that financial sector reforms are critical for enforcing financial discipline, increasing domestic financial saving and ensuring that credit is allocated to the most efficient users. The elimination of directed credits from the NBU, the maintenance of real positive interest rates on refinance credits, and the removal of ceilings on interest rates of banks should promote both greater financial saving and more efficient allocation of credit based on market relations. Government has already submitted to the Parliament a proposal to reduce the tax on profits of banks to 40 percent effective January 1, 1995 to bring this rate more into line with the profit tax rates of other sectors.

34. Progress has also been made in up-grading the accounting systems and operating standards of the banking system in general and a limited sub-set of new commercial banks in particular. The NBU is

committed to maintaining and extending efforts in order to create new banking structures which can conform to international standards in all major banking functions.

35. Progress has also been made in establishing and implementing an improved system of commercial bank regulation and supervision. In the first quarter of 1995, the organizational arrangements for regulating non-bank financial institutions (eg. insurance companies and the new portfolio investment funds for privatized shares) will be reviewed to ensure consistency of approach, information sharing, etc.

36. In the context of the on-going reform program and the restructuring of the economy, the Government/NBU will undertake a study of the former state banks to assess the magnitude of their bad loans and possible options for limiting the adverse consequences for the viability of the banking system. The study will be completed by March 15, 1995 and concrete proposals for restructuring developed by mid-June 1995.

C. Social Safety Net and Labor Markets

37. Resolute implementation of the reform program described above will generate sustainable economic growth in the medium-term and allow living standards in Ukraine to improve. Speedy and decisive action on the adjustment program is the best possible means for avoiding and alleviating poverty in Ukraine -- social protection measures in the absence of a vigorous adjustment program can only redistribute poverty. Especially in the short run, however, the Government is aware that its program of economic stabilization and structural adjustment requires strengthening social security to protect the most vulnerable segments of the society. Yet this strengthening cannot be brought about with an increase in taxes. Competing successfully internationally, bringing new private enterprises into the official economy, and creating new jobs will partly depend on lowering the 53 percent payroll tax.

Social Assistance

38. The Government intends increasingly to focus social benefits on the truly needy. To protect the living conditions of needy families with children and pensioners, the Government has increased eligibility thresholds and benefits levels to reflect inflation since the last increase in December 1993. It will adjust benefits monthly to reflect further price increases. In addition, the Government has introduced targeted payments for housing maintenance for all households in which the per capita income falls below a poverty threshold.

39. In order to provide a sound basis for further targeting social benefits, the Government intends to initiate an integrated household survey of the type already being implemented in Russia, Belarus, Kazakhstan, and many other countries. The survey will be conducted by the Ministry of Statistics, or by Ukrainian institutes under the general supervision of the Ministry of Statistics, or by Ukrainian institutes working independently. The survey will make it possible to identify social groups in the greatest need of social assistance, as well as provide detailed information to be used for the development of a broad range of economic policies and programs.

40. Some programs are poorly targeted and not cost-effective in providing benefits. The Government will consider the issues of expenditures by the Social Insurance Fund that are not targeted and will propose cutting the expenditures of the Fund.

41. The Government recognizes that social assistance is vulnerable to abuse as families and pensioners may apply for the benefits without declaring their additional incomes. During 1995, the Government intends to improve the methods for the assessment of individuals' financial position by random "spot checks" to fight fraud and abuse. Further measures for strengthening the methods for the assessment of financial position will be recommended in the Social Assistance Strategic Policy Paper given below.

42. While the measures described above will help to improve a difficult situation, the Government recognizes that a thorough reform of social assistance and social insurance is desirable. Accordingly, Orders of the Cabinet of Ministers have been issued to the Ministries of Social Protection, Labor, Finance, Economy and Statistics and the Employment, Chornobyl, Pension and Social Insurance Funds to prepare two strategic policy papers. A Social Assistance Strategic Policy Paper to be completed under the direction of the Ministry of Social Protection, will (a) describe the present system of benefits and its beneficiaries, (b) identify the system's objectives and critically assess its ability to meet them, and (c) recommend a program of action for the next few years. It is the Government's intention to complete the paper by March 15, 1995 and to begin implementing a comprehensive program of social assistance reform during 1995. The second paper, on social insurance, is described in paragraph 44 below.

Employment scheme

43. The Government believes that the primary goal of the Employment Fund should be providing cash assistance to the unemployed, not extending credit to state-owned enterprises that promise job creation. Credits from the Employment Fund for job creation have been discontinued. The Government intends to explore mechanisms for strengthening benefits for the unemployed, including replacing severance pay in part with unemployment compensation.

44. The Government has initiated an in-depth, comprehensive Social Insurance Strategic Policy Paper in parallel with the paper on social assistance (paragraph 42). The paper will (a) include a comprehensive description of Ukraine's Pension and Employment Schemes, including the legal and institutional framework, the structure of benefits, and a picture of present beneficiaries, (b) identify the objectives of the Pension and Employment Schemes and critically assess their ability to meet them, and (c) recommend a program of action for the next few years, including increasing gradually the retirement age. As with social assistance, it is the Government's intention to complete the paper by March 15, 1995, and to initiate a comprehensive program of social insurance reform during 1995.

Labor mobility

45. Under market economy conditions, workers should be free to improve their wages by seeking employment in all regions and occupations. In this regard, steps will be taken in 1995 to eliminate the use of propyska as a requirement for applying for a job. This means that propyska will no longer be an obstacle to labor mobility. The Government is also reviewing the role of propyska apart from its impact on labor markets. The lack of housing resulting to a great extent from the absence of a private housing market is the main obstacle to labor mobility. The Government intends to promote the housing market development by stimulating privatization of the housing stock, including by increasing housing rents.

UKRAINE REHABILITATION LOAN POLICY MATRIX

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
I. MACROECONOMIC STABILIZATION			
To create a stable macroeconomic environment conducive to economic growth. Reduce the monthly rate of inflation to no more than 5% by end 1995. Introduction of new stable national currency.	Monthly rate of inflation was brought down from 65% in the last quarter of 1993 to about 2% in July-September 1994. Initially this improvement was attributable to very restrictive monetary policy. Inflationary pressures have remained subdued due to continuing positive real interest rates, increased demand for money, and the accumulation of excess cash reserves by banks.	Agreement reached with the IMF on a stabilization program. First purchase under STF approved on October 26, 1994. Presentation to Parliament of revised Q4 budget by which the deficit of the consolidated state budget including directed credits and Pension Fund will be limited to 10% of expected GDP in 1994. This is to be achieved through sharp cuts in government expenditures, including coal and bread subsidies, subsidies for housing and communal services and subsidies to agriculture (see II on necessary price adjustments).	Agreement on Standby Arrangement with IMF in early 1995. Stabilization policies to be defined in the context of the Standby Arrangement.
	Despite large cuts in expenditures, there continued to be a significant need for monetary financing of the deficit. On a cash basis, including directed credits, the budget deficit for the first half of 1994 was 9% of GDP (compared with 11% in whole of 1993). Without corrective policies, the budget deficit could increase to about 25% of GDP in the second half of 1994.	Consistent with the targeted inflation path, increase in net domestic assets of NBU and the growth of money supply restricted. No increase in credit to non-government sector in Q4, 1994. Outstanding stock of credit of each bank to non-government sector to be frozen during Q4.	Satisfactory implementation of the Standby Arrangement.

ANNEX 4

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
I. MACROECONOMIC STABILIZATION (cont'd)			
		As of October 25, NBU refinance rate increased to 25% per month from 11.5%. Rate is to be adjusted to maintain real positive level with respect to expected inflation. All NBU credit allocated partly in proportion to the banks' capital and partly by auction where the interest rate is determined by supply and demand. Ceilings on interest rates of banks removed as of October 25. Directed credits from NBU eliminated as of October 25, and no conditions set for use of NBU resources by banks. Continued tax-based incomes policy restricting the growth of the enterprises' wage bill to 80 percent of the targeted rate of inflation.	
Moderate the decline in economic activity, and promote the growth of the private sector.	Real GDP is estimated to have fallen by 27% in the first half of 1994 compared to one year earlier, and industrial production by 36%. However, a growing underground economy moderates the overall decline in economic activity. Open unemployment is negligible but about 16% of the labor force is estimated to be underemployed in some form or other.	Implement structural reforms in II and III to promote output recovery.	Accelerate implementation of structural reforms.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
II. COMPETITIVE ENVIRONMENT			
To promote competition by reducing government intervention in economic activity and fostering market-based allocation of resources.	Extensive state interference in price formation and domestic and foreign trade. Competition from imports inhibited by high cost of imports and price regulations. Lack of payment discipline and absence of a hard budget constraint for state enterprises further weakens competition.	Significant liberalization of prices, domestic and foreign trade and foreign exchange (see below).	Further liberalization of prices, foreign trade and domestic trade (see below).
A. Prices			
To liberalize all prices, except for a few natural monopolies. Regulated prices to be set so as to fully recover the cost of providing the good.	Extensive state (central and local) intervention in domestic price formation at the producer and retail level. These interventions include direct price controls (at central and/or local government level) for some goods and services, limits on profit margins, ceilings on trade mark-ups, advance notification requirements for price increases, etc.	A majority of state controls on prices, abolished including direct controls and required advance declaration of price changes, including for commodities produced by monopolists. At the producer level, price controls maintained only for electricity, gas, district heating, water and sewage, municipal transport, and rents, and a few and declining number of artificial monopolies. At the retail level, price controls remain only for bread, public utility charges, fares for public transport, fuel for households, and rents.	Further price liberalization (as below). The number of artificial monopolies subject to price regulation to be sharply reduced by January 1, 1995. At the retail level, by year end, price controls to be maintained only for public utilities, public transportation, fuel for households, and rents. Limits on profit margins for crude oil and oil products to be eliminated as of January 1, 1995.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
A. Prices (cont'd)			
	Administered prices have been maintained at levels that are well below the real cost of supplying the goods and services. The use of a highly appreciated exchange rate is converting dollar prices to karbovanets has resulted in a large subsidy on imported gas. The average wholesale price of natural gas was 25% of border price at the market exchange rate in the first half of 1994.	(i) In two steps, on October 25, and November 5, 1994, domestic prices of imported natural gas for industrial and agricultural producers and governmental organizations were raised by factors of 3 and 1.5, respectively.	In 1995, natural gas prices for industrial, agricultural and governmental organizations will be periodically adjusted to maintain a level that fully covers import, domestic distribution, and transportation costs at the unified exchange rate.
	Electricity prices for producers were raised by 45% in September.	(ii) Average electricity prices were raised from Krb 500/kwh to Krb 1950/kwh in October and November to fully reflect recent increases in fuel costs. A system of periodic price adjustments put in place to compensate for additional changes in fuel and other basic import costs until the competitive wholesale market is established.	Wholesale electricity prices to be liberalized by the end of 1995, when competitive market will be established.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
A. Prices (cont'd)			
		(iii) Implementation of an Action Plan was initiated to establish a competitive wholesale market for electricity in 1995. As part of the Plan the Government announced the establishment of an Electricity Regulatory Commission as of December 1, 1994, and the corporatization of hydropower plants will also be initiated by that date.	Competitive wholesale market for electricity to be established in late 1995.
	The price of coal covered only 60-65 percent of the cost of production.	(iv) On November 5, domestic coal prices for producers were raised by 90% to Krb 1,967,000/ton to reduce subsidies to no more than 20% of price. (v) Price of fuel oil under state orders raised on Oct 1 by 2.5 times to Krb 4.9 million/ton.	Coal prices to be liberalized on January 1, 1995 except for household use.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
A. Prices (cont'd)			
	Public utility tariffs and rents cover no more than 5% of costs while fares for public transport cover only 3-4% of cost.	(vi) For households, public utility tariffs and housing rents were increased in end October to recover at least 20% of costs of providing such services. This implied an increase of 8 times for natural gas, 6 times for coal, 5 times for LPG, 7 times for district heating and 5 times for electricity. Overall, the cost of housing, including communal services increased 7 times in October. Transportation fares were raised 6 times to cover 20% of cost. Further adjustments in these prices in November and December to maintain cost recovery rates.	Electricity prices for households to be increased to achieve 40% cost recovery ratio in January 1995 and 60% in June 1995. Other household public utility prices and housing rents will also be raised substantially in January and June 1995.
		(vii) Bread prices were raised 4-5 times in late October to achieve full cost recovery at the 1994 harvest price of grain. As a temporary measure profit margin ceilings were imposed on bread products, baby food and flour.	Bread prices to be liberalized as of January 1, 1995. Profit margin ceilings on bread products, baby food and flour to be eliminated as of January 1, 1995.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
B. Private Sector Development			
To promote domestic competition, foster the growth of the private sector.	The growth of the private sector is hampered by government interference in setting prices, controls on trade (domestic and foreign), the segmented market for foreign exchange, the heavy tax burden, the unstable macro- and institutional environment, and the lack of necessary infrastructure (such as transport, marketing outlets, etc.) and productive assets. Despite these obstacles, there is a growing underground private economy.	The scope of government regulations on prices, mark-up on trade and profit margins significantly narrowed (see IIA above). Dual exchange rate system dismantled in late October with the re-opening of the interbank market for foreign exchange and the abolition of the official exchange rate (see IID below). Export quotas and licenses eliminated for many products as of Nov 1 (see IID below). Tax reform proposals submitted to Parliament to reduce the overall burden of taxation. Small-scale privatization accelerated (see III below). Preparatory steps initiated for rapid privatization of medium and large enterprises (see III below) and asset sales. Measures implemented to harden budget constraint on SE's through elimination of state support and subsidized credit, forcing them to divest assets (see III below).	Government regulation of prices largely eliminated except for natural monopolies (see IIA above). Export quotas and licenses to be eliminated (with few exemptions) and import taxes reduced by January 1, 1995 (see IID below). 90% of small-scale privatization to be completed by end 1995 (see III below). Mass privatization program for medium and large enterprises to be accelerated (see III below). Budget constraint on SE's to be hardened through elimination of state support, forcing them to divest assets (see IV below).

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
C. Liberalization of Domestic Trade			
To eliminate discrimination against domestic trading activity which is hindering the development of markets and perpetuating state interference in commercial activities.	Domestic private trade is constrained by ceilings on trade mark-up at central and local levels, by the dominance of the state order system, by discriminating taxation, and by lack of access to necessary infrastructure, such as transport, storage, and retail space.	Decreed that as of January 1, 1995, Presidential decree (of November 3, 1993) imposing a maximum ceiling of 55% on marketing mark-ups will be repealed and all central and local government ceilings on marketing mark-ups will be eliminated. Proposals submitted to Parliament to lower profit tax on intermediaries to 30% by end of 1994. Small scale privatization accelerated (see III below). Mass privatization program initiated for medium and large enterprises (see III below), including in trucking and warehouses, etc.	As of January 1, 1995, existing system of state orders, including for grains, to be abolished. State procurement as of January 1, 1995, will be limited to goods and services necessary for activity of the budget organization and will be done on competitive principles, through open bids and tenders, within the resources allocated in the budget for this purpose. Privatization of 90% of small-scale enterprises to be completed by end-1995 (see III). Privatize some trucking and warehouse facilities, through the mass privatization program, by mid-March 1995 (see III). Privatize some grain silos.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
D. Reform of the External Regime			
To create a policy environment that does not discriminate against exporters and does not inhibit competition from imports.	Currently, exporters are disadvantaged by the implicit tax resulting from the compulsory surrender of part of their earnings (30% since Aug 23, 1994) at a highly overvalued official exchange rate. Exporters are also hampered by the system of export quotas and licenses that covers approximately 40% of exports. The system of indicative prices is also a potential source of export control. On the import side, there are no quantitative restrictions (except for licenses for a few commodities for health and safety reasons). The average tariff rate in 1993 was approximately 11%, but rates varied significantly, with the maximum rates in excess of 300%. Excise duties on imported goods significantly higher than for domestically produced goods.	Inter-bank foreign exchange market reopened on Oct 5. The official rate of exchange was abolished on Oct 26 and the exchange rate was unified at the market determined rate. As of Nov 1, 1994, export quotas and licenses eliminated, with the exception of coal, grain, ferrous and non-ferrous scrap, cast iron and some other goods subject to voluntary export restraints (VER) and other international contingent agreements. No quantitative restrictions will be applied on imports.	The interbank market will be progressively opened to all licensed banks. By January 1, 1995, all export quotas and licenses, to be eliminated except for goods subject to VER and other international contingent agreements. The maximum import tariff rate will be lowered to 30% by January 1, 1995 and further lowered by end 1995. Import tariffs may be raised temporarily above the maximum rate. However, the cumulative share of goods whose tariffs exceed the maximum rate in total imports in 1993 must not exceed 1 percent Excise duties on imported and domestically produced goods will be unified by March 1995. No quantitative restrictions will be applied to imports.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
III. HARDENING ENTERPRISE BUDGET CONSTRAINT			
To ensure that economic agents (including enterprises, farms, banks, households) respond appropriately to market signals, and do not escape from the discipline imposed by market forces and competition.	Continuing government interference in business decisions (pricing, trade, etc.). Dominance of state-owned enterprises with unclear distinction between rights of owners, managers, and workers. Continuing subsidization and bail-out of state enterprises through the budget and the banking system.	Significant narrowing in scope of government interference in pricing, domestic trade and foreign trade (see II above). Acceleration of privatization and development of private sector. Limitation of state support to loss-making enterprises.	Further liberalization, privatization, and private sector development.
A. Privatization			
To accelerate the transfer of ownership of productive assets from the state to private owners who will be more responsive to market signals. This transfer will also eliminate the pressure on the government from branch ministries to bail out loss-making enterprises in their jurisdiction.	Though the basic legal and institutional framework has been largely established, there has been very slow progress in privatization. By end June 1994, only about 5,000 small enterprises had been privatized out of a total of more than 100,000. And only about 1,000 medium and large enterprises (out of 20,000) had been privatized, mostly by transfer of ownership to workers' collective.	1. Privatized about 6,000 small enterprises. 2. Initiated Mass Privatization Program (MPP) for large enterprises, using simplified procedures and methodology. This included the following steps: a. Issued decree outlining simplified procedures including the merger of corporatization and privatization processes	Complete privatization of 90% of small enterprises by end 1995. Distribute paper certificates in 5 oblasts by Dec 15, 1994. By March 15, 1995, complete stock auctions (including trucking and warehousing) in 5 oblasts for at least 200 medium to large enterprises using simplified procedures. Some grain silos to be privatized.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
A. Privatization (cont'd)			
		b. Announced the list of sectors to be included in the MPP for 1995, including trucking, warehouses, storage and distribution. The statement confirmed that the MPP for 1995 will include at least 8,000 medium and large enterprises. c. Launched national campaign to publicize the government's plan for mass privatization, including use of streamlined mass privatization procedures and the distribution of certificates to the population.	Auctions to be extended to the entire country by April 1995. Auction at least 1000 medium and large enterprises between Jan-June 15, 1995. Sale of shares by public auction of at least 8,000 medium and large enterprises to be completed by end 1995.
	In agriculture, though the 1992 Land Code allows for private ownership, privately owned and cultivated land is only 11% of total agricultural land. The Land Code also entitles farm members in collective and state farms to receive a certain fraction of the available land at the local level, but by and large the entitlement has not resulted in property rights on identifiable plots of land. At most, identifiable land plots have been allocated only to those farm members who wish to leave the state or collective farm. The development of the land markets has been constrained by the failure to distribute identifiable land plots to members of state and collective farms, as well as by a six year moratorium on land sales.		By Jan 1, 1995, present to Parliament amendments to Land Code to (a) ensure right of state and collective farm members to receive physically identified average land shares; (b) reduce the moratorium on land sales to 2 years after possession or Jan 1, 1996 whichever is sooner and (c) enforce lease payments by private farmers for land received above their entitlement of the average land share, or transform these leases into sales from the land reserves. By January 1, 1995, present to Parliament a draft Law on Registration of Land and Other Real Estate specifying the procedures for registering urban and rural land and other real estate.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
B. Financial discipline and corporate governance			
To improve corporate governance and tighten financial discipline in enterprises that are not privatized.	The government continues to provide support directly (through budgeting transfers, or tax exemptions) or indirectly through the banking system (in the form of subsidized directed credits) to non-performing state-owned enterprises. The organizational structure of SEs that are not corporatized also promotes diffusion of accountability and a lack of clarity regarding the role of owner and manager. Payment discipline is weakened by government directives preventing punitive measures, such as the implementation of bankruptcy proceedings.	Instructions issued to 20 large state enterprises that either have huge losses, or receive large budgetary support to develop action plans for their restructuring by mid-March, 1995. Begun corporatization of SEs that will not be privatized. Approved restructuring plan of electricity industry (see IIA). Established inter-ministerial commission to initiate actions to reduce payment arrears to energy suppliers from enterprises and budgetary organizations.	Implementation of restructuring plans in 20 large enterprises. These plans to include partial or full privatization, partial or complete closure, partial divestment of assets, etc. Government will not take measures to block the implementation of bankruptcy proceedings by courts. Close down some large non-viable state enterprises.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
C. Financial Sector Reform			
To strengthen the capacity of the banking system to enforce financial discipline and to mobilize financial savings and allocate credit to efficient users.	The financial sector is unable to enforce financial discipline and efficiently mobilize and allocate resources. The government continues to influence lending decisions, including through directed credits and ceilings on interest rates. Banks are also burdened by bad loans that further undermine their capacity to make prudent lending decisions. The framework for bank supervision also needs to be strengthened.	Directed credits from NBU eliminated as of late Oct. Ceilings on interest rates of banks eliminated. Interest rates on refinance credits from the NBU raised to a monthly rate of 25% and regulated with respect to expected inflation to remain postive in real terms as of Oct 25, 1994. No credits issued by the NBU to clear inter-enterprise arrears as of October 25, 1994. Proposals submitted to Parliament to reduce profits tax on financial intermediaries to 40% by end of the year.	Eliminate credit ceilings on banks and shift towards market-oriented measures to conduct monetary policy by early 1995. By March 15, 1995, complete study defining, evaluating and costing alternative restructuring plans for the former state banks and develop concrete restructuring proposals by mid-June 1995 for implementation starting later in the year.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
IV. SOCIAL SAFETY NET			
To protect the neediest members of society against hardship during the adjustment and reform process. To reform the existing programs of social assistance and social insurance to make them financially sustainable, better targeted to those who need assistance most, and compatible with reforms to promote labor mobility and efficient resource use. To promote economic growth and employment by reducing payroll taxes that financed untargeted and wasteful programs.	Ukraine has an extensive and expensive system of social protection. In 1993, expenditures on social programs accounted for 25.4% of GDP, with 2/3 of the population receiving benefits of one kind or another. This extensive system of social programs is largely financed by very high levels of payroll taxes, with the total tax on labor about 53% of the taxable wage bill.	Initiated two strategic policy papers, one on social assistance and the other on pensions and unemployment compensation, which will recommend a program of actions, to be implemented starting in 1995, to meet the reform objectives.	Completion of policy papers by March 15, 1995. Implementation of comprehensive reform to be initiated by end 1995.
A. Targeted Assistance			
To protect the living standards of the neediest members of the population, in particular low income families with children and low income pensioners.	Targeted assistance is provided to low income families with children and low income pensioners, but the overall benefit structure is not well targeted. However, the targeted programs provide a base on which a strengthened means-tested program can be built. Approximately 162,000 children in 105,000 families (slightly more than 1% of all children under 18) and approximately 1.2 million pensioners (9% of total) collected these benefits in 1993.	The income threshold for child benefits for low income families, and the level of such benefits indexed to price increases. Similarly, means-tested supplementary pension benefits also indexed to protect low-income pensioners against price increases. "Housing vouchers" issued to families with per capita income below Krb 780,000. The voucher covers up to 70% of the housing and utility cost, but no more than Krb 250,000 per family.	Continue implementation of targeted assistance programs including indexing income threshold and level of child benefits for low income families to inflation. To improve targeting, the government will initiate integrated household survey to identify groups of population in the greatest need of social assistance, and to provide information needed for designing a broad range of social policies/programs. The government will implement improved targeting schemes based on survey. Random "spot checks" will be implemented to prevent abuse of means-tested targeting.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
B. Pension Fund			
To strengthen the capacity of the pension system to provide adequate pensions to needy pensioners by tightening eligibility criteria, and, if necessary, reducing the real level of benefits to pensioners that are not needy.	Approximately 27% of the population receive one kind of pension or other. In 1993, the expenditures of the Pension Fund far exceeded the revenues of the fund, and the shortfall of 3% of GDP was made up from the state budget, undermining macroeconomic stability.	Pension expenditures adjusted so as to maintain Pension Fund in balance in 1994. Pension supplements to low income pensioners indexed to inflation. Other pension benefits will be correspondingly reduced in real terms to ensure the Fund is in balance.	Continue to protect pensions of low income pensioners. Based on study on pensions and unemployment compensation (above), initiate measures to strengthen the pension system over the long term, for example by gradually raising the normal retirement age for both genders and by discouraging granting of pensions to active workers.
C. Employment Fund			
To improve the functioning of the Employment Fund so as to respond more effectively to rising unemployment. This will require reducing outlays on administration ineffective programs, such as government-dictated training and credits to state enterprises for "job creation." The savings so generated may be deposited in banks to earn a real positive return, to be utilized when unemployment increases, for demand-driven training programs, or on well-designed "social works" programs. They could also be used to reduce the payroll tax and thereby help to create more jobs.	The Employment Fund, financed by a 3% payroll tax, allocates a disproportionately large share of its resources to creation of Employment Centres and on providing credit to enterprises promising to create jobs. Only a minute fraction of current expenditures are used to provide unemployment benefits, training of jobless workers, and "social works."	Extension of credits from Employment Fund to enterprises for job creation discontinued. Explore mechanism for strengthening benefits for the unemployed, including replacing severance pay in part with unemployment compensation.	Based on study of Social Insurance (above), initiate implemention of comprehensive reforms of the unemployment compensation scheme.

OBJECTIVES	CURRENT STATUS	MEASURES TO BE TAKEN	
	(as of Oct 1, 1994)	Before Nov 28, 1994	Between Nov 29, 1994 - end 1995
D. Social Assistance Programs			
To strengthen social assistance to those who truly need it, financing increases in targeted benefits with reductions in untargeted benefits. To reduce the burden of payroll taxes by eliminating programs that have little social merit.	The Social Insurance Fund, financed by 4.4% payroll tax, finances some benefits for the poor, such as sick and disability pay (40%) and child and maternity allowances for workers and families (20%). However, other benefits it finances, such as visits to sanatoria and vacation camps (40%) have little social merit.		Review expenditures of the Social Insurance Fund with a view to re-directing those poorly targeted and not cost-effective to other purposes.
E. Labor Mobility			
To remove obstacles to labor mobility.	The main constraint is the shortage of housing and the absence of an active private market for housing. Though the Privatization Law of 1992 allows tenants in apartments owned by enterprises and municipalities to be privatized almost free of charge, very little privatization has occurred. Mobility may also be restricted by the propyska, the system of regulations governing movement of workers across regions.	Implemented measures including raising rents on public apartments, to accelerate privatization of housing.	Accelerate privatization of housing. Intiate measures to eliminate use of propyska as a requirement for applying for jobs.

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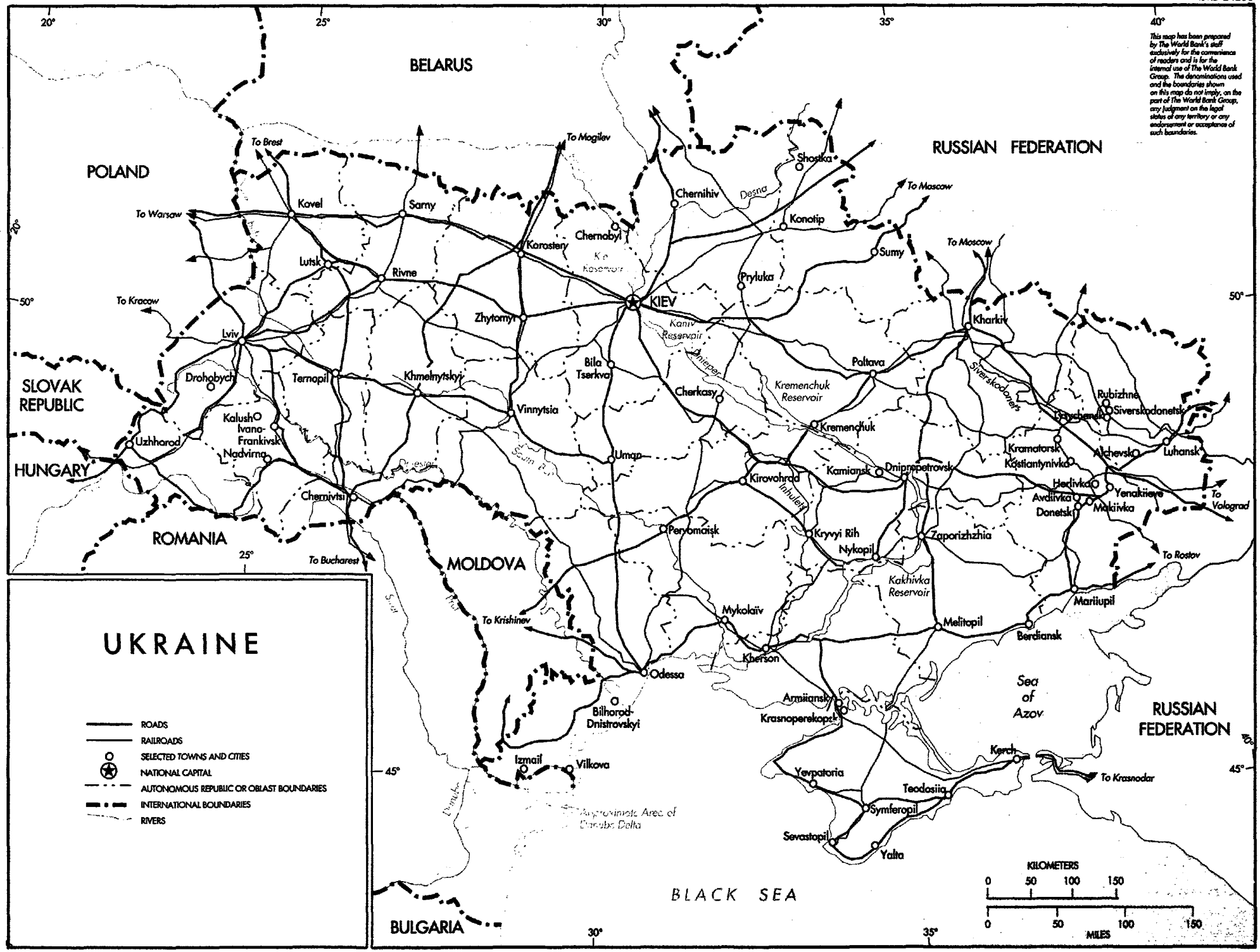

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