EXHIBIT 17

European Bank for Reconstruction and Development

STRATEGY FOR UKRAINE

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1. The Bank's Portfolio

1.1 Overview of Activities to Date

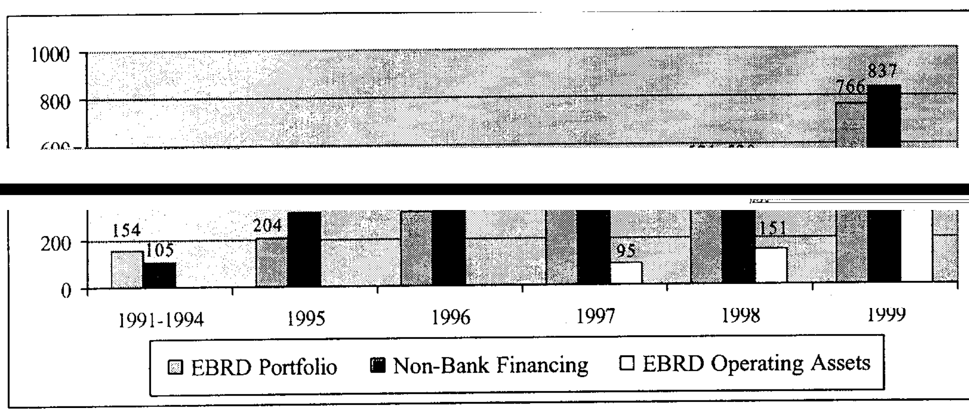
The Bank's Ukraine portfolio consists of 37 signed projects for which it has provided net business volume of EUR 901 million. The portfolio stands at EUR 811 million.

While these commitments only amount to EUR 19/capita, the relatively low disbursed amount for Ukraine (EUR 306 million, only 34% of net business volume) actually represents over 9% of all foreign direct investment in the country ($3.2 billion). In terms of its net business volume of EUR 901 million, the Bank can certainly be characterised as "the largest *and* most diversified investor/lender" to Ukraine.

The commitment to Ukraine represents about 7% of the Bank's global commitments.

The graph below shows the build-up of Bank commitments from 1994 to the end of 1999, showing the parallel build-up of all other funding mobilised for its Ukraine projects. The graph also points out the wide disparity between commitments and actual disbursements.

DEVELOPMENT OF COMMITMENTS, DISBURSEMENTS AND OTHER FUNDING MOBILISED[1]



1.2 Private/public split of the portfolio and sectoral diversity

Figures showing the commitment to individual projects and sectors can be found in the table in Annex 5.1.

57% of the total commitment (EUR 463 million) is for 28 projects in all, classified as "private sector". Of this amount, nearly half is to the financial sector and directed towards SMEs (EUR 195 million). The balance goes to 16 private projects in other sectors and amounts to EUR 268 million. 3 of these projects involve wholly-owned Ukrainian companies but the majority, by far, involve foreign-owned or joint ventures companies. There is a heavy

[1] **Operating Assets**: Loan and equity investments owned by EBRD, net of those written off. Sometimes referred to as "net disbursements". Net Disbursements are defined as Gross Disbursements less (i) total repayments, (ii) prepayments, (iii) sales of net disbursed loans and equity investments and (iv) write offs.

Portfolio: Operating Assets plus undrawn commitments of the Bank.

Net Business Volume: Net of cancellations and sales of commitments.

emphasis in the private sector portfolio on consumer products and services, with food production and processing representing over 31% of the portfolio. Aside from this emphasis, which reflects Ukraine's potential comparative advantage in the agri-business sector, the Bank has been present in private sector projects in such diverse sectors as telecommunications, hotel construction and shipping.

Eleven projects (including two "private" SME-oriented credit lines) worth EUR 508 million have a sovereign guarantee. These projects include loans to the communications, power generation, transport infrastructure and telecommunications sectors.

1.3 Portfolio performance, transition impact and lessons learned

The Bank's Ukraine portfolio is characterised by a slow pace of disbursement, high level of cancellation and uneven performance in debt servicing. Operating assets represent only 37% of portfolio compared with an average of 57% for the Bank's overall portfolio.

Three of the Banks' 37 projects (IASP, Poltava, Zarya) are classified and have risk ratings higher than 7. Of these, two have been fully provisioned and one further project has been written off which is 4% of portfolio. The remaining 34 are still, in the main, at the pre-completion stage and performance is satisfactory.

8 signed transactions and 1 Board approved transaction worth EUR 238 million and 7 partially disbursed operations worth EUR 34 million have been cancelled. A power generation efficiency improvement project has come perilously close to cancellation after several years without major disbursements. Two further projects have yet to commence following lengthy delays in the parliamentary ratification process.

Delays in disbursement and/or project cancellation can be attributed to one or more of the following factors:

- lack of co-ordinated decision-making on the part of the authorities
- fundamental conditionalities, including provision of local counter-party funding, not being met prior to disbursement of public sector transactions
- slow ratification by the Ukrainian parliament
- legal and institutional constraints associated with the lack of structural reform
- lack of compliance with the Bank's procurement rules
- changes in scope and implementing agency

The Bank's activities in Ukraine have had a demonstrated transition impact. Much has been achieved through the SME line of credit in terms of developing the fundamental competence of emerging private banks, and the ultimate beneficiaries of these credits have been a wide diversity of SMEs. Direct Bank investment across a wide range of sectors in larger, high visibility domestic and joint venture enterprises has demonstrated the importance of commercialisation, international competitiveness and sound governance. Early infrastructure projects were aimed primarily at relieving critical bottlenecks (e.g. *Borispol airport modernisation*) but are now increasingly oriented towards commercialisation and structural reform of utilities and services (e.g. *Zaporizhiya Water, Railways Modernisation* projects).

The lessons learned from the Bank's involvement in the private sector include:

- the necessity of involving a strong local party with the management vision and strength not only to meet the Bank's criteria, but also to operate successfully in the Ukrainian business environment
- when foreign investors are involved, it is important to ensure they are able to take a long-term view and are capable of managing inevitable setbacks
- the need to obtain the full support of regional authorities.
- bankable projects are not easy to find and development and execution of such projects can take several years, suggesting that the Bank's improved presence on the ground in Ukraine should be used to cast the net wider to ensure that more and better projects are identified and the implementation time, where possible, reduced.

The lessons learned from the Bank's involvement in sovereign sector projects include:

- the need for support not only from the regional and central levels of government, but also from the legislature,
- the awareness that projects which aim to bring about institutional and structural reform will be difficult to realise and some have even been cancelled (e.g. the *Power Market* and *Wholesale Vegetable Market* projects), while others have remained largely undisbursed and come very close to cancellation (e.g. *Starobeshevo* power generation project)
- the acceptance of the need for well-defined institutional boundaries, sponsors and strong champions, while the Bank itself steers a politically neutral course.

To conclude, in an environment where many political obstacles can arise over protracted lead times to threaten fulfilment of the Bank's conditionalities, a principal lesson learned is that commitments to sovereign-guaranteed projects should not in future be signed ahead of achieving greater certainty that some of the most fundamental conditions will be met (most notable of these have been commitments by state institutions to contribute co-funding to projects), thus raising expectations unrealistically and increasing the likelihood of non-disbursement and/or eventual cancellation. Policy dialogue and use of technical co-operation funds should emphasise the need for legal, regulatory and institutional reform to precede or complement investments by the Bank.

1.4 Portfolio Ratio: challenges and strategy

Ukraine is one of the Bank's largest and most important countries of operation whose transition progress has been slow. It continues to present a unique combination of issues from the perspective of balancing the portfolio, which stands at 58% "private"/42% "public".It has not yet fully reached the targeted 60/40 portfolio ratio, but there has been a clear progress in this direction: 33%/ 67% in 1993, 50%/50% upon the approval of the previous country strategy in July 1997, and now 58%/42%.

It may take a few more years to achieve the 60%/40% ratio. The private sector is still, as of today, relatively new, developing without the benefit of a strong banking system. Large-scale privatisations are imminent but have not yet occurred with the benefit of re-structuring or any significant inflow of western strategic capital. This means that viable private sector transactions still require special efforts to identify and implement. At the same time there are quite a few large-scale public sector projects of a relatively large scale in the Bank's pipeline that promise to have significant transition impact. These projects include a much needed road project, a number of municipal utility and district heating projects, and the potential financing of the completion of the nearly complete nuclear power plants, Khmelnitsky 2 and Rivne 4.

The *strategy* of the Bank with regard to the Ukraine country portfolio ratio is to devote time and resource to the building of private sector opportunities in order, over time, to re-balance the portfolio in the desired manner, assuming that the ratio may be adversely affected in the near term by the addition of large new public sector deals. In all the Bank's *public sector* operations in Ukraine, it will continue to focus, as per Article 11 of the Agreement Establishing the Bank, on supporting "the public sector in its transition from purely centralized control to demonopolisation, decentralisation or privatisation and to a competitive business environment".

There are a number of reasonable grounds for expecting that, towards the end of the strategy period in 2002, the portfolio ratio should be close again to the targeted 60/40 ratio.

1. The enhanced presence of the Bank on the ground in Kiev has been mandated to develop business in the private sector as a primary objective
2. The Bank's pipeline already envisages several major private sector projects
3. Improvements in the investment climate resulting from the general efforts of the present government (e.g. tax reform) leading to stronger capital inflows in the form of direct investment and a climate in which small local private business can grow
4. Important new "demonstration" privatisation projects which encourage further strategic investors (these are expected this year and next in the energy sector and telecommunications)
5. The benefits of the Bank's policy dialogue and of the conditionalities associated with its public utility transactions should begin to show themselves in the form of increased private sector activity and related opportunities for the Bank.

ACTIVITIES WHERE THE BANK HAS AN ADMINISTRATIVE ROLE WITHOUT PORTFOLIO IMPACT

The Bank is administering the grant funded Chernobyl Shelter Fund and the Nuclear Safety Account on behalf of the donor community and is supporting the G7 Memorandum of Understanding on Chernobyl through participation in the preparation of alternative generating capacity. The Bank also initiated the creation of the multilateral Energy Task Force aimed at raising cash collections and accelerating privatization in the energy sector.

Technical co-operation activities include 155 projects for EUR 31.6 million and are mainly for project preparation and implementation (see Annex 5.2). The Bank is an active founder member of the Foreign Investment Advisory Council (FIAC), established in 1997 with the support of President Kuchma to facilitate improved foreign investor relationships and an improved investment environment.

2 Operational Environment

2.1 The General Reform Environment (a fuller assessment is provided in Annex 1)

2.1.1 Political Developments

Despite achieving a peaceful consolidation of Ukraine's sovereignty, the President and his previous governments have found it almost impossible to build a national consensus and persuade political parties to coalesce around a clear reform agenda. This lack of consensus has been the key obstacle to progress with economic transition. Disagreements between the President and the Rada have been a constant feature of Ukraine's political system. In this divided system, informal clans based on regional and sectoral ties have come to play an unusually influential role in the policy process. This has led to pervasive corruption at all levels of the system, perceived to be among the highest of any of the transition countries.

The re-election of President Kuchma, the appointment of Mr Yushchenko as Prime Minister and the creation of a new pro-government majority in the Rada have created the potential for a political breakthrough on reform, but serious risks to political stability remain. President Kuchma and his new government have launched an attempt to restructure the political system to address many of the fundamental problems that have held back reform. They have wrested control of the Rada away from the leftist parties. In the year to date this initiative has produced dividends as the parliament has approved important parts of the government's reform programme which hitherto it has either opposed or seriously delayed. [redacted] an issue which parliament had opposed for a number of years. However, the vote in President Kuchma's controversial national referendum held in April risks sparking a constitutional crisis in Ukraine that could provoke additional political uncertainty. The referendum was strongly opposed by the parliament, partly because it argued only it has the right to call for referenda under the current constitution, but also because the changes proposed by the President could lead to a substantial weakening of the parliament. Much will depend on how [redacted]

2.1.2 Environment

The environmental situation in Ukraine has not significantly improved. Public participation and consultation in environmental decision-making is still limited. The most significant issues involve atmospheric pollution in urban and industrial areas, water pollution in rivers and the Black Sea and solid and hazardous (including radioactive) wastes, inefficient and highly polluting thermal electricity generation using low-grade local coal. Health statistics indicate a significant increase in mortality and morbidity, which is likely to be linked to environmental pollution.

An environmental policy document, "Main Directions of State Policy for the Protection of Environment, Use of Natural Resources and Environmental Safety" was finalised in 1998 by the government. The document identifies a range of environmental "hot spots" such as the Donetsk Oblast (a principal centre for coal mining and heavy industry) and lays down long-term environmental policies. However, further work is needed in order to prioritise environmental issues and to prepare financing plans for environmental investment. Clean-up and decommissioning of the Chernobyl nuclear power plant are among the highest environmental priorities of the Ukraine government.

For EBRD's industrial sector projects, improvement in energy efficiency as well as mitigation measures for air and water emissions will be achieved through the implementation of cleaner production technologies and the promotion of sound environmental management practices. Annex 2 provides further information on environmental development.

2.1.3. Legal Environment

A sound and effective legal framework for the creation of a market-based economy in Ukraine is still needed. Actual and consistent implementation, rather than the passage of new decrees, is the chief missing ingredient. Ukraine is known for frequent and unpredictable legal and regulatory changes. During 1999 positive advances were made with the adoption of new legislation on bankruptcy, concessions and accounting standards. However, the effectiveness of this legislation can only be determined through its use by the private sector and enforcement by government agencies and the courts. Recent steps by the President and Rada to revise retroactively privileges previously extended to foreign funded ventures will continue to raise uncertainty among foreign investors (although the Bank's position has been and remains that there should be a level playing field without special incentives for foreign investors). The Bank has experienced difficulty in obtaining authoritative interpretations of the existing laws making investment difficult and risky even in areas apparently covered by existing statutory regimes.

A key problem is the inconsistent and ineffective application of commercial law. Additional attention and resources need to be given to the development of effective implementing agencies (e.g., the Securities Commission and an independent telecommunications regulator) as well as the court system. Foreign investors look beyond the passage of laws to their effective enforcement and application: ineffective implementation is one cause of low foreign investor interest in Ukraine.

The EBRD can play a role in the legal transition process by continuing to press the Government to make progress on legal reforms through policy dialogue and by looking for opportunities to assist the Ukrainian legal reform effort where these reforms support the Bank's operations and priorities. **Key areas for Policy Dialogue in this area are highlighted in Annex 3.**

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions for Bank Operations

During the first few months of this year industrial production has continued to grow steadily, there are indications of an increase in bank deposits and lending and lower interest rates, while during the first quarter there was a small budget surplus so that the government did not have to borrow from the National Bank of Ukraine (NBU). During the first four months of the year GDP rose by 5.5% over the low level of output in the first quarter of last year. The prospects are for GDP growth of 2% this year, although all these data exclude the informal economy where activity has continued to increase and which may now be as large as the recorded economy.

Economic growth this year will represent the first year of positive growth after a decade in which Ukraine recorded declines in GDP every year, mainly because of the slow pace of reform. Towards the end of the decade, and in common with many CIS countries, the Russian crisis had an immediate impact on domestic output as demand fell in both Russia (exports to Russia represented 7% of Ukraine's GDP) and in the domestic market (real wages fell by over 5% in 1999). The exchange rate also fell sharply, one effect of which was to increase the external debt burden, both as a share of GDP and in terms of the amount to be financed from the budget. The Government sought to limit the initial impact of the crisis by announcing a package of anti-crisis measures. These measures slowed the rate of devaluation, but were unable to prevent a sharp decline in reserves and the need for some rescheduling of both domestic and external debt.

In these circumstances it became essential to reduce the budget deficit. The government had considerable success in cutting back expenditure so that the deficit was halved in 1998 and then fell to 2.4% in 1999. However, the underlying fiscal position remained weak owing to the tolerance of tax arrears and other forms of state support including state guarantees to enterprises and tax exemptions to specific groups. Estimates of the amount of revenue lost from these exemptions (especially on VAT) are substantial and raise the tax burden on other parts of the economy.

The Rada approved the Government's budget for this year with a zero deficit (or –1.7%of GDP (if projected privatisation revenues are excluded). The budget includes a number of measures designed to boost tax revenues including limits on netting out, reducing the scale of VAT exemptions and specific targets for revenues from gas transit fees. In addition there is to be more emphasis on targeting spending, while there are provisions to cut expenditure if taxes are underpaid. The main challenges the government will face are the need to meet its commitments, especially to reduce wage and pension arrears, contain the deficit and to maximise cash receipts to the budget. The latter is partly dependent on the success of the privatisation programme, the revenues from which are assumed to finance the deficit.

With the departure of most domestic and foreign banks from the Treasury bill market towards the end of 1998, the government became almost entirely dependent on the NBU to fund the deficit via purchases of government securities. This, together with occasional purchases of hard currency to increase foreign exchange reserves, resulted in an easing of monetary policy. Base money rose by almost 40% and contributed to the weakness of the exchange rate. Other factors also resulted in pressure on the rate at particular times, including the removal of most foreign exchange restrictions in March 1999 (the main exception being the 50% export earnings surrender requirement), the shortage of oil products in mid-1999 and political uncertainty in the run up to the elections. Thus the Hrynia fell from HR 2.14/US$[2] at the onset of the Russian crisis to the bottom of its (revised) corridor of HR4.6 in November last year. With limited reserves the NBU then had little alternative but to let the currency float, a policy which was formally announced in February this year. By June the rate had fallen to HR5.4, the decline slowed by administrative measures.

These events had a number of important economic consequences. These included:-

i) the earlier decline in inflation was reversed so that the CPI (annual average) rose by 23% last year and is projected to increase by a similar amount this year;

ii) the large fall in the nominal rate was sufficient to result in a real depreciation of the Hryvnia against the US$, reversing the gradual real appreciation that characterised the period up until the Russian crisis. Ukrainian industry as a whole responded to this stimulus and the boost to competitiveness from the fall in the exchange rate is an important factor behind the recovery in output;

iii) in addition domestic output has been relatively successful in replacing imports so that despite the overall collapse in trade volumes, the current account moved into surplus last year, easing Ukraine's financing problems.

The important issue is whether this recovery in output will be sustained through the period covered by the strategy and beyond. One of the principal problems has been the persistence of soft budget constraints, reflecting the ineffectiveness of earlier bankruptcy procedures, the tax and regulatory obstacles to market entry especially for SMEs, and continued state support. Although a majority of agricultural enterprises (mainly state owned) and around half of all industrial enterprises are reported to be unprofitable, many loss making enterprises have been able to remain in production. The new bankruptcy law, which took effect from the beginning of this year (though not in agriculture until 2004), as well as the land ownership reforms now underway in agriculture, should result in improvements over the longer-term.

The lack of hard budget constraints has contributed to the growth of non-monetary means of payments, obscuring the transparency of transactions and thus the extent to which entities add value to the economy. It is particularly prevalent in the state sector; in the private sector there is a much greater tendency to use cash. Within the enterprise sector, inter-enterprise arrears have steadily increased from 56% of GDP in 1995 to almost 140% by the first quarter of this year, and although some of the arrears represent revolving trade credits, half are classified as overdue. The energy utilities have emerged as one of the main sources of credit to heavy industry, agriculture and under-funded state sector institutions. Barter has been one of the main form of transaction, especially within agriculture, although the proportion of domestic trade settled by barter has now fallen to below 20% following recent government measures. In general these practices assist the non-profitable enterprises in remaining in business and accentuate the payments problems of more profitable companies. All these trends have been made worse by the shortage of bank credit - the ratio of bank credit to enterprise payables fell from 10% in 1995 to 3% last year.

Although industrial production has increased, the absence of hard budget constraints has contributed to the lack of any major change in the structure of industrial production. Thus it

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2 The Hryvnia was introduced in September 1996 at 1.76 HR/USD and in the month before the Russian crisis had weakened to only HR2.14, close to the limit of its then band of HR1.8-2.25. In September 1998 the NBU announced a new band of HR2.5-3.5, but the rate fell sharply to HR3.42 by the end of that month. With the introduction of foreign exchange restrictions the NBU was able to hold the rate at this level until March 1999. In anticipation of the removal of the restrictions in the foreign exchange market, a new corridor of HR3.4-4.6 was announced and the rate was then allowed to fall. The rate fell out of this band in early November and was allowed to float. The change in the policy towards the exchange rate was formally announced in February 2000.

is primarily heavy industry, especially steel and metals, which have been responsible for much of the growth of output so that their share of industrial production has increased from 16% in 1994 to 26% in 1999. The output of the engineering sector (machine tools) has collapsed while there has been a modest decline in the share of output from light industry. As a result of these trends, the share of exports of metal and chemical products has now risen to around half of total direct exports (and exports of metal products also represent some 40% of metal production). As competition in metal and chemical products on world markets remains strong, Ukraine producers have been subject to allegations of dumping.

A further consequence of these trends is that the energy intensity of production in Ukraine remains very high, since steel and metals are among the largest consumers of energy. Estimates by the IEA in the mid-1990's indicated that the energy intensity of production in Ukraine was at least five times the OECD average.

In the ***agricultural sector***, state intervention and the slow pace of privatisation have also inhibited structural change. Land share certificates have been distributed to virtually everyone on the 11,000 collective agricultural enterprises so that these farms have been privatised in a technical sense. However, the opposition to private ownership of land has delayed the development of a land market, and thus of collateral (other than farm products).

In recent years the government, through state monopolies, has provided many of the necessary inputs, seeking repayment of the loans through purchases of farm produce. The relatively low (implicit) prices received by farmers in their transactions with the state have reduced incentives, while the dependence of the farmers on the state has limited the opportunities for the private sector, especially in the supply of inputs. The result of an increasing resort to barter relations has been a drastic fall in the production of grain and livestock – since 1990 gross agricultural output is estimated to have fallen by almost 45%, and by even more from state sector farms.

2.2.2 Transition Success and Transition Challenges

Progress in Transition: In terms of structural reform, progress has been mixed. The original small-scale privatisation has been completed and the mass privatisation programme was completed last year, with over 9,500 enterprises more than 70% privatised. Privatisation of larger size enterprises (including some of Ukraine's largest enterprises in metallurgy, chemicals and the energy sectors) has been slower. This partly reflects opposition in the Rada to privatisation, especially of Ukrtelecom. On average about 40% of the electric power utilities have been privatised, but progress slowed last year until a Presidential decree in August provided for the sales of these companies to strategic investors.

The initial attempts last year to sell shares of the larger commercial enterprises via open tenders was relatively unsuccessful owing to the lack of transparency of procedures and

enterprises combined with the initial emphasis on sales to management/employees and through vouchers has meant that only a few enterprises have benefited from new management or additional capital. As a result industrial restructuring has been very limited.

A combination of the need to accelerate the pace of privatisation and the need for more revenues for the budget have resulted in the government proposing a more radical privatisation programme for the period 2000-02, which the Rada recently approved. The emphasis will be on cash sales including the sale of controlling stakes in many of the 252 large and /or strategic enterprises to strategic investors (both domestic and foreign) and on improving the transparency of procedures. Progress with the privatisation of the power utilities, as well as with Ukrtelecom, will be essential if the ambitious revenue targets of HR 2.5 billion (and more than double this in both of the following two years) are to be met.

The government has begun to address some of the problems that have emerged in the agricultural sector. A recent Presidential decree on land reform provides for the transfer of ownership of collective farms to their members, which was completed in April. The main challenge is to ensure that each member has the right to develop their own land and property. A programme of land registration will commence which should eventually provide the basis for using land as collateral. The government also recognises the need to reduce the extent of state intervention in agriculture. In the ***banking sector*** there have been some important positive developments, including the introduction of IAS for commercial banks, the completion of diagnostic studies of the seven main banks (five of which are state owned). The Rada approved a new law on the NBU last year which clarifies the NBU's functions and its relations with both government and the Rada, and is also currently considering a new draft law on the banking sector. However, the sector remains underdeveloped with a low deposit base, while credit to the private sector was equivalent to just 9% of GDP at the end of 1999. The sector is also highly concentrated with the seven largest banks (of the 163 banks operating in Ukraine) accounting for 53% of sector assets. Although bank capital has increased in local currency terms to meet higher reserve requirements, the fall in the value of the Hryvnia has left many banks under-capitalised in dollar terms.

The sector will require considerable institutional strengthening if it is to support economic recovery. Injudicious use of the tax enforcement mechanism known as Kartoteka[3] has in the past forced many enterprises to do business outside the banking system. Following a Presidential decree in mid-1999, the Rada is currently reviewing legislation which would abolish the practice, while preserving the State's rights to collect taxes via asset sales, an approach which could lead to more bankruptcies.

Progress in certain other areas has been mixed. Ukraine is still negotiating to join the WTO and it is probable that the tendency to resort to certification procedures and non-tariff barriers to protect domestic industry has slowed progress. Although a large degree of price liberalisation was achieved in the early years of transition, the extent to which non-monetary means of payment are now used has obscured price signals.

The business environment: There have been a number of specific examples of progress since the last Strategy including a package of deregulatory measures for business, a simplification of tax and accounting procedures for small companies, a reduction in the payroll tax (to 37.5%) and the introduction of a flat corporate tax (of 30%). In addition the Rada is considering the draft of the Civil Code and will also shortly review the Government' proposed Tax Code.

A recent survey of nearly 250 Ukrainian enterprises[4] (including new, privatised and state owned companies) revealed, however, that the ***investment climate*** remains difficult. Excessive tax rates, costly compliance procedures and a discretionary regulatory regime were identified as the main constraints on the expansion of business and investment activity, confirming the results of earlier business surveys in Ukraine. The overall rate of corporate sector tax, the complex compliance procedures for making both VAT and payroll tax payments and delays in receiving reimbursement of VAT on imports, remain major concerns. In addition the ambiguities and uncertainties in respect of the large number of permits and

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[3] The practice known as Kartoteka gives the tax authorities the right to freeze the bank account of a debtor company and have first call on any revenues coming into that account. This limits the ability of the debtor to meet their obligations to other creditors, contributing to the persistence of inter-enterprise arrears.

[4] The survey results, based on the responses from enterprises in 20 of the Bank's 26 countries of operation, were included in the Transition Report 1999 (see Chapter 6 in particular).

licences required in all areas of business have created a plethora of rent seeking opportunities. The excessive and discretionary tax and regulatory regime also explains why some of the emerging private sector has been pushed into the informal economy, with important fiscal implications relating to tax collection and pension reform.

The government has taken some measures to promote foreign direct investment (FDI), although the record has been mixed. A number of Special Economic Zones have been established with the intention of attracting projects which introduce new technology and create more employment through the provision of tax incentives. Although the original intention was to provide standardised terms for such zones, under pressure from the regions the approach has become increasingly case by case so that the nature of the tax concessions and their duration has differed between the zones. This led the government to suspend the policy towards the end of last year pending a review. The Law on Concessions (of state and communal property) could create new opportunities for investment in municipal infrastructure.

The Task Ahead: Among the main challenges for the new government are the need to exploit the comparative advantages of the economy, most notably its agriculture and skill base, but also its mineral and energy resources within the industrial sector. The new law on Production Sharing Agreements could lead to higher investment in mineral resources. In the competitive world markets for the commodities and intermediate products that Ukraine produces, industry cannot rely on a weak exchange rate to maintain competitiveness. Industrial restructuring is essential to ensure rationalisation of product ranges and stronger productivity growth and would also contribute to the urgent need and huge potential for greater energy efficiency.

Both President Kuchma and the new government led by Mr Yushchenko have announced programmes to address the main issues. At the end of January President Kuchma presented his "Strategy of Economic and Social Policy for 2000-2004" to the Rada. The programme includes various macro-economic measures to achieve economic growth over this period. In April the Rada approved the Government's reform programme for 2000-04 which identifies four strategic goals. These are development of Ukraine's human resources, reduction of poverty, increasing competitiveness of the economy and the promotion of closer integration with the European Union. Underpinning the programme will be the government's emphasis on improving governance, including the continuation of the reform of the public administration, designed both to reduce the size of the administration and decentralise responsibilities where possible.

2.3 Access to Capital and Investment Requirements

Investment expenditure in the economy as a whole has fallen sharply in real terms from 27% of GDP in 1995 to an estimated 20% last year in a situation in which recorded GDP has contracted, although investment may have risen in the first quarter of this year. Savings have also declined, although by a smaller amount, reflecting the deterioration in the enterprise sector and the weak banking sector. Opportunities for raising capital within Ukraine are limited. Much of the growth in domestic credit has been to the government sector and, as noted above, credit to the private sector accounts for less than 10% of GDP. Lending to the private sector is constrained by its cost (the weighted average of commercial bank's nominal interest rates was over 50% last year, implying continuing high real rates) and general uncertainties that limit most maturities to less than six months. The capital market has not been an important source of new capital, though this might change if there is successful privatisation of utilities involving foreign investment and foreign portfolio investor interest in Ukrainian equities can be rekindled.

Foreign capital, especially FDI, has thus been relatively important in meeting some of the investment requirements. Annual inflows of FDI have slowly increased in recent years, although amounted to just USD 489 million in 1999, equivalent to 1.6% of GDP. The stock of FDI is USD 3.3 billion with food, domestic trade and engineering the main recipients. But this level of FDI is only a small fraction of what Ukraine needs to restructure and modernise its industrial sector and is paltry compared to levels in neighbouring countries. Flows of FDI have been constrained by the difficult investment environment.

There has been virtually no syndicated lending to Ukrainian entities in recent years although a few large enterprises have issued ADRs. The government accessed the international capital markets between mid-1997 and mid-1998, including two eurobonds and issues linked to domestic treasury bills, but the terms were unfavourable. In addition the spreads deteriorated sharply after the Russia crisis, implying that Ukraine would have difficulty in accessing these markets for some time to come.

With low reserves and weak exports the authorities undertook several reschedulings of its external commercial debt, as well as some of its domestic debt. However, the result was to accentuate the very peaked debt repayment profile for the years 2000 and 2001. In order to avoid a default, earlier this year the authorities announced the terms for the rescheduling of $2.6 billion of its short-term commercial obligations, giving investors the opportunity to swap into medium-term paper. The offer was successful; not only did the vast majority of bond-holders accept the terms, but it also represented the first rescheduling where a large proportion of the creditors were retail, rather than institutional, investors. The agreement will lead to a much needed flattening of the debt repayment profile, although debt service payments will still amount to over $1 billion a year for the next few years.

Against this background, Ukraine's main sources of external funding in the immediate future are likely to be the IFIs and other official lenders until it establishes a sufficient track record in both stabilisation and reform, and thus regains credibility in international capital markets. This emphasises the importance of Ukraine remaining on track with the IMF programme.

3. Strategic Orientations

3.1 Priorities for Strategy Period

The Bank's operational Strategy aims to support Ukraine's transition to an open market economy, having given careful consideration to the need for focused selection of areas where:

- the Bank can build on its track record and experiences to date and its in-country competence
- the Bank is best placed to advance and meet the country's immediate transition objectives and requirements, and to play a policy reform role, and
- the Bank's operations and activities will best fit with and complement other IFI and donor economic development and transition initiatives.

In line with the above requirements, the Bank's operational Strategy has four complementary components aimed at:

i. meeting SME, micro enterprise and emerging private sector credit needs by enhancing the intermediation capacity of the emerging private banks and facilitating development of new credit delivery vehicles

efficiency to improve their operational efficiency, self-sustainability while encouraging overall amelioration of the environment

iii. improvement of nuclear safety both country-wide and in the context of Chernobyl,

iv. facilitating transition of the corporate enterprise sector with particular emphasis on enterprise restructuring, transfer and demonstration of management know-how and catalysing foreign direct investment.

During the strategy period, the Bank will take a more aggressive approach to seeking out new private sector business opportunities in Ukraine, having in mind the importance of adhering to its private/public portfolio ratio priorities notwithstanding the potential impact of a project such as K2R4. The past 8 years have seen the build-up of a country portfolio which has required, in some areas, considerable management attention and deflected resources from the need to refresh the pipeline of new business. With the advent and growth of decentralisation as a principle of the Bank's organisation, and against a backdrop of a reform-minded regime in Ukraine, the Bank proposes to use its forces in Kyiv as well as London to extend its range of project opportunities in the country, enhance its selection capabilities while ensuring a satisfactory level of portfolio performance.

Key areas of continuing policy dialogue will be banking sector reform and consolidation, [illegible]

the areas of power, water, gas, transport and telecommunications.

At the same time, "opportunism with an eye to strong demonstration effect" will need to be a principle underlying the Bank's search for new business, opportunism in the sense that highly bankable private sector projects with exceptional management will be valuable assets indeed in the Ukrainian context, *regardless of the particular sector in which they occur.*

In terms of taking on future commitments, the Bank will focus especially hard on implementation of current facilities where a programme of multiple transactions has been initiated (e.g. lines of credit, operation of specially created institutions such as the MicroFinance Bank and Ukresco), and concentrate on effective management of client expectations by signing transactions only when many fundamental conditions have already been met.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Financial Sector and SMEs

Underlying objectives and background

The Bank's strategy in the financial sector remains focused on promoting growth of the SME sector. During the strategy period, it will continue bank strengthening to improve credit delivery, explore new means of credit delivery in line with the ongoing reform process and, in addition, make fresh efforts to champion the cause of SMEs and promote a healthy environment for their further development by actively engaging state interest in their future, bearing in mind the three pillars of the Banks SME Strategy.

(a) Banking sector

The banking sector was weakened in the aftermath of the Russian crisis and both the capital base and profitability of the banks remain low. The aggregate capitalisation of the Ukrainian banking system as at 31 December 1999 was HR 5.1 billion (Euro 850 million). Confidence needs to be restored, enabling banks to attract deposits and expand their lending to the private sector, thus supporting the development of the real economy.

Over the last several years, a mismatch between tight monetary policy and lax fiscal policy has resulted in a credit squeeze. The result has been unrealistically high interest rates and a shortage of credit for the productive sector. Although the average lending rate for local currency credits fell from 54% in the first quarter of 1999 to 41% by the third, cost remains a deterrent to many enterprises.

Banks are still not seen by a great many smaller and larger enterprises as reliable, professional partners offering a reasonable source of financing. Much of this is due to officialdom's continuing disregard for customer/bank relations in its application of heavy-handed techniques such as "Kartoteka", mentioned elsewhere. Indeed banks are often viewed as convenient databases for tax inspectors rather than sources of credit.

Achievements to date

EBRD has made a significant contribution to the Ukrainian banking sector based on a strategy that initially aimed to establish vehicles providing debt and equity financing for SMEs. The Bank's strategy to date has provided tools to complete significant transactions whilst showing no losses, no specific provisions and only one write-off, BNP Dresdner. EBRD's total commitment to the financial sector amounts to EUR 195 million (or 24% of total portfolio). Main transactions are the following:

- Through the SME Line of Credit, the Bank has participated in the strengthening of the banking sector, and has disbursed over USD 140 million of scarce medium term finance to 153 private SME projects.
- The Bank is also a significant investor in the country's banking sector, and has invested equity in three banks (FUIB, WUCB, KIB).
- The Bank granted a subordinated debt facility to Raiffeisenbank in 1999.
- The Bank also participated in three equity funds with a reasonable track record given the uncertain environment (Ukraine Fund, East Ukrainian Post-Privatisation Fund, Black Sea Fund).

Long-term vision

In Ukraine, the Bank, in its dialogue with the National Bank of Ukraine to procure more rigorous regulation of the sector, sees a need for a broader based and professional banking network to cover and foster growth in the micro and SME sectors and the commercial industrial and trade sectors. There is a need for at least two significant retail and deposit gathering banks with a comprehensive national network, two wholesale banks offering a range of corporate investment, industrial and trade services, six to ten regional banks offering service for micro to corporate clients and another three to four foreign bank branches to facilitate foreign investment, trade and corporate and project lending. *Operational Priorities in the Banking Sector*

Implementing Commitments to the Micro and SME Sectors and Strengthening the Banks

The Bank will focus on efficient implementation of the SME 2 credit line. The eligibility criteria for the SME 2 are stricter than for SME 1 and this, combined with the weakening banking sector, the illiquidity of treasury bills and depreciated hryvnia based equity, means that only one bank meets the more stringent criteria. Discussions are ongoing on a step-up criteria that would allow more banks to participate in the program and five new applicants are presently being assessed.

The Bank is also finalising a Ukraine Enterprise Support Facility (UESF), a framework facility of USD 50 million, for senior debt financing for periods up to 5 years. This facility uses a selection of leading Ukrainian banks as on-lending channels to other enterprises. Four participants are expected in 2000 (Credit Lyonnais Ukraine, FUIB, KIB, WUCB), and discussions are ongoing with three more potential participants.

The Bank has also taken the lead role in the establishment of the Ukraine Microfinance Bank (MFB), which will provide financial services to Ukrainian private micro enterprises. MFB will enhance the intermediation, and competition in, the field of micro finance. Other shareholders include IFC, the German-Ukrainian Fund, the Western NIS Enterprise Fund and the German IMI; a joint stock company specialised in equity investments in Microfinance institutions. In addition to their EUR 10 million equity contribution, the shareholders have agreed to provide up to EUR 35 million in debt finance, including a EBRD credit line of EUR 10 million. A TA budget will be provided to enable the bank to expand its lending activities to up to 8 regions within 2 years. MFB will start its operations in 2000. MFB will actively seek a local/strategic investor, as the shareholders are committed to offer up to 20% to such an investor.

Direct Investment in Banks

The Bank is aiming to develop a portfolio of direct equity investments in Ukrainian banks, designed to provide capital strengthening, support long-term funding, encourage other investors as well as depositors and improve corporate governance standards and financial discipline. Some of these investments will be effected through the Multi Bank Equity Facility, a USD 20 million framework approved in 1997 for equity and convertible debt transactions. The Bank will also continue to explore the possibility of providing subordinated loans, such as that signed with Raiffeisenbank, to other interested foreign banks in Ukraine.

Trade Facilitation

Ukraine is one of the main countries targeted under the enhanced Regional Trade Facilitation Programme. The constraint, however, is that there is only a low volume of conventional L/C based trade finance ,and that it tends to be conducted via the larger banks, often in the state sector and/or is unable to meet "sound banking" criteria. The volume is thus likely to be limited. The current focus is to work with a priority list of banks that are both sufficiently creditworthy and have genuine trade transactions to support. This group includes foreign owned banks operating in Ukraine.

(b) New Credit Delivery Mechanisms

The Bank has also been working with IFC and bilateral agencies to prepare the way and to identify opportunities for establishing ***asset based financing***. There is a sizeable volume of cross-border leasing and some local banks have set up leasing type operations, but as yet there are no special purpose leasing companies. A specific leasing law has been prepared for parliamentary consideration, but for leasing to develop more widely, a broader set of constraints will need to be addressed including the lack of legal clarity on ownership and repossession rights, and inconsistencies and ambiguities in respect of depreciation of and application of VAT to leased goods. Such legal obstacles will be addressed through policy dialogue.

(c) Non-bank Financial Institutions

The Bank will continue to look for, opportunities to assist foreign strategic sponsors in the insurance sector, although the capital requirements for start-up insurance operations are small relative to the Bank's preferred minimum investment contribution. Nevertheless, a dialogue is underway with 3 major international insurers on co-investing with them in Ukraine.

It is today unclear what future role the Bank might play in the systemic development of the securities markets in Ukraine in the light of heavy technical assistance contributions already made from other sources and the Bank's project-oriented, rather than capital-market based, emphasis (although the Legal Transition Team has been considering some work in this area – see Annex 3). If market regulation, the legal framework, and trading volumes improve, the Bank will consider a greater participation in investment fund opportunities and other capital-market-related business. Pension is still at an early stage and awaits reform as well as serious capital market development. A recent increase of the minimum capital required for insurance companies creates opportunities for joint ventures and foreign companies to establish a presence in the local market, as Ukrainian insurers are not able to raise such amounts.

(d) Promotion of SMEs beyond use of bank lines of credit

A brief discussion of the role of SME's in Ukraine and the institutional support they receive is given in Annex 7.

but using the leverage which this extensive involvement provides. It will seek in particular to promote the interests of SMEs operating in Ukraine and demonstrate the value of such private sector development to the State and State-owned organisations with an interest in more commercial functioning. It will also seek more actively to promote its credit lines, DIF facilities and other equity instruments through various Ukrainian SME-support organisations and business centres operated with donor funding in various regions of the country.

Through policy dialogue with the government the Bank will aim to achieve the following improvements in the climate for SME operation, smaller companies being particularly vulnerable to the obstacles described in Section 2 of this paper:

- More consistent implementation of tax laws and reduction in the number of taxes
- Less bureaucratic procedures relating to certification
- The final and complete abolition of the system known as "kartoteka" whereby the tax collecting authorities still act as though exercising the right to freeze enterprise bank accounts ahead of court proceedings to establish whether tax is due. *Aside from the damage done to small enterprises, this negatively affects the perception of banks as reliable intermediaries.*

The Bank also plans to select and implement a number of cases where it can intervene in, or catalyse, a state-owned company's commercialisation plans by helping to evaluate opportunities for spin-offs. The objective would be to facilitate the transition from ancillary units to independent businesses, and to persuade the state-owned company of the merits of this change in terms of the reduced burden on its budget. A pilot project is already underway with the Ukrainian State Railways administration and further similar opportunities will be sought.

The Bank plans additionally to concentrate on business promotion opportunities in certain selected regions in Ukraine where the local authorities are well disposed towards job creation initiatives in the light of the decline of traditional industries (e.g. Lugansk and Donetsk in Eastern Ukraine, where SME "demand" could be stated to be high in the light of the continuing misfortunes of the mining industry) and where donors have helped to establish business centres. In pursuing this aspect of the strategy, the Bank will exploit synergies with its existing contacts with municipal and local authorities, as well as utilise contacts obtainable [illegible] TRANSFORM, and USAID. If the Bank is able to provide funding through intermediaries or the marketing assistance of these business centre organizations, this should assist in realization of pillar 3 of the SME Strategy, by enhancing the value of these centres to the SME communities which they serve. <u>The Bank may in the future consider a pilot project to finance directly or indirectly SME opportunities in the telecom and internet sector.</u>

Finally, the Bank may attempt to raise the profile of SMEs and the role they play in the life of the country by public relations initiatives, such as promoting a competition run in conjunction with selected Ukrainian Banks participating in the SME lending program, to reward promising new investment initiatives by SMEs themselves. Such a competition is under discussion and, if considered appropriate, will be launched in autumn this year.

[illegible]

- ***For the banking sector***: legal infrastructure for banking activities, tighter prudential rules, enforcement of prudential rules, improvement and enforcement of bankruptcy law.
- ***For capital markets***: increase of transparency, consolidation of broking activities, stock exchanges and of registrars.
- ***For pensions and insurance sectors***: finalisation and enforcement of a workable legal framework.

- ***For SMEs***: improvement of the legal system and enforcement of legal decisions, simplification and rationalisation of the tax system, reduction of the administrative burden, reduction of the level of corruption in the state sector.

More specifically in the banking sector, key issues for dialogue are:

- The required increase in the capitalisation of the banks cannot be met from government or retained earnings. It will require foreign capital and expertise that will only come as the regulatory environment and investment climate improve.
- The need for consolidation in the sector through mergers will be difficult, given the lack of transparency in ownership structures, but will accelerate with NBU's increased emphasis on supervision. The Bank will position itself to facilitate and encourage such mergers.
- The privatisation of several banks and liquidation of insolvent banks are also essential. The Bank will assist this process actively wherever possible, by assisting performing banks prior and during their privatisation.
- Increased transparency and depoliticisation of the sector. The Bank will continue to promote good corporate governance in the banks in which it is an investor through active participation as a Board member.
- The Bank will continue to recognise the important role of regional banks in the economy, and will seek ways of working with the various regions of Ukraine through credit lines or investments in regional banks.

3.2.2 Public Utilities and Services

a) Energy Efficiency

Transition Goals and Strategy

The Bank's energy efficiency goals are facilitation of more focused attention to decreasing energy wastage through demonstration of specific sector initiatives such as Escos.

Ukraine remains one of *the worlds most energy intensive industrialised countries*. The level of energy wastage imposes an enormous burden on the economy and the environment, indeed it constitutes a central structural challenge and renders the country vulnerable, especially in view of Ukraine's need to import some 70% of its energy resources. Thus, on top of social issues associated with the closure and restructuring of loss-making or non-viable industries, Ukraine has to suffer pressure in its balance of payments and its indebtedness, owing to its liabilities with regard to Russia and Turkmenistan. Improving energy efficiency is thus fundamental to Ukraine's economic recovery and transition and its future international competitiveness. As such it is an important priority for the Government of Ukraine and a core component of the Bank's operational Strategy. While there is no energy efficiency sector as such, all activities aimed at realizing the potential major economic and environmental gains from improved efficiency of energy utilization can be considered to fall within the energy efficiency sector.

Bank activities in the energy efficiency sector have been directed at establishing the first Energy Service Company in Ukraine (UkrEsco) and at identifying project possibilities in the district heating sector. UkrEsco was established as a joint effort between the Bank, the Government and the EU. It is the first project of its type and is the major programme in Ukraine for providing financial and technical resources needed to improve the energy efficiency of industrial, commercial and public sector clients. As well as investing a total of EUR 30 million in energy saving projects, UkrEsco will have a major transition impact by demonstrating the operation of ESCOs in Ukraine. The Bank's priority is to make UkrEsco work properly, identify commercially viable projects and ensure smooth funds disbursement.

The ***district heating sector*** remains a concern as the reforms necessary have not been addressed by government or municipal authorities. The main transition constraints include:

- poor collection ratio of heat utilities, severely limiting cash flow;
- inadequate tariffs combined with an inefficient subsidy structure that is rarely paid on time or in full;
- lack of clarity in commercial arrangements between district heating companies and municipal owners; and
- lack of any strategy by government or municipal authorities to address district heating reform.

In these circumstances it remains difficult to attract private sector finance or to identify financially viable projects in which the Bank may invest. The Bank's project focus in the district heating sector includes the major rehabilitation programme underway in Kyiv and a possible regional programme to finance rehabilitation in smaller cities. Both these projects would be under sovereign guarantees. In addition to working with the government and municipal authorities to agree investment priorities, in the above light *policy dialogue* will focus on formalizing clear commercialization goals to this end, on establishing a clear reform strategy and on identifying how the main *institutional and structural constraints* can best be addressed. Because of the commercial weakness of the sector and the need to reduce dependence on sovereign guarantees, Bank investment will remain conditional on adequate commitment by government to implementing *reform measures* aimed at facilitating the *transition to long term sustainability* of district heating utilities.

b) Power Generation and Distribution

Transition Goals and Strategy

The Bank's Power Generation and Distribution goals are to support projects to improve efficiency in conversion, transmission, distribution and consumption of energy and to improve the quality of energy services through a focused dialogue for sector reforms and attraction of private investors to the sector.

Ukraine's power system is comparable in size and complexity to the power systems of the large West European economies. The *main sector issues* are nuclear safety, sector financial performance and (despite a 42% drop in demand between 1990 and 1998) a shortage of energy for the economy and the population. The technical (energy conversion and utilisation efficiency) and financial performance of the power sector has deteriorated markedly since independence. The main reasons for this are:

- inefficient use and conversion of energy throughout the economy mainly because of old industrial technologies and use of worsening quality fuels;
- high technical and commercial losses in transmission and distribution
- shortages of coal and gas and spare parts for power generation; and
- financial distress of power sector entities due to an inability of the Government to support enforcement of financial discipline in the public sector.

Sector reform: In 1994 the Government initiated a radical reform of the power sector aimed at commercialising power supply and distribution entities and introducing competition. There has been significant progress, but flaws in the power sector structure need to be addressed and the regulatory environment is still subject to Government interference. The new Yushchenko government is committed to implementing reforms, which include majority privatisation of the distribution companies followed by the thermal generating companies and major changes in the structure of the Energomarket. If these changes are effectively implemented and supported by the government at all levels, power sector performance can be expected to improve.

Environmental issues. Atmospheric and effluent emissions have increased on a unit output basis as a result of the utilisation of low quality coal and mazut. The emphasis on maximum operation of low fuel cost nuclear plants in preference to the operation of thermal plants has led to the continuous operation of units in need of safety upgrades and to the extended operation of Unit 3 at Chernobyl. The Government has reconfirmed its commitment to close down Chernobyl by the end of 2000 and has also announced 15 December as the closing date.

Financial issues. Despite the adjustment of tariffs to close to full cost-recovery levels, cash collection rates are low and insufficient to cover minimum investment requirements or to improve operational and environmental performance in a situation in which there has been eight years of sector de-capitalisation. Payment is poorest in the state owned agricultural and industrial sectors and for budget funded entities, because of the inability of the government for political reasons to enforce payment discipline. The Government is keen to address the issue and recognises private management of power distribution as the most effective mechanism for achieving this in the Ukrainian context.

In support of sector restructuring the Bank has initiated discussions with the authorities through a ***Task Force*** co-chaired by the Bank and the Government, with the participation of other IFIs and donors. Its primary task is to foster an improvement in sector performance through effective privatisation and action to improve overall and cash collections. Privatisation of the remaining local power distribution companies (Oblenergos) to strategic investors has received consensus agreement by the Task Force as a necessary step for improving payment systems and discipline, as well as attracting vitally important investment resources and management skills. Such is the importance with which the IFIs view privatisation that they have made it the cornerstone of their *recommendations for structural reform* and a key condition for their continued support to the sector. The IMF has also made it a condition of the renewal of its Extended Funds Facility.

Technical performance. In 1999 although there was 53,900 Mw of rated capacity only 48,181 was operating. The average capacity factor of thermal power plants was 29% and nuclear plants 60-67%. Comparable figures for western electric utilities would be 70% and 80%. This is due to a shortage of cash to purchase spare parts and fuel. More than half of the thermal plant has 30 years of operation.

The Bank is active in the sector and has been developing a number of projects and initiatives. The focus has been and will continue to be on projects which promote *sector reform, and energy efficiency.*

With the objective of *improving energy efficiency and pioneering better use of locally produced fuels*, the Bank is lending EUR 121 million to the Donbasenergo thermal generating company for the rehabilitation of unit 4 at the *Starobeshevo* thermal power plant. This project is intended to replace highly inefficient units with a high efficiency boiler and reduce atmospheric emissions through introduction of a modern fluidised bed able to burn environmentally hazardous coal rejects. In parallel the Bank is also providing support to four thermal generating companies (Gencos) through a comprehensive (USD 2 million) TC funded "twinning" programme. This will strengthen the management and accounting systems of newly created Gencos, thereby providing them with the capability to operate independently in the power market.

In support of *private investment and better environmental performance*, the Bank is investigating the possibility of financing private operation of a gas-fired co-generation plant at the *Darnitsya* CHP. If finalised, this would be the first private sector operation of the Bank in the power sector in Ukraine. The Bank is also investigating possibilities for financing several private projects replacing old inefficient polluting thermal units with modern technology (such as *Dobrotvor*) and also a series of projects utilising coal process wastes (schlam) in fluidised bed boilers.

K2R4

The Bank's review of the request from the Government of Ukraine to provide co-financing for completion of the K2R4 power plant and its appraisal of the project are continuing. The project must meet the normal conditions for Bank funding, including transition impact, sound banking principles and additionality. It must also satisfy certain other conditions, including the closure of Chernobyl, stringent nuclear-safety requirements, and represent a least-cost alternative to meeting Ukraine's future power needs (Annex 13 of the Bank's Energy Operations Policy (BDS00-10 [illegible] they are directly linked with the closure of high-risk reactors operating in the country concerned ... meet the same least-cost criteria ... as non-nuclear projects, be financially viable, and would be subject to the same standard of environmental due diligence"). An important condition for Bank financing and project implementation is the restructuring and reform of Ukraine's energy sector, including increased tariff collection and privatisation of distribution companies. The Bank is considering providing loan financing of about US$200 million to total estimated financing requirements of K2R4 completion of about US$1.45 billion. The Bank's financing is dependent on the Government of Ukraine obtaining co-financing commitments sufficient to ensure completion of the plant. Co-financing is expected to come from various sources including Euratom, export credit agencies, internal cash flow generation and government contributions.

c) Telecommunications

The development of telecommunications is a crucially important element of economic development and transition. Ukraine's telecommunications sector has an important growth potential largely unrealised. The dominant player, UkrTelecom, is underdeveloped, inefficient and in need of significant investment. A large number (34) of relatively small private operators, including six mobile telephone service providers, provide mainly local and regional telecommunication services. Fixed line teledensity in Ukraine remains low at about 19% [illegible]

In addition to maintaining a dialogue with the Government on sector reform, the Bank has made three investments in the Ukrainian telecommunications sector. The first in 1994 was an investment of EUR 39 million in the ITUR project, a fibre optic cable system connecting Italy, Turkey, Ukraine and Russia. The second in 1997 was an investment of EUR 16 million in a private joint venture, Ukrainian Wave, a project that will supplement the local telephone network in the Lviv region using wireless, digital technology. The third was a EUR 37 m commitment to Kyivstar, a mobile operator with partly foreign investment, signed in June this year.

In 1998, the Bank received a mandate from the Prime Minister to assist with the privatisation of UkrTelecom and the reform of the telecommunications sector. After a year of little progress, the Bank's mandate has been renewed and it has revived a dormant technical assistance project aimed at developing the necessary regulatory framework in Ukraine. The successful first reading of the law permitting privatisation of Ukrtelecom took place in June this year. The Bank is also considering the provision of pre-privatisation financing to UkrTelecom during 2000. The availability of this pre-privatisation financing will be conditional on the implementation of a programme of sector liberalisation and transition milestones. These will include the preparation of a new telecommunications law consistent with WTO principles and the establishment of an independent telecommunications regulatory authority.

Other main areas for continuing policy dialogue will be: (a) licensing and tariff policies and (b) foreign investment attraction. The perception from foreign players is that there is a need to reform to effectively create a level playing field among competitors. This should clearly improve the ability of foreign strategic investments to enter the market and promote its development. At present, attempts by Ukrtelecom to buy-out the foreign investors in U-tel, a long-distance telephone joint venture established some years ago, are not assisting perceptions of the sector amongst potential future investors.

Apart from its work on privatisation of Ukrtelecom and ongoing commitments to the mobile sector, the Bank will also continue to explore opportunities in the information technology and media sectors.

d) Transportation Infrastructure and Services

The transport sector is of considerable importance for Ukraine's transition to a market economy and, given the country's size and its key location as a gateway between East and West, for the development of diversified trade. Transport enterprises have been badly affected by reduced spending power and by changes in patterns of movement, which have resulted in loss of traffic and revenue, particularly for railway and urban transport operations. Tariff levels are generally inadequate for cost recovery, particularly in the road sector, where road user charges are almost non-existent.

The decline in traffic levels has so far served to mask the effects of any shortage of transport capacity. This will become an increasing problem, however, as infrastructure and equipment deteriorate through lack of funds. These problems will be felt in grain handling and petroleum traffic through the ports and associated rail and road linkages. Passenger traffic will also be increasingly constrained in both urban areas and on inter-urban rail services. When the economic ties with Western Europe intensify, upgrading of the East-West Road corridor will become essential. The need for organisational reform in the sector and revised policies have been recognised, but present major challenges.

To date the Bank has invested cumulatively EUR 34 million in three projects in the sector, (Borispol Airport rehabilitation, Ukrrichflot shipping and Air Navigation control) and another project, the Railways Development Project (EUR 55 million), has been signed in late 1999 and is awaiting ratification by the Rada. Preparation of a road project is now underway, but other projects that have been examined in the areas of civil aviation, shipping, ports and urban transport have yet to materialize given the enormity of the institutional and sector reform challenges, inertial constraints and the difficult enabling environment.

The Bank will continue to focus on institutionalizing self-sustainability and related reform of the sector, with priority to removal of critical transport bottlenecks and to strengthening linkages with Ukraine's new European trading partners. To date most projects considered have been debt-based investments in large state-owned enterprises aimed at promoting commercialisation and sound corporate governance. But opportunities for smaller scale investments in private sector transport projects will also be actively sought, particularly ones where a strategic foreign investor can bring know-how and commercial expertise, and thus demonstrate the viability of a market-oriented approach to provision of transport services. The most promising opportunities are likely to be in ports, airports and air transport services, and combined transport terminal projects.

The main areas of policy dialogue will continue to be implementation of steps (such as corporatization, restructuring of urban transport services, change of state from operator to regulator, performance and tariff regulations, etc.) that will allow newly created enterprises to operate sustainably and access investment finance, and will improve the general enabling environment. Dialogue is ongoing in respect of the cofinancing enabling environment and, in particular, the need to establish a broader group of more flexible bi-lateral guarantee framework agreements for Export Credit Agency (ECA) financing.

e) Municipal and Environmental Infrastructure (MEI)

The efficient and reliable supply of water and the provision of other municipal services have important social, environmental and economic implications. The MEI sector has suffered in the same way as other infrastructure sectors from lack of the institutional and structural reforms needed for sustainable market economy operations. The outcome has been inadequate investment and maintenance, and a severe and worsening deterioration of services, with both social and environmental consequences.

The main *transition* related sector development *constraints* are:

- lack of financial autonomy of local governments/service providers vis-à-vis the centre and a related inability to secure funds for capital investment;
- an inability of service providers to improve poor revenue collection performance and a reluctance to accommodate private sector involvement;
- the need to resort to a high level of barter deals and other non-cash settlements; and
- inadequate tariff-setting methodologies and procedures, preventing economic pricing of services.

The Bank's MEI goals have been and will continue to be to address the above transition constraints, with *priority to those municipal authorities that are prepared to embrace and demonstrate necessary institutional and structural reforms.* The Bank aims to establish a basic regulatory framework for municipal utilities within 2-3 years, tariff reform being the centrepiece.

Despite broader efforts starting in 1995, to date the Bank has only invested in one project, the recently signed *Zaporizhiya Water* Utility Development and Investment Programme. This project will significantly reduce pollution of the Dinner River from municipal wastewater effluents, and includes important institutional and structural reform components, the key one being the establishment of a mechanism to set tariffs (on a pilot basis) for water user charges as a model for Ukraine as whole. It is the Bank's first loan to a municipal or sub-municipal client in Ukraine, and the first loan in the water sector by an International Financial Institution.

The Bank's objective is to increase its activities in the sector based on the lessons learnt from the *Zaporizhzhia* operation. Bank financing will generally be targeted at investments that will improve the operational and financial performance of existing assets, reduce operating costs, increase cash flows and lead to improvement in service quality. The main criteria for project selection will be strong management of utility or service, strong *commitment to institutional and structural reforms*, and explicit mechanisms for acceptable levels of revenue generation and cash collection.

In this framework, the Bank is now developing two water projects: in the Crimean city of Sevastopol and a multi-city programme targeted at 5-8 medium-sized cities (Municipal Utility Development Programme); and a solid waste management project in Kharkiv. Signing of these projects is scheduled for 2000 and 2001. All will require a sovereign guarantee.

Recognising that full recourse to the sovereign will likely limit its activities in the sector, the Bank will explore the possibility of partial recourse mechanisms. The medium/long term goal [illegible]

The Bank will also encourage improvements in current regulations to allow economic pricing of municipal services (cost recovery), the adoption of mechanisms for setting tariffs in an objective and predictable way, and adequate accounting rules for public and/or private utilities (e.g. provision for debts). It also aims to introduce privatisation participation within the next 2-3 years.

3.2.3 Nuclear Safety

Transition Goals and Strategy

The Bank's nuclear safety goals are improved nuclear safety through the Nuclear Safety Account and Chernobyl Shelter Fund initiatives.

Inadequate attention to nuclear safety is one of the legacies of the Soviet era and a problem with very large economic and social consequences for both Ukraine and the region. The Bank only has the capacity to deal with some of the more immediate symptoms and it is clearly a matter for the international community at large to address the enormous risks from deficient nuclear safety. The challenges that face Ukraine in this context are threefold: to shut down Chernobyl, to transform the Sarcophagus around the wrecked Chernobyl reactor into a stable and environmentally sound structure and to increase nuclear safety at other nuclear power plants (NPPs). Through its administration of the Nuclear Safety Account (NSA) and the Chernobyl Shelter Fund (CSF), the Bank is involved in assisting the Donor Community in its multilateral effort (in addition to many bilateral schemes) of supporting Ukraine with the challenge in connection with the closure of Chernobyl.

The NSA, through grants, is financing a EUR 118 million project for the Chernobyl Nuclear Power Plant. This project is part of a comprehensive programme to support Ukraine's decision to close Chernobyl on 15 December 2000 as was announced in principle at the Chernobyl Shelter Fund Assembly Meeting in March and confirmed in July.. The main part of the project (approx. EUR 100 million) finances two decommissioning facilities (one radioactive waste treatment plant and one interim spent fuel storage facility), but the project has also financed some short-term safety upgrades for Chernobyl 3. The remaining safety upgrades have all been carried out and do not justify longer term operation. Contracts for the decommissioning facilities were placed in summer 1999, and these facilities are scheduled to be completed by the year 2002.

The CSF finances the Shelter Implementation Plan, which is a plan for transforming the Chernobyl sarcophagus into a safe and environmental stable system. It became operational at the end of 1997 and is scheduled to take 8–10 years to complete at an estimated cost of USD 768 million. The European Union and 25 countries originally committed USD 395 million to the project. Additional financial commitment to the Fund, necessary for its timely and economic finalisation, was made at a Pledging Conference in July 2000, when additionally USD 320 million was committed. This will secure the financial basis to maintain the momentum of the project for the coming years. Strict application of the Bank's procurement rules has resulted in many leading international companies being involved in the project in alliances with Ukrainian companies. To date Ukrainian companies have provided about 70% of the engineering and construction man-months. This figure is expected to increase further when the construction phase of the project starts in the second half of 2000

3.2.4 Corporate Enterprise Sector

a) Agribusiness

Agribusiness is a key sector for the Ukrainian economy and the Bank will increasingly stress this comparative advantage in the course of its policy dialogue with the government. As noted elsewhere in this document, significant legislation to underpin private land ownership and farming has been passed, but the pace at which a political consensus on agrarian reform has been reached and the inconsistent application of laws has led to a situation where it is difficult for the Bank to participate in primary agriculture projects or promote credit schemes for private farmers. However, it has been active in the food-processing and beverage sectors and plans to keep growing its pipeline in these areas.

EBRD agribusiness and food processing projects in Ukraine total more than EUR 144 million in commitments out of the total EUR 463 million for private sector projects. This represents about 31 % of the private sector committed portfolio. The projects cover almost the complete [illegible] with [illegible] production of grain, through primary processing of agricultural commodities such as sun seed and extending to [illegible] stopping short of the farm sector itself.

As mentioned in section 2.2.2 the slow progress in land privatisation as well as systematic government intervention in the sector have limited growth and transition. More seriously, the Bank's clients in this sector have been subjected to intervention by both state and local tax authorities, who attempt to withhold VAT refunds thus distorting the market, severely reducing the client's working capital and placing clients at financial risk. The judicial and enforcement system at local level appears to be biased against foreigners. As a consequence, good local companies in this sector remain very difficult to penetrate.

The Bank's main objective in this sector in Ukraine is to keep its portfolio in line with the importance of the sector within the economy. The pipeline of operations is being built through systematic marketing activities both in Ukraine and in Western countries. Current pipeline and recently signed operations, modest in relation to the country's potential, include:

Cercalia - a cereals processor sponsored by a Swedish company -- EBRD equity EUR 3.2m;

- Marg-Vest - margarine producer in Donetsk, sponsored by Unilever -- EBRD equity EUR 13m;
- Extension of Donetsk sunflower-seed processing plant – EBRD equity EUR 4.8m.

The Bank' objectives are to use existing financial products and develop new ones with an appropriate mitigation of the risks linked to the sector. During the strategy period, new directions will include lending to, and investing in, strong local corporates, small equity investments through DIF, support of FDI by working with strong foreign sponsors. The Bank will continue to use technical cooperation products through its FAO framework agreement to keep a policy dialogue with the Ukrainian Ministry of Agriculture and to keep aware of any business opportunity in the sector.

The Bank intends to develop further its policy dialogue with the Ministry of Agriculture, ensuring that the interest of clients are taken into account in Ukrainian agricultural policy-making.

b) Property Development

Experience in countries at a more advanced stage of transition shows that *development of the property sector is an important driver of transition* in the post-early transition period. Despite the current softening of demand for all forms of real estate in Ukraine due to the downturn in investor interest in the region, as a result of limited development in recent years, the sector continues to be characterised by: (i) a significant unmet demand for modern hotels in Kyiv (as reflected in over-pricing of substandard hotel accommodation and services); (ii) growing unmet demand for modern warehouse facilities (both in the Kyiv region and at international trade dispatch centres such as Odessa); and (iii) growing unmet demand for hotels in Odessa, Lviv etc. The hotel and commercial property markets will require substantial development if long term demand for international standard accommodation is to be met. A main constraint to sector development has been the numerous severe bureaucratic and institutional constraints associated with competing monopoly interests, rights to land use and the lack of a legal enabling environment. Another constraint has been the general inability and/or unwillingness of domestic and foreign banks to provide term debt financing for commercial property or hotel projects in such an environment.

In 1998, the Bank committed financing to the first international standard hotel to be built in Kyiv. The EUR 40 million hotel will be managed by Radisson SAS and co-financed by RZB, the Austrian banking group. This project represents a landmark development in the property market in Kyiv and Ukraine generally, and *its demonstration effect will be substantial.*

Key operational issues that will continue to be the subject of *policy dialogue* will be implementation of steps to bring about *consistent and transparent tax treatment of international investors*, and the need for VAT import duties to be applied in accordance with the stated regulations and for VAT rebates to be paid promptly and in full. *Privatisation of state owned hotels* will be pursued as this would accelerate the development of the hospitality industry, as international hotel management groups would be able to enter the market at lower cost (via the refurbishment of current hotels) than would be possible with new build hotels. This would particularly stimulate the development of 2/3 star hotels.

The priorities for the strategy period are as follows:

- to ensure that construction gets underway on the Radisson SAS project by year-end 2000 so that the hotel is operational by year-end 2002
- develop the mid-range hotel project with East Point Holdings for Board approval in 2000
- work with Raiffeisen bank on smaller projects in Kyiv (office and residential) as part of the joint venture between EBRD and the Raiffeisen group
- develop a small multi-phased warehouse development

- consider financing well-structured hotel projects outside Kyiv in other major Ukrainian cities.

c) Consumer Goods and Light Industry

Ukraine has an extensive consumer goods and light industry sector, contributing 10+% of the countries industrial output.

The sector was the first to be privatised and by 1996 was virtually out of the State hands. The most technically advanced facilities, such as textile companies operated under tolling schemes selling up to 100% of their products in the export markets (such companies are the main contributors to sector growth figures). Very few corporates have been able to operate efficiently outside tolling arrangements. The limited and diminishing purchasing power of the Ukrainian population has been the main constraint to sector development. Lack of liquidity creates constant pressure on working capital, causing disruptions and undermining long term initiatives.

The majority of industries from the sector remain undercapitalised as term financing is unavailable locally and is unlikely to be attracted internationally in significant amounts. From this it follows that a large part of the sector will ultimately be closed. Future development will be greenfield. This may occur through emerging, small, local start-ups (of which there are examples in clothes manufacturing, printing and low capital investment plastic product manufacture) or through new foreign entrants, who can play an important demonstration role.

To date the Bank has invested a total of EUR 9 million in light motor vehicle manufacture (*Iveco Kraz*), glass packaging (*AD-Zarya*) and hygiene product manufacture (*Procter & Gamble Ukraine*), the first two of which are joint ventures, the last two of which are greenfield developments and all of which involve foreign sponsors. The Bank is currently investigating an investment opportunity in *Yunost* (textiles). The Bank will continue to select the best local corporates in the sector with good management that proved able to privatise the company successfully, change its strategy and marketing approach and demonstrate a strong commitment to the learning process and company development, while understanding the need to operate within the constraints of a more regulated, less informal economy in future.

Policy dialogue issues will be much the same as those for property development and agribusiness. As with all private sector transactions in Ukraine, a recurring issue is *collateralizing assets in a legally enforceable manner*.

d) Intermediate Goods and Heavy Industry

Metallurgy, metal processing, chemical and petrochemical enterprises could potentially offer considerable investment opportunities. This sector is a major contributor to Ukraine's GDP (it accounted for 45% of the country's industrial output in 1999) and is an important hard currency generator for Ukraine. Metallurgy (base metals and rolled products) contributed 42% of total export of goods in 1999. Chemical products (industrial chemicals, mineral fertilisers and plastics) accounted for 11% of all exports. Metal processing and industrial machine building provided 8% of the total country export in 1999.

Very few firms in the sector have been privatised. Since the new Government took office, the State Property Fund has approved a plan to sell the most attractive companies in the sector to strategic investors through commercial tenders. The privatisation of heavy industry, if successful, could lead to revitalisation and commercialisation. In turn, this could create a pipeline of opportunities for the Bank.

Due to slow progress with large enterprise privatisation, reform and the restructuring of the newly privatised enterprises, the Bank has yet to invest in the sector, although it has established working relations with companies transformed into joint stock companies in the first wave of privatisation (1996-97). One such pioneer, Donetsk Metallurgical (DMZ) has

within the larger DMZ concern, and owned by International Steel & Tube Industries Ltd. ("ISTIL") and DMZ. ISTIL-DMZ's assets includes an electric arc furnace ("EAF") facility which produces high quality concast billets that are sold world-wide. ISTIL-DMZ has requested a pre-export financing facility, which would support the only modern steel mini-mill in Ukraine which has international calibre management, quality products with a competitive cost structure and profitable export markets. The Bank is also exploring pre-export working capital financing opportunities with other leading exporters in the sector. Such financing should enable the Bank to enter the market (with attendant transition impact) at an earlier stage and at the same time prepare the way for later investment by the Bank or other financiers.

The Bank's activity in the sector should demonstrate to the Government that transparent and efficient privatisation and restructuring could increase investment from serious foreign strategic investors with long term strategic objectives.

e) Oil and Gas

Ukraine has proven oil reserves of 395 million barrels yet currently imports nearly 80% of its oil. Oil production has declined by more than 60% over the last 20 years due to lack of investment. Ukraine has proven natural gas reserves of 39.6 trillion feet, but can meet only about 20% of domestic demand. These upstream shortages are matched by downstream over-capacity. Ukraine's six refineries (with a combined crude oil refining capacity of just under 1.3 million bbl/d) are characterised by and environmental problems, poor efficiency, outdated technology, and declining refining volumes. Insolvency and non-payment are endemic in the sector. No major oil companies have committed to tangible investment projects, with most of the foreign activity limited to joint venture agreements rather than privatisation. BP's well-publicised departure was an adverse signal to the international community.

A Law on Production Sharing Agreements was passed in September 1999. Aside from this encouraging development (which should promote transparent tendering and appears to correspond to international standards), the position remains as in early 1998, when a presidential decree created a single state-owned oil and gas company, Naftogaz Ukrainy by combining 50 state-owned oil and gas companies. This re-centralization of an entire sector has not advanced modernisation, rationalisation, or crucial institutional, structural and legislative reform of a sector critical to Ukraine's overall economic performance and central to its economic recovery and transition Under the Oil and Gas of Ukraine to 2010 Programme, the country aims to meet at least 50% of domestic demand by 2010 by developing new wells, boosting production from existing wells, developing coal-bed methane production, and increasing foreign investment.

More specifically, *sector development and transition constraints* include:

lack of a proven sector legislative framework, especially regarding production sharing legislation (the legislation now passed has yet to be tested);

- discretionary taxes, frequent state audits, bureaucratic inertia, corruption and partiality of regulatory agencies, resistance to Western technology, limited understanding of international financial procedures; and limits on the sale of production;
- a general lack of the transparency and the stability needed for long lead time investment;
- huge end-user arrears and state arrears to domestic and foreign natural gas and oil suppliers; and
- an inability in this environment to attract substantive foreign strategic investment from a highly competitive international environment.

Against this background, the Bank will encourage and still consider participation in private sector investment initiatives that advance transition of the regulatory and institutional environment and greater transparency and stability, and thus improve the overall foreign investment environment in the sector. However, experience forces the Bank to take a cautious and long-term approach to all proposals.

To date the Bank has only invested EUR 7.6 million in a EUR 40.5 million joint venture project with JKX, *Poltava Oil and Gas*, the first significant upstream oil and gas joint venture in Ukraine. While successful from a technical and management standpoint, loan repayment has already been marred by failure of the state to pay for delivered product. Foreign investors have been deterred by the JKX experience, although smaller operators are now establishing themselves in Ukraine with varying degrees of success. In the area of oil transport, the Bank has been involved in preparations for planned investment of USD 300 million in an oil trans-shipment terminal at Odessa to handle oil supplies from the Caspian and Caucasus region and capable of supplying all six of Ukraine's refineries.

In the area of gas pipeline infrastructure, the Bank has invested in the *Balkan Gas Transit* project. The Bank has also been party to preparatory discussions with a consortium of the oil majors considering a future or possible investment of up to USD 1.5 billion in the upgrade and operation of Ukraine's gas transit network, although this is of necessity a long term prospect.

Bank participation in the above planned investments will depend on the outcome of sector *policy dialogue*. This will continue to concentrate on developing a *clear vision for sector reform*, decentralisation of controls, including demonopolisation of gas purchases, with attention to establishing a *credible regulatory regime* and to *privatizing operations* as main mechanisms for *attracting foreign investment*, *improving efficiency and tackling end-user arrears and state arrears to suppliers*. In the long-term, the Bank believes it is a correct objective to help Ukraine increase its indigenous sources of energy, as well as use them more efficiently.

4. Other IFIs and Multilateral Donors

Donor organisations and countries represented in Ukraine fall into four main categories: (i) IFIs and multilateral donor organisations, (ii) countries with broad-based, bilateral assistance programs, (iii) countries with bilateral activity concentrated on only two or three sectors, and (iv) countries with bilateral activities focused on expert exchanges and small grant programs.

During the Strategy period, there will be opportunities for the Bank to co-ordinate closely with other IFIs and multilateral donor groups in banking and financial sector development activities and privatisation reform. Bi-lateral donor programs focused on SME development, municipal finance and local rather than national programmes could also provide leverage for Bank investment.

4.1 IMF, World Bank and IFC activities in Ukraine

Ukraine became a member of both the IMF and the World Bank in 1992. Both institutions have not only approved and advanced substantial amounts of financial assistance, but have also funded necessary technical assistance and in the case of the World Bank, sector studies and a Country Economic Memorandum. Many of the targets of the current IMF program - the *Extended Fund Facility (EFF)* - set policy objectives in some of the main sectors in which the World Bank (as well as the EBRD) are active. Much of the official lending has become effectively tied to the successful implementation of the EFF.

Ukraine made its first drawing from the IMF in 1994 under the *Systemic Transformation Facility*. This was followed by three *Standby Arrangements*. The last of these programmes went off track in March 1998, mainly because fiscal targets were missed. The authorities were, however, able to conclude negotiations on the EFF (which had not proved possible during the previous year). The *EFF* was subsequently approved by the IMF Board in September 1998 for SDR 1.6 billion (USD 2.2 billion) over 3 years. The facility was augmented by USD 366 million at the end of May 1999, partly to compensate Ukraine for the loss of exports to Russia.

The EFF program is intended to consolidate macroeconomic stabilisation and promote structural reform over the three-year period of the programme. Successful implementation of the EFF would strengthen fiscal policy, through measures aimed at rationalising tax revenue (mainly on account of elimination of exemptions) and cutting subsidies to reduce unproductive expenditures. The structural component of the EFF consists of a series of measures, ranging from specific objectives to be achieved by a certain date to the more general development of appropriate policies throughout the period in a number of key sectors of the economy. These include the banking sector, promoting reform in the enterprise sector through deregulation, privatisation and demonopolisation, accelerating reforms in the energy and agricultural sectors as well as the elimination of restrictions on external trade.

The EFF has, however, been suspended on several occasions, most recently at the end of September last year, following the failure to meet certain programme targets. A resumption of the programme will depend on the attainment of a number of specific policy objectives and on the outcome of the separate audit of the NBU's reserves following the allegations regarding the misuse of IMF funds in the past.

The most recent *Article IV* consultation with the Fund staff was completed in March 1999.

The main objectives of World Bank activities in Ukraine have been to assist the authorities with the transition to a market economy and in particular to restore sustainable economic growth and improve living standards for the population. By early 2000 the World Bank's commitments amounted to over USD 3 billion of which USD 2 billion has been disbursed. The current pipeline comprises about 10 projects.

There have been a number of projects to support and promote reforms in **the *energy sector***. In 1996 the World Bank approved a loan for USD 317 million for the *Electricity Market Development Project* intended to support the introduction of market pricing in the wholesale electricity sector. The loan was suspended a year later, however, when the government failed to implement tariff increases. The loan was eventually closed at the end of 1999.

The World Bank has a number of other projects in the sector at the moment. The $300 million *Coal Sector Adjustment Loan (Coal SECAL)* is almost fully disbursed. The project deals with issues of implementation of economic restructuring in the coal sector including the liberalisation of prices and trade, promoting investment in profitable mines, decommissioning of unprofitable mines and the social consequences of mine closures. The World Bank is also contributing a $114 million (the *Improved Rehabilitation and System Control Loan*) to a project intended to rehabilitate hydropower turbines and generators and improve the dispatch and control network. A $200 million loan to improve *Kyiv's District Heating* system was approved in May 1999 while a project to improve energy efficiency in Kyiv was approved at the beginning of this year.

The World Bank has supported privatisation in the ***industrial sector*** with two *Enterprise Development and Adjustment loans*, the first for USD 310 million and the second, which was approved in September 1998, for USD 300 million. The second loan also provides post-privatisation assistance and is intended to encourage reform of the bankruptcy system and strengthen capital markets regulation. It also provides funding for critical imports and for technical assistance in post-privatisation enterprise restructuring.

The World Bank has approved two loans to develop the infrastructure of the ***banking sector.*** The main one is a *Financial Sector Adjustment loan* for USD 300 million, approved in September 1998, with an emphasis on strengthening the regulation and supervision of banks. The main objectives are to increase the autonomy and independence of the National Bank of Ukraine in the provision of monetary stability, improve the monitoring and regulation of commercial banks and create a favourable environment for the future development and structure of the banking sector in Ukraine. The second was the *Export Development Loan* (USD 70 million) which provides technical assistance for the institutional development of Ukreximbank and credit finance to private exporters.

In the case of ***agriculture*** the main project, the *Sector Adjustment Loan* for USD 300 million to promote trade liberalisation, privatisation and restructuring in the sector was fully disbursed. A *Pre-Export Guarantee Export Facility*, intended to stabilise the agricultural policy environment, was cancelled in September of last year following the Rada's failure to ratify it. The new Government has however, recently requested the World Bank to revive this facility, although this is likely to depend on progress with other reforms in the sector.

The World Bank is currently considering a *Programme Adjustment Loan*, the amount and coverage of which will be discussed in the context of the Bank's new Country Assistance Strategy.

The International Finance Corporation's (IFC's) program in Ukraine is heavily weighted towards technical assistance. IFC mainly manages donor SME development program funds (which include improving SME access to financing and land reform). IFC has also co-financed two projects with the Bank in Ukraine and will be a partner in the Micro-finance Bank.

4.2 EU and Bilateral Assistance

4.2.1 The European Union

The European Union provided EURO 46 million through the TACIS National Action Programme in 1999. The three priority areas were: institutional reform and development; support for economic reforms and private sector development and energy and environment reform and development. In addition, a number of smaller scale activities were supported.

4.2.2 Bilateral Assistance

[illegible] bilateral agencies are provided by USAID (USA), CIDA (Canada) [illegible] development, privatisation and post-privatisation support. These agencies provide consultancy support for the presidential administration as well as national and municipal authorities. Transform also provides training programmes for civil servants and SME managers. USAID and CIDA also run energy sector and environmental projects. Together with the EBRD they provide funding for components of Chernobyl Shelter project, and USAID is a major contributor to the work of the Energy Sector Task Force described in Section 3.2.3. (b).

The USAID budget for 2000 is the largest at USD 72.1 million, while CIDA and Transform have budgets of about USD 10 million each. Opportunities for continuing Bank co-operation with these agencies exist in the energy and municipal sectors, as well as in the SME and post-privatisation spheres.

DID UK has a budget of USD 14.5 million mostly aimed at legal support and restructuring of the agricultural sector. The Netherlands, France and Italy are chiefly involved in SME support and technical assistance programmes.

Annex 6, "Donors in Ukraine", provides more detail of individual country programmes.

ANNEXES

ANNEX 1 - POLITICAL ASSESSMENT

Compliance with Article 1

Ukraine is committed to and abides by the principles of democracy and the market economy in compliance with Article 1 of the Agreement Establishing the Bank. The 1996 Constitution provides a legal framework for the functioning of multi-party pluralism and for the protection of civil and human rights. Over the past two years, Ukraine has continued to make progress on a number of basic freedoms, including the right of peaceful assembly and association, freedom of religion, and respect for human rights.

However, problems persist in the enactment of enabling legislation to support constitutional guarantees. In January 1999, the Parliamentary Assembly of the Council of Europe expressed its deep concern about the slow pace at which Ukraine is fulfilling its remaining obligations and commitments as a member of the Council of Europe, in particular in adopting: a framework act on the legal policy for the protection of human rights, a framework act on legal and judicial reforms, a new criminal code, a new civil code, a new law on political parties, the European Charter for Regional or Minority Languages and the protocol of the European Convention of Human Rights abolishing the death penalty. In June 1999, the Assembly decided to postpone procedures to annul the credentials of the Ukrainian parliamentary delegation and suspend Ukraine from the right of representation in the Council of Europe until after the presidential elections. Since then, the Rada has adopted a new law on political parties and ratified the European Charter for Regional or Minority Languages. In February 2000, the Rada also voted to abolish the death penalty from the criminal code, thus resolving one of the key issues threatening Ukraine's membership in the Assembly.

Competitive, multi-party elections for the president and parliament were held in the course of 1998-99. However, the presidential elections were criticised by international and domestic election monitors for irregularities, in particular regarding the non-neutrality of the state in the electoral process including infringements on the freedom of the press. According to international human rights agencies, government pressure led to a general climate of self-censorship within the media, though the media still represent a wide range of views including opposition to the current government.

2. The Political Environment

The progress of economic reform in Ukraine has been impeded by weaknesses in the structure of governance and national policymaking. Underlying these weaknesses are strong cleavages within the country across a number of different dimensions: nationalism, statehood, East-West divisions, transatlantic alliances, and relations with Russia and the CIS. The attitudes of different groups towards market-oriented reforms have been closely interwoven with these existing cleavages making these reforms even more politically contentious than they have been in neighbouring countries. The political institutions designed to mediate these cleavages and conflicts have not been effective. The division of powers between the President and the [illegible]. The Rada itself is split into a large number of shifting political factions [illegible]

Political parties are weak and largely oriented towards supporting individual political personalities. This has led to prolonged policy stalemate on economic reform.

As a result of the slow pace of economic reform, government officials have retained substantial powers to intervene in the economy rooted in the legacy of the command system. The executive branch of government has decree-making powers which have been used to provide selective privileges and exemptions to powerful economic actors. The reliance on extra-budgetary funds has weakened the transparency of fiscal relations. Bureaucrats at all levels of the system have a high degree of regulatory discretion. Informal "clans" based on regional and sectoral ties have arisen to take advantage of government intervention in the economy and have come to play an influential role in the policy process.

These factors have all contributed to a very high level of corruption. Household and firm-level surveys conducted by the EBRD, the World Bank and independent researchers have all shown that the degree of corruption in Ukraine appears to be among the highest in the region. This has severely weakened the investment climate with major implications for the development of SMEs and the level of foreign investment.

Recently, President Kuchma and his newly formed government have launched an attempt to restructure the political system to address many of the fundamental problems. However, this strategy entails significant risks of sparking a constitutional crisis. In November 1999, President Kuchma was re-elected with a decisive majority of votes over his opponent, Petro Symonenko of the Communist Party. Following the Rada's refusal to reappoint the existing premier (Valery Pustovoitenko), Viktor Yushchenko, the former chairman of the NBU, was approved as the new prime minister in December. Highly regarded both domestically and abroad for his work at the NBU, Mr Yushchenko has declared his commitment to reversing the political stalemate.

In the Rada, eleven political factions from the centre-right joined together to form a majority in support of President Kuchma and the new government. With strong electoral backing, a reform-minded government and a parliamentary majority, President Kuchma set out to wrest control of the Rada from the leftist parties, and to restructure the balance of power between the parliament and the president. The new pro-government majority in the Rada attempted to change the voting rules in an effort to oust the existing Rada speaker and former presidential contender, Oleksandr Tkachenko of the Peasants' Party, but were rebuffed when Tkachenko refused to allow the vote. In protest, the pro-government parties split off from the Rada and held separate sessions outside of the Rada building eventually attracting 253 of the 450 Rada deputies. With the necessary quorum, the break-away parliament elected a new speaker, Ivan Pliushch of the pro-Kuchma People's Democrats, and began passing legislative acts with the approval of President Kuchma. Four leftist factions remained in protest in the Rada building refusing to recognise the new leadership.

The parliamentary crisis subsided as the break-away majority reclaimed the Rada building and most of the leftist parties returned to parliamentary sessions accepting Pliushch's leadership. Nevertheless, the Rada majority has already proved fragile in the face of the new government's first legislative initiatives. In response, President Kuchma pushed for a national referendum on 16 April 2000 designed to restructure the parliament. The referendum sought a vote of no-confidence in the current Rada and constitutional amendments to reduce the number of Rada deputies (from 450 to 300), to create an upper chamber composed of regional governors (appointed by the President), to increase presidential powers to dissolve the Rada, and to abolish the deputies' immunity from prosecution. Such changes would significantly increase the President's powers over the parliament. After the Constitutional Court ruled against the posing of several questions in the Referendum, it was duly held and the result declared overwhelmingly in favour of President Kuchma's objectives. It is now uncertain, however, how quickly the "will of the people" will secure law through adoption of its recommendation by the Rada.

The referendum provoked strong opposition within the Rada, even from the new chairman and members of the pro-government majority. According to the current constitution, only the Rada has the right to call national referenda and it recently voted against the April referendum. Moreover, the President only has the right to call for a popular vote on constitutional amendments following parliamentary approval of these proposals, which has [illegible] constitutional crisis. The referendum has also drawn international criticism, in particular from the Parliamentary Assembly of the Council of Europe. If the results are implemented, the referendum will have a major impact on the structure of the Ukrainian political system, strengthening substantially the powers of the President and breaking the grip of the left on the parliament. Yet the referendum itself runs the risk of further polarising the political system. Given the weak political support for the referendum, it could break up the fragile eleven party coalition supporting the current government, leading yet again to a divided government at a time when urgent reforms will require parliamentary support. It could also strengthen the unity and resolve of anti-Kuchma forces on the left. More importantly, it could raise questions about the legitimacy of any new political arrangements that would be a source of considerable political uncertainty in the future.

Crimea

There has been some progress in clarifying the status of Crimea, the Russian-dominated autonomous republic that was attached to Ukraine in 1954 by the then Soviet government. However, there are still a number of important issues that have not yet been resolved. The Crimean parliament approved a new constitution in December 1998, which gives the Crimean government control over its own fiscal policies, some approval powers over selected government appointments and considerable legislative powers though subject to compatibility with the Ukrainian constitution. The Crimean constitution does not resolve the issue of the status of the Crimean Tatars, who have been seeking special representational guarantees in the Crimean parliament as well as official status for their language.

3. Social and labour issues

The political stalemate on economic reform has led to a prolonged economic stagnation with quite serious social consequences. Inequality has increased substantially since the start of the transition as has the share of the population below the poverty line, generating a major concentration of wealth and income among a small and disproportionate share of the population. Pensioners have been particularly hard hit by the very low level of pensions and persistent arrears. Such social problems remain a potential threat to stability in the medium term.

The Constitution does protect a broad range of worker rights, including the right to associate and to strike. Though a new law on trade unions is currently under consideration by the Rada, independent trade unions exist in many sectors of the economy alongside the now independent successor to the Soviet trade union, the Federation of Trade Unions. The Labour Code does provide for internationally accepted labour practices. However, labour conditions remain poor due to exceedingly high wage arrears, low minimum wage levels, continued restrictions on labour mobility, lax safety standards and an ageing capital stock. These problems have prompted strikes and labour actions, especially in the coal-mining sector.

4. External Relations

Ukraine has continued to place priority in its foreign policy on strengthening ties with the West, normalising relations with Russia and resisting efforts to enhance the power and scope of these CIS institutions of which it is a member. President Kuchma has persistently maintained the importance of closer integration with Western Europe. Ukraine is seeking associate member status in the EU. Though relations with the Council of Europe are currently experiencing difficulties, Ukrainian authorities have expressed their intention to take the necessary steps to honour the country's commitments and obligations. Initial concerns that the NATO action in Kosovo might derail Ukraine's relationship with NATO have not come to pass, as the Rada failed to pass legislation limiting further co-operation with NATO.

The ratification by the Russian Federation Council of the Russian-Ukrainian Friendship and Co-operation Treaty on 25 December 1998 was an important step in settling a number of outstanding issues between Russia and Ukraine. The treaty, to which the two presidents had agreed back in May 1997, confirms existing borders, defines the terms for the division of the Black Sea Fleet and establishes the terms of Russia's access to naval facilities in Sevastopol. There have been disputes over implementation of the treaty's provisions. Recently, bilateral relations between Russian and Ukraine have been strained due to a dispute over the size of Ukraine's gas debt to Russia.

Ukraine's relationship with the countries of the CIS appears to be based on two key principles: strengthening the role of sub-regional groupings within the CIS and resisting any increase in the governing role of CIS structures. Though Ukraine did recently enter the CIS Inter-Parliamentary Union, the initiative came largely from the left-wing forces in the Rada. The new speaker has called for the Rada to cease participating directly in the Union. The approval of Union Treaty between Russia and Belarus did not receive a strong endorsement from Ukraine. Ukraine has also resisted efforts to strengthen the collective security agreement among the CIS states, focusing instead on the role of the CIS in fostering economic co-operation. At the same time, Ukraine has been a key force in the creation of GUUAM, a sub-regional alliance among Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova.

ANNEX 2 - ENVIRONMENTAL DEVELOPMENTS

EBRD's involvement will be mainly through projects with an environmental component. All EBRD operations in Ukraine are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans (EAPD) in the legal documentation in order to address issues raised during due diligence.

Environmental analyses and EAPs were carried out for Gastransit in the context of the Balkan Gas Transit project in oil and gas and the State Administration for Railway Transport of Ukraine sector in the transport sector.

In the industrial sector, an environmental audit and an environmental analysis have been conducted for a steel mill export-financing project. Restructuring of large industrial facilities will be used as an opportunity to achieve significant environmental benefits and demonstrate positive effects in the relevant sectors.

[illegible] K2R4 Environmental Impact Assessments (EIA) were carried out for both units, and a comprehensive public consultation process was carried out by Energoatom at the Bank's request. On the basis of the EIAs and the results of the public consultation process, detailed Environmental Action Plans were developed to address environmental, radiation protection and public information issues.

In the financial sector, EBRD has conducted environmental due diligence training for First Ukrainian International Bank, the SME Credit Line and Ukraine Fund and plans to conduct it also for Raiffeisen Bank and Kyiv International Bank. The training aims to ensure that the Bank's financial intermediaries (FIs) are capable of implementing environmental due diligence procedures which are compatible with the Banks own procedures.

The EU has been implementing an energy efficiency project in the food processing sector and a development project of a national information network for energy conservation. Project preparation capacity development was recently supported by TACIS which has been supporting a project preparation unit at the environmental ministry. The World Bank is implementing a GEF biodiversity conservation project, a municipal water and wastewater project, Donetsk environmental project (setting a mechanism to channel funds to enterprise's environmental abatement investment), and Kyiv public building energy efficiency project. The Kyoto Protocol to the Framework Convention on Climate Change, was adopted in December 1997 and deals with several forms of carbon trading (including Joint Implementation, or JI) which aim to facilitate a cost-effective reduction of greenhouse gas emissions. The JI mechanisms may enable the Bank to attract beneficial forms of co-financing for certain projects which lead to a reduction of greenhouse gas emissions. Ukraine has signed the Kyoto Protocol, which determines the country's reduction target at the 1990 level of greenhouse emissions for the period 2008 - 2012. Given the decreased industrial outputs, the country is expected to meet this target.

ANNEX 3 - LEGAL TRANSITION

LEGAL REFORM DEVELOPMENTS

Secured Transactions. Secured transactions in Ukraine are governed by the Law on Pledge of 1992 as amended and the Ukrainian Civil Code of 1964 as amended. The registration of pledges is regulated by the Government Resolution No. 1185 of July 1999. The main deficiencies of the Ukrainian legislation on secured transactions are:

- the impossibility to grant pledges over assets unless specifically described;
- the impossibility to grant pledges for a fluctuating pool of accounts receivables;
- the lack of protection of bona fide acquirers, including those acquiring in the normal course of business of the pledgor; and
- the inefficiency of the enforcement provisions.

In 1999 a new pledge register came into operation operated by the Information Centre of the Ministry of Justice. There are a number of registry offices linked to the Central Registry throughout the country. The new register contributes significantly to an increased efficiency of the secured transactions legislation. However, some further reforms to tackle remaining deficiencies remain necessary.

New Accounting Law. The Law on Accounting and Financial Reporting came into force in January 2000. The law introduces the new accounting system based on Ukrainian accounting standards but which conforms to International Accounting Standards. Though passage of this Law does not resolve all the practical problems connected with integrating Ukrainian and western accounting practices, this is nonetheless a positive step towards making private enterprises more competitive and efficient, and encouraging foreign investment.

New Bankruptcy Law. A new Law on Bankruptcy, which substantially amends the Bankruptcy Law of 14 May 1992, came into force on 1 January 2000. The Law provides for "sanation," a rehabilitation procedure for corporate debtors, as well as liquidation procedures. The new Law may reduce the difficulties encountered in bankruptcy proceedings in Ukraine and provide some reassurance to creditors. The effectiveness of the Law will depend on how it is implemented in actual proceedings.

Abolition of Privileges to Enterprises with Foreign Investments. The President of Ukraine signed a Decree on 16 February 2000 to tighten state regulation of enterprises with foreign capital. Under the Decree the Cabinet was given one month to determine whether adequate reasons exist for granting certain privileges to joint ventures and to abolish within two weeks any privileges granted earlier to enterprises with foreign capital. On 10 February 2000, during the second-reading debates on the draft budget for 2000, the Ukrainian Rada unanimously voted to suspend privileges, which had been granted to enterprises with foreign capital Article 16 of the budget, approved by the Rada, also suspended the Rada's resolution of 6 July 1999, which provided for immunity against changes in Ukrainian law for enterprises with foreign capital. There is strong opposition to these measures in the Ukrainian business community which may affect actual implementation of these measures.

New Concession Law. A new Concession Law was adopted on 16 July 1999. The Law sets terms and procedures for the concession of state and communal property, including procedures for open public tendering.

Telecommunications regulatory environment. Ukraine's telecoms market is regulated by the Telecommunications Law of 1995 and amendments made in 1996. In 1997, the Ministry of Posts and Telecommunications, the industry's watchdog and regulator, was re-organised and renamed the State Communications Committee, in preparation for the privatisation of the national PTO Ukrainian Telecom (Ukrtelecom). The Law which is often unclear and confusing, does not create an outright monopoly; this, in connection with the Government's readiness to award licences in a number of sectors has often been invoked as evidence of an open and competitive market. However, in reality, both the law and the implementation policy followed by the Government have given rise to a number of important restrictions which have hindered development of the sector:

- The Telecom Law fails to impose on Ukrtelecom any obligation to provide access to its network in an objective, transparent and non-discriminatory way. As a result, Ukrtelecom tends to behave in an arbitrary and monopolistic way.
- The law does not create any obligation to adopt a cost oriented tariff policy.
- The sector is regulated by a Government agency, the State Communications Committee, not an independent regulator, creating an obvious conflict of interest.
- The privatisation of any "public communications network" (essentially all existing telecommunications networks) requires approval from the Rada, which has, to date, rejected all proposals for privatisation.
- A barrier to investment and development of the sector is created by the restriction on foreign ownership in all telecommunication and postal operators to 49% of the company's share capital.
- The Government of Ukraine has made arbitrary decisions on retroactive frequency fees, introducing them in May 1999, then withdrawing them four weeks later.

Banking regulation. The banking system is governed by the Law on the National Bank of Ukraine, the Law on Banks and Banking, and the National Bank of Ukraine's regulations (the "NBU"). While the NBU has made a good start by tightening its licensing requirements in recent years, the Banking Law includes neither requirement that bank managers and large shareholders be of high integrity nor fiduciary standards for managers and directors. Neither the Banking Law nor current NBU regulatory provisions against insider lending are sufficiently strong compared to international practice. While the NBU has the power to take a number of severe measures in response to virtually any violation, the NBU in fact lacks the legal authority to take more proportional intermediate measures.

Capital market regulation. The Securities and Stock Market State Commission (the "Commission") was established by a Presidential decree in June 1995, and given a broad mandate in October 1996 by the Law on State Regulation of the Securities Market in Ukraine. The current law regulating the securities market, passed in 1991, requires substantial improvement. The Commission has prepared a new draft law "On Securities and the Stock Market" which has undergone an extensive comment process within the Government, but is still pending at the Rada. The draft law contains provisions more accurately defining securities and securities derivatives; regulating securities offerings, secondary market trading, stock exchanges, electronic stock markets, and professional market participants; requiring regular and special disclosure of material information by issuers of securities; requiring disclosure regarding owners of large (10%) blocks of shares; and providing new protections against insider trading, market manipulation, and unfair advertising in the securities markets. While the Commission has made strides in the past few years to begin to fulfil its assigned functions, it still lacks the financial and human resources to effectively regulate Ukraine's markets.

Legal Transition Assistance

Telecommunications Regulatory Reform: EBRD has agreed to assist the Ukrainian authorities in preparing a new telecommunications regulatory framework likely to attract private investment and permit the development of the market. The project has already been advertised and in agreement with the Ukrainian authorities a short list has been compiled. The project is expected to start during the first quarter of 2000 and run for 18 months.

Capital Markets Reform: The Securities Commission has requested the Bank to assist in reforming their existing legal and regulatory framework in order to bring it into line with sound internal standards and facilitate further development of the Ukrainian securities market. A number of other donors have been working in this area and specific areas where EBRD assistance will be additional will need to be identified. However, subject to the availability of sufficient funding, the Bank is prepared to develop a legal reform project for Ukraine in that regard.

ANNEX 4 - SELECTED ECONOMIC INDICATORS FOR UKRAINE

Ukraine

Updated 03/2000

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 *Estimate*	2000 *Projection*
Output and expenditure						*(Percentage change in real terms)*						
GDP	4.0	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.0	-1.7	-0.4	2.0
Industrial gross output	3.0	-0.1	-4.8	-6.4	-8.0	-27.3	-12.0	-5.1	-1.8	-1.0	4.3	na
Agricultural gross output	na	-4.0	-13.2	-8.3	1.5	-16.5	-3.6	-9.5	-1.9	-9.8	-5.7	na
Employment						*(Percentage change)*						
Labour force (annual average)	na	na	1.3	-1.0	-0.3	0.1	2.4	-0.7	-0.5	0.4	0.3	na
Employment (annual average)	na	na	-1.7	-2.0	-2.3	-3.8	3.0	-2.1	-2.7	-1.1	-0.7	na
						(In per cent of labour force)						
Unemployment (end-year)	na	0.0	0.0	0.2	0.3	0.3	0.5	1.3	2.3	3.7	3.9	na
Prices and wages						*(Percentage change)*						
Consumer prices (annual average)	2.2	4.2	91	1,210	4,735	891	377.0	80.0	15.9	10.6	22.7	24.0
Consumer prices (end-year)	na	na	161	2,730	10,155	401	181.7	39.7	10.1	20.0	19.2	20.0
Producer prices (annual average)	na	4.5	125	2,384	4,619	1,134	489.0	52.1	7.7	13.2	32.0	na
Producer prices (end-year)	1.7	4.5	163	3,828	9,668	774	172.0	17.3	5.0	35.3	15.7	na
Gross average monthly earnings in state sector (annual average)	na	na	na	1,220	2,255	786	483.9	71.4	13.3	7.2	15.8	23.7
Government sector 1/						*(In per cent of GDP)*						
General government balance	na	na	na	-25.4	-16.2	-7.7	-6.1	-6.1	-5.2	-3.0	-1.5	-2.0
General government expenditure	na	na	na	58.4	54.5	51.4	33.0	42.8	43.2	38.5	33.8	na
General government debt	na	na	na	na	na	na	27.0	21.0	28.2	45.2	na	na
Monetary sector						*(Percentage change)*						
Broad money (M3, end-year)	na	na	na	na	na	540.0	117.4	35.1	33.9	25.3	41.0	na
Domestic credit (end-year)	na	na	na	na	na	na	166.1	22.1	32.3	47.3	27.9	na
						(In per cent of GDP)						
Broad money (M3, end-year)	na	na	na	na	33.6	26.5	12.7	11.5	13.4	15.1	17.4	na
Interest and exchange rates						*(In per cent per annum, end-year)*						
Refinancing rate	na	na	na	80	240	283	97	40	25	79	45.0	na
Treasury bill rate (3-month maturity) 2/	na	na	na	na	na	na	164	51	44	40	44.0	na
Deposit rate 3/	na	na	na	82	149	209	70	24	19	24	20.0	na
Lending rate 3/	na	na	na	77	184	250	123	61	43	54	55.0	na
						(Hryvnias per US dollar)						
Exchange rate (end-year)	na	na	na	0.01	0.13	1.04	1.79	1.89	1.90	3.43	5.07	na
Exchange rate (annual average)	na	na	na	0.002	0.05	0.32	1.47	1.83	1.86	2.45	4.13	na
External sector						*(In millions of US dollars)*						
Current account	na	na	na	na	na	-1,163	-1,152	-1,185	-1,335	-1,295	997	350
Trade balance	-9,000	-12,700	-3,400	-600	-2,500	-2,575	-2,702	-4,296	-4,205	-2,584	-482	-900
Merchandise exports	77,100	74,600	50,000	11,300	12,800	13,894	14,244	15,547	15,418	13,699	12,463	13,600
Merchandise imports	86,100	87,300	53,400	11,900	15,300	16,469	16,946	19,843	19,623	16,283	12,945	14,500
Foreign direct investment, net	na	na	na	na	na	151	257	526	581	747	489	750
Gross reserves (end-year), excluding gold	na	na	na	469	162	710	1,134	1,995	2,375	782	1,090	1,210
External debt stock	na	na	na	na	na	7,167	8,142	9,170	11,807	11,700	11,481	12,503
						(In months of imports of goods and services)						
Gross reserves (end-year), excluding gold	na	na	na	na	na	0.5	0.7	1.1	1.3	0.6	1.0	0.9
						(In per cent of exports of goods and services)						
Debt service	na	na	na	na	na	12.1	9.3	6.0	9.4	19.7	12.1	na
Memorandum items						*(Denominations as indicated)*						
Population (end-year, millions)	51.7	51.8	51.9	52.1	51.9	51.7	51.5	51.1	50.5	50.1	49.7	49.5
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Share of agriculture in GDP (in per cent)	28.0	24.4	24.4	20.3	21.6	16.0	14.5	12.2	11.8	11.4	na	na
Current account/GDP (in per cent)	na	na	na	na	na	-3.1	-3.1	-2.7	-2.7	-3.1	3.2	1.3
External Debt - Reserves, in US$ millions	na	na	na	na	na	6,457	7,008	7,175	9,432	10,918	10,391	11,293
External Debt/GDP (in per cent)	na	na	na	na	na	19.1	22.0	20.6	23.5	27.6	37.3	46.0
External Debt/Exports (in per cent)	na	na	na	na	na	51.6	57.2	59.0	76.6	85.4	92.1	91.9

Note: Data for 1991-98 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD. Data for 1999-2000 reflect EBRD evaluations, partly based on information from these sources.

1/ General government includes the state, municipalities and, from 1994, extrabudgetary funds. Data are on a cash basis until 1995, and on an accrual basis thereafter.

2/ Treasury bills were introduced in March 1995.

3/ Weighted average over all maturities.

Ukraine

Updated 07/2000

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure						*(Percentage change in real terms)*						
GDP	4.0	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.0	-1.7	-0.4	2.0
Industrial gross output	3.0	-0.1	-4.8	-6.4	-8.0	-27.3	-12.0	-5.1	-1.8	-1.0	4.3	na
Agricultural gross output	na	-4.0	-13.2	-8.3	1.5	-16.5	-3.6	-9.5	-1.9	-9.8	-5.7	na
Employment						*(Percentage change)*						
Labour force (annual average)	na	na	1.3	-1.0	-0.3	0.1	2.4	-0.7	-0.5	0.4	0.3	na
Employment (annual average)	na	na	-1.7	-2.0	-2.3	-3.8	3.0	-2.1	-2.7	-1.1	-0.7	na
						(In per cent of labour force)						
Unemployment (end-year)	na	0.0	0.0	0.2	0.3	0.3	0.5	1.3	2.3	3.7	4.3	na
Prices and wages						*(Percentage change)*						
Consumer prices (annual average)	2.2	4.2	91	1,210	4,735	891	377.0	80.0	15.9	10.6	22.7	28.0
Consumer prices (end-year)	na	na	161	2,730	10,155	401	181.7	39.7	10.1	20.0	19.2	25.0
Producer prices (annual average)	na	4.5	125	2,384	4,619	1,134	489.0	52.1	7.7	13.2	32.0	na
Producer prices (end-year)	1.7	4.5	163	3,828	9,668	774	172.0	17.3	5.0	35.3	15.7	na
Gross average monthly earnings in state sector (annual average)	na	na	na	1,220	2,255	786	483.9	71.4	13.3	7.2	15.8	23.7
Government sector 1/						*(In per cent of GDP)*						
General government balance	na	na	na	-25.4	-16.2	-7.7	-6.1	-6.1	-5.2	-3.0	-1.5	-2.0
General government expenditure	na	na	na	58.4	54.5	51.4	33.0	42.8	43.2	39.0	33.8	na
General government debt	na	na	na	na	na	na	27.0	21.0	28.2	45.7	49.1	na
Monetary sector						*(Percentage change)*						
Broad money (M3, end-year)	na	na	na	na	na	540.0	117.4	35.1	33.9	22.3	41.0	na
Domestic credit (end-year)	na	na	na	na	na	na	166.1	22.1	32.5	58.0	30.5	na
						(In per cent of GDP)						
Broad money (M3, end-year)	na	na	na	na	33.6	26.5	12.7	11.5	13.4	14.9	17.0	na
Interest and exchange rates						*(In per cent per annum, end-year)*						
Refinancing rate	na	na	na	80	240	252	110	40	35	60	45.0	na
Treasury bill rate (3-month maturity) 2/	na	na	na	na	na	na	164	51	44	40	45.0	na
Deposit rate 3/	na	na	na	82	149	209	70	24	19	24	21.0	na
Lending rate 3/	na	na	na	77	184	250	123	61	43	54	55.0	na
						(Hryvnias per US dollar)						
Exchange rate (end-year)	na	na	na	0.01	0.13	1.04	1.79	1.89	1.90	3.43	5.22	na
Exchange rate (annual average)	na	na	na	0.002	0.05	0.32	1.47	1.83	1.86	2.45	4.13	na
External sector						*(In millions of US dollars)*						
Current account	na	na	na	na	na	-1,163	-1,152	-1,185	-1,335	-1,295	834	200
Trade balance	-9,000	-12,700	-3,400	-600	-2,500	-2,575	-2,702	-4,296	-4,205	-2,584	-482	-900
Merchandise exports	77,100	74,600	50,000	11,300	12,800	13,894	14,244	15,547	15,418	13,699	12,463	13,300
Merchandise imports	86,100	87,300	53,400	11,900	15,300	16,469	16,946	19,843	19,623	16,283	12,945	14,200
Foreign direct investment, net	na	na	na	na	na	151	257	526	581	747	489	750
Gross reserves (end-year), excluding gold	na	na	na	469	162	651	1,051	1,960	2,341	761	1,046	1,100
External debt stock	na	na	na	na	na	7,167	8,142	9,170	11,807	11,700	11,481	12,503
						(In months of imports of goods and services)						
Gross reserves (end-year), excluding gold	na	na	na	na	na	0.4	0.7	1.1	1.3	0.5	0.8	0.8
						(In per cent of exports of goods and services)						
Debt service	na	na	na	na	na	12.1	9.3	6.0	9.4	19.7	12.1	na
Memorandum items						*(Denominations as indicated)*						
Population (end-year, millions)	51.7	51.8	51.9	52.1	51.9	51.7	51.5	51.1	50.5	50.1	49.7	49.5
GDP (in millions of hryvnias)	1.5	1.7	3.0	40.9	1,483	12,038	54,516	81,519	93,365	102,593	127,126	165,976
GDP per capita (in US dollars)	477.4	543.1	168.8	396.5	635.5	727.6	718.6	872.2	992.9	834.8	619.5	na
Share of industry in GDP (in per cent)	na	34.7	45.8	44.6	27.6	30.0	34.4	27.5	26.4	24.6	na	na
Share of agriculture in GDP (in per [illegible]	28.0	24.4	24.4	20.3	21.6	16.0	14.5	12.2	11.8	11.4	na	na
[illegible] millions												
External Debt/GDP (in per cent)	na	na	na	na	na	19.1	22.0	20.6	23.5	28.0	37.3	46.0
External Debt/Exports (in per cent)	na	na	na	na	na	51.6	57.2	59.0	76.6	85.4	92.1	94.0

Note: Data for 1992-98 represent official estimates of outturns as reflected in publications from the national authorities,the International Monetary Fund, the World Bank, the OECD. Data for 1999-2000 reflect EBRD evaluations, partly based on information from these sources.

1/ General government includes the state, municipalities and, from 1994, extrabudgetary funds. Data are on a cash basis until 1995, and on an accrual basis thereafter.

2/ Treasury bills were introduced in March 1995.

3/ Weighted average over all maturities.

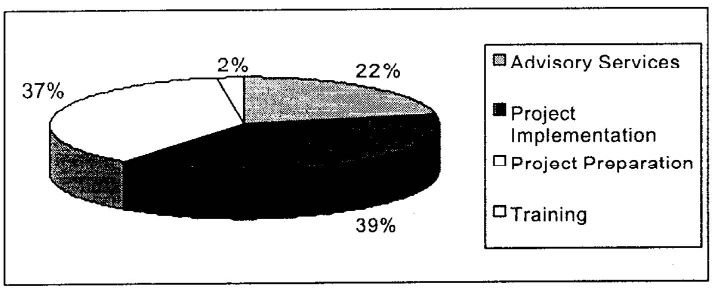
ANNEX 5.1 - SIGNED PORTFOLIO IN UKRAINE (EUR M) as of 28 June 2000

	Total Project Cost	Net Business Volume	Operating Assets	Portfolio	Repayments	Sector
Private Sovereign Financial Sector						
SME Line of Credit	129,527	129,527	111,478	112,615	16,911	SME Finance
SME Credit Line II	139,534	47,165	0	47,165	0	SME Finance
Sub-total	***269,061***	***176,692***	***111,478***	***159,780***	***16,911***	
Private Non-Sovereign Financial Sector						
Ukraine Fund	12,612	3,741	2,283	3,556	185	SME Finance
Ukraine Fund Capital Increase	11,508	3,495	2,263	3,495	0	SME Finance
FUIB Credit Facility	13,895	13,895	6,971	6,971	6,924	Finance
FUIB under MBEFF (Share Purchase)	6,146	4,927	4,927	4,927	0	Finance
Kiev International Bank	5,000	1,750	1,750	1,750	0	Finance
Kiev International Bank	1,750	791	791	791	0	Finance
Regional TFP : Kiev International Bank (KIB)	3,000	0	0	0	0	Finance
Ukraine Subordinated Credit Facility to Raiffeisenbank	10,688	10,688	5,130	10,688	0	Finance
Multi Bank Equity Finance - West Ukrainian Commercial Bank	3,298	3,328	3,328	3,328	0	Finance
BNP Dresdner Ukraine	10,003	1,001	0	0	1,001	Finance
Sub-total	***77,900***	***43,617***	***27,443***	***35,506***	***8,110***	
Private Non-Sovereign with Local Sponsor						
Ukrrichflot	40,081	8,818	4,413	6,096	2,722	Shipping
Svitoch Confectionery	7,715	4,508	0	0	4,508	Confectionery
Obolon Brewery	78,132	42,753	33,554	39,999	2,754	Beverage
Sub-total	***125,928***	***56,079***	***37,967***	***46,095***	***9,984***	
Private Non-Sovereign with Foreign Sponsor						
Poltava Oil and Gas Project	45,746	8,551	2,019	2,019	6,532	Oil & Gas
Integrated Agricultural Services and Processing	30,995	10,723	10,389	10,723	0	Agribusiness
Dnipropetrovsk Oil Extraction Plant I(DOEP I)	21,911	9,085	0	0	9,085	Agribusiness
Dnipropetrovsk Oil Extraction Plant II (DOEPII)	21,377	21,377	5,344	5,344	16,032	Agribusiness
DOEP (AMENDED)	78,559	25,118	18,247	25,118	0	Agribusiness
Ukrainian Wave (f.k.a L'viv Wireless)	38,371	16,032	7,482	16,032	0	Telecoms
IVECO/Kraz Joint Venture	56,648	20,462	14,049	20,462	0	Automotive
AD-Zarya	52,181	12,830	12,830	12,830	0	Glass Packaging
Procter & Gamble Distribution	146,109	16,077	1,849	16,077	0	Consumer Goods
Radisson SAS Kyiv	39,497	13,575	0	13,575	0	Property/Tourism
Sunflower-seed Processing Plant	102,608	59,855	13,037	59,855	0	Agribusiness
Cerealia BCP	8,551	3,206	0	3,206	0	Agribusiness
Kyivstar	204,254	36,554	0	36,554	0	Telecoms
Sub-Total	***846,807***	***253,445***	***85,246***	***221,795***	***31,649***	
Sovereign						
Starobeshevo Power Modernisation Project	160,560	121,013	2,325	121,013	0	Power Generation
Zaporizhzhia - Water Utility Development & Investment Progr.	46,293	29,927	741	29,927	0	Water Supply
Ukraine Energy Service Company - UkrEsco	35,418	32,065	415	32,065	0	Energy Efficiency
Balkan Gastransit Project	82,193	42,753	0	42,753	0	Oil & Gas
ITUR	66,143	56,737	38,627	38,627	18,110	Telecoms
Eurovision - Ukraine	1,764	1,069	163	163	906	Telecoms
State International Airport Borispol	15,819	5,451	909	909	4,543	Transport
Air Navigation System Upgrading	46,174	27,148	271	27,148	0	Transport
Railway Development Project	100,743	55,451	0	55,451	0	Transport
Sub-Total	***555,107***	***371,614***	***43,451***	***348,056***	***23,559***	
Portfolio Total	**1,874,803**	**901,446**	**305,585**	**811,232**	**90,213**	

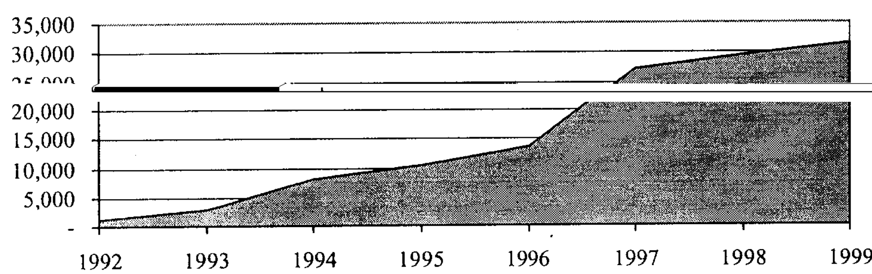
ANNEX 5.2 - TECHNICAL COOPERATION PROJECTS

COMMITMENTS BY TYPE (EUR Million)

	Committed	Disbursed	Number of Operations
Advisory Services	6,926	3,598	46
Project Implementation	12238	5,311	28
Project Preparation	11721	11,374	76
Training	730	730	5
Total	**31,617**	**21,014**	**155**



COMMITMENTS BY YEAR (EUR Million)



ANNEX 6 - DONORS IN UKRAINE

N.B The contents of this section have been contributed directly by the Constituency Offices where indicated with an asterisk.

*EUROPEAN UNION

TACIS is currently preparing its Indicative Programme for 2000-2003. TACIS has selected the following areas as its priority sectors to advance transition: institutional, legal and administrative reform; support for economic reform and private sector development and addressing social consequences of transition. Additional assistance will be provided separately under the Nuclear Safety Programme, Inter-State and the Cross-Border Co-operation Programmes.

The European Commission and the EU Member States are active in the nuclear safety programme and on the Chernobyl Shelter Implementation Programme in particular. To date, EC TACIS assistance to Ukraine in the field of nuclear safety totals over EURO 370 million. This includes grants for Chernobyl and Chernobyl-related projects, such as the special shelter fund administered by the EBRD, preparatory work for Euroatom/EBRD loans for the major power replacement projects, preparation of the decommissioning plants for the remaining units 1-3 at Chernobyl and the construction of a solid waste treatment and disposal facility. Over EURO 160 million has also been given in grants under TACIS for nuclear safety in Ukraine other that for Chernobyl.

In addition, the EU adopted a third macro-financial loan in October 1998 of up to EURO 150 million. EURO 58 million was disbursed in July 1999. Further disbursement of this loan is conditional on the IMF's EFF getting back on track.

UNITED STATES

US assistance is primarily delivered through The United States Agency for International Development (USAID). In 2000, USAID will continue to support national level legal, social and financial sector reforms in Ukraine together with the World Bank and IMF. The assistance provided through USAID in 2000 has 13 Strategic Objective areas. The most important ones are: Privatisation support (including the Western NIS Enterprise Fund) – USD 19.3 million, SME Support - USD 11.9 million, Financial/Banking sector Reform – USD 7 million and the Kharkov and Lviv Initiatives programmes - USD 9 million. The total 2000 budget is USD 72.18 million, of which USD 70 million has been already approved by the US Congress.

UNITED KINGDOM

British assistance is supervised by the Department for International Development. (DfID). The pipeline of DID projects includes some 41 projects. Key areas are Agriculture, Energy, Environment, Financial Sector Support, Governance, Private Sector Development, Social Protection, and Macro-Economic Management. For the past 4 years annual budget allocations for DID programmes are in the region of GBP 9 million (USD 14.5 million). The 2000 budget is GBP 9.25 million (about USD 15 million). Each of the above sectors have approximately 10 % of the annual budget for this year and agriculture has a more substantial portion of 20%. No energy projects have been included in the 2000 program budget.

GERMANY

As of February 2000, Germany has 36 assistance projects. The German government delivers assistance primarily through its Transform programme and projects. Principal areas of Transform activity are: the German Advisory Council to the President of Ukraine (3 projects), SME support (14 projects), Training programs for civil servants, commercial bank managers and SME managers (8 projects), Finance Sector and Agribusiness Sector (2 projects each). The approved budget for Transform programs for 2000 is DM 18 million (USD 9 million)

***CANADA**

The objectives of Canada's program of co-operation with Ukraine, administered by the Canadian International Development Agency (CIDA), are to: support the transition to a market economy; promote good governance, democracy, political pluralism, the rule of law, and adherence to international norms and standards; facilitate Canadian trade and investment links with the region; and enhance nuclear safety.

Between 1991 and 1999 Canada committed more than $280 million (USD 187 million) in bilateral assistance to Ukraine: $196 million (USD 131 million) in the form of technical co-operation; $14 million (USD 9 million) in humanitarian assistance; and $70 million (USD 47 million) in commercial credits. In addition, in June 2000 Canada announced $10.4 million (USD 7 million) in new bilateral technical co-operation projects in Ukraine to support scientific research and development, to assist Ukraine in its efforts to attain membership in the World Trade Organisation and to help the Ukraine Ministry of Justice address issues of corruption in the public sector.

Furthermore, Canada actively participates in multilateral and regional initiatives relating to Ukraine, including the Chernobyl Shelter Implementation Plan (SIP). In June 2000 Canada announced a new contribution of $19.5 million (USD 13 million) to the SIP, which is in addition to Canada's first contribution of $30 million (USD 20 million) in 1997.

NETHERLANDS

Dutch assistance for 2000 is included in "PSO" Initiative project with a total budget amount of GLD 18 million. (USD 9 million). Funding of the "PSO" Initiative is provided by the Ministry of Finance of the Netherlands. The amount of funding has remained the same for a few years. Funding will be directed to activities in the following sectors: agriculture, industrial development, energy, transport sector and environment.

JAPAN

The Japanese government usually provides assistance in two ways: through ODA (Official Development Assistance) and various programmes related to Nuclear/ Chernobyl issues. The Japanese government has offered $150mn of untied loans, has supported the provision of export credits totalling $50mn and has pledged $45 mn to the Chernobyl Shelter Fund.

ITALY

Italian assistance to Ukraine is aimed mainly at support to SMEs (mainly in transport, trade, agriculture and light manufacturing). The budget for this activity in 2000 is about USD 1 million.

***FINLAND**

In addition to Finland's participation in the NSA and the CSF (with EUR 3.5 million) in 1999-2003, Finland assists energy sector development in Ukraine by financing rehabilitation studies of the District Heating System in Kiev, Kharkiv and Sevastopol.

FRANCE

The French government has a special program of technical assistance, which includes know-how transfer, consultancy support and exchange of specialists. Its budget for 1999 was Euro 1.8 million. No specific programmes aimed at SME support or other businesses are envisaged. However, according to information provided by the French Embassy in Kyiv, they will consider any sound project for funding. Such funding will be provided on a case-by-case basis rather than in the form of ear-marked grants or funds. It was noted that the potential total budget figure may become 2- 3 times bigger if projects are considered. In the context of EU donor help to Ukraine, for the period 1991-1998, France allocated total funding of ECU 279 million, out of which Technical Assistance amounted to ECU 7 million, Export Credits to ECU 106 million, Nuclear Safety programmes to ECU 21 million, Humanitarian Aid to ECU 0.133 million, and others to ECU 12 million.

***AUSTRIA**

Austria's grant disbursements to the Ukraine for 1999 amounted to ATS 30 million (USD 2.2 m) the major part of which was for health, education and humanitarian assistance.

***SWITZERLAND**

Swiss assistance amounts to USD 6 million per year and is supervised by the Swiss Development Cooperation (SDC) (technical assistance) as well as the State Secretariat for Economic Affairs (seco) (financial assistance). The technical assistance programme includes several projects in the area of reintegration of returning deportees and different training programmes for unemployed people, social worker and judges. The financial assistance (approximately USD 4 million per year) has three key areas: Energy (nuclear safety, rehabilitation of hydro power plants), Environment (upgrading of waste-water treatment installations), Banking Sector (training programme for bank managers and staff).

***SWEDEN**

Ukraine is one of the prioritised countries in the context of Swedish development cooperation with Central and Eastern Europe. The activities are primarily handled by Sida (Swedish International Development Agency). In 1999 SEK 66 million (appr. USD 7.4 million) was allocated to initiatives in Ukraine, mainly in the economic and social spheres. Support is given for instance to public administration and local government reform, training of social workers and journalists. The Swedish bilateral development cooperation with Ukraine has steadily increased since its commencement in 1994, and it is foreseen that it will continue to grow the next few years. Focus will be on support for public administration, business and industrial development and social security.

ANNEX 7: SME IN UKRAINE

Background

In early 1998, about 137,000 small and medium-sized businesses were reported as registered in Ukraine, of which roughly 90% can be considered active. These enterprises employ about 6% of the total workforce of the country and produce roughly 4% of the total output. The existence of a further large category of individual entrepreneurs, traders who sell frequently for cash to consumers, can also be assumed. The total number of these micro-enterprises can only be estimated, but must comprise several hundred thousand.

The highest concentration of SMEs in Ukraine is in Kyiv, with the oblasts of Crimea, Donetsk, Kharkiv, Lviv, Mykolayiv, Zakarpatska, Zaporizhia and Sevastopol also having above-average concentrations of SMEs. More than 50% of all SMEs are in trade and catering, a pattern that holds for most of the Ukrainian oblasts. The number of SMEs as a proportion of all industry is 14% for Ukraine as a whole, with Crimea and Kherson recording the lowest proportion (9%) and Kyiv having the highest proportion (20%).

Institutional background

A number of state organisations exist to promote SMEs in Ukraine. The following *governmental bodies* represent the most visible players at national and regional level:

The **State Committee of Ukraine for Entrepreneurship Development** is a state body which is supposed to represent the interest of private entrepreneurs vis-à-vis various government authorities. The committee is presently being restructured and renamed as 'the State Committee for Deregulation'. New regulation to govern the committee in its new role has just been submitted to the president of Ukraine and it will probably take another month before the structure of the committee will be finalised. Although the committee expects to obtain two further staff positions it fears that it will not have sufficient resources to fulfil its tasks.

The committee reported that since 1998 it had instigated 120 "normative acts" to overcome administrative barriers to SME development. This resulted in the abolition of a large number of regulations. The committee stages public hearings on draft laws to get a feedback from the business community. A further feedback mechanism is the institution of ombudspeople at regional level They gather complaints from regional business communities and pass them to the committee, which has the authority to cancel any acts that are not in accordance with the SME policy set out in presidential decrees. The committee also passes on a summary of the complaints to the cabinet of ministers. However, not all ministries comply with the co-ordination rule regarding new, SME-relevant legislation.

At the oblast level, the **Unit for Enterprise Development** within the local departments of the Ministry of the Economy are responsible for supporting the national policy to promote SMEs.

Chambers of Commerce and business associations

In 1993, the Ukrainian branch of the All-Union (USSR) Chamber of Commerce was transformed into the **Ukrainian Chamber of Commerce and Industry** (UCCI). In its current form it is a non-governmental organisation with 1,670 employees and about 2,500 members throughout Ukraine, which include industrial enterprises, R&D institutions, trading companies, banks, commodity exchanges, small and medium enterprises, and other public and private entities.

The UCCI's primary role is to represent its members vis-à-vis Ukrainian governmental bodies and international business communities. Services include helping to forge links with foreign partners, certification of goods, legal and tax advice as well as translation services.

The **Yednannia Association for Promotion of Private Enterprise Development** was established in 1994 as a Ukrainian association of SMEs. Its legal status is that of non-governmental, not-for-profit organisation. Main services to its members include legal and management advice (including a hot-line), training courses and seminars. It is represented in 6 principal centres throughout Ukraine.

Obstacles to SME development in Ukraine

According to an IFC survey conducted in 1998, the four most frequently cited barriers to small business development (the generally low level of domestic demand aside) were high tax rates, a large number of different taxes, frequently changing tax reporting requirements and frequently changing laws and regulations.

Other surveys largely confirm this picture. Among the various taxes, VAT seems to be the most problematic, in particular with regard to compliance procedures and the frequent failure to refund VAT which has been unlawfully deducted at source. The impact of the frequent changes in tax legislation is normally exacerbated by the high number of inspections and the strict and sometimes arbitrary application of rules. The kartoteka system of collecting tax debts continues to pose a particular problem.

A further problem concerning the tax system lies in the simplified tax regime for very small companies. Although this system is meant to facilitate tax compliance for small enterprises, it is viewed with suspicion by many entrepreneurs. There have been cases where enterprises were granted inclusion in the scheme which was then revoked retrospectively shortly afterwards, some businesspeople regard this as an instrument to bring enterprises into the formal sector to then impose the full tax burden on them.

The overall bureaucratic burden on enterprises is best exemplified by the excessive certification requirements. Ostensibly for reason of quality control, the authorities require a large number of certificates before permitting goods to be traded. These requirements differ from sector to sector. One medium-sized producer of non-alcoholic beverages is known to be obliged to have a certificate for each product in each shipment to each customer. These excessive requirements consume much of the scarce management resources of smaller companies.

EBRD activities in Ukraine

- Overview of EBRD activities and key objectives
- EBRD signed projects in Ukraine
- EBRD Strategy for Ukraine (Acrobat)
- Investment Profile 2001
- Khmelnitsky 2 and Rivne 4 (K2R4) completion project

As at 30 June 2001, the European Bank for Reconstruction and Development (EBRD) had signed 45 projects in Ukraine totalling €1.2 billion, 34 of which are in the private sector. Investments have been made in a broad range of sectors, including food processing, the financial sector, oil and gas extraction, transportation, agricultural services, telecommunications and municipal infrastructure.

The EBRD acts as the administrator of the Chernobyl Shelter Fund, which was established in December 1997 to help Ukraine transform the existing Chernobyl sarcophagus into a safe and environmentally stable system. The Chernobyl Shelter Implementation Plan (SIP) is being carried out under the Fund, which is administered by the EBRD on behalf of the G-7 and other contributing countries. A dedicated project team within the Bank is managing the SIP. The EBRD role is very similar to that already undertaken as administrator of the Nuclear Safety Account (NSA) and follows similar procedures.

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EBRD activities by country

overview of activities and key objectives

The EBRD is placing a high priority on the development of its private sector portfolio through increased financial resources to private small and medium-sized enterprises (SMEs), direct private corporate financing, private bank development support and private financing for infrastructure development, particularly in sectors such as power and telecommunications.

Particular attention is being focused on the energy sector, including helping to privatise the sector and making the country more energy efficient via projects in conservation and efficiency, nuclear safety and new technology for power generation. Special attention is also being paid to developing the vast potential of the agricultural sector. The EBRD is also active in the upgrading of key infrastructure, including transport and municipal services. The Bank's main operational objectives are as follows:

- To support private sector development through credit lines and equity funding for SMEs, and through direct financing of both joint-venture and local private companies. The low number of foreign investors limits opportunities for direct financing of joint ventures, but the EBRD continues to be responsive to demand for project financing resulting from privatisation and foreign investment.

- To support privatisation by providing financing and technical services for the most promising newly privatised enterprises. The Bank is actively participating in the preparation for privatising major companies in the energy and telecommunications sectors. This work includes procurement of technical assistance for regulatory and

- To support the strengthening of the financial sector, with special emphasis on financing micro, small and medium-sized business. In the banking sector this requires close monitoring of the SME credit lines to ensure efficiency and to coordinate the implementation of institution-building programmes in participating banks. The EBRD will also consider credit lines for, and equity participation in, leading private banks and bringing more Ukrainian banks into the Trade Facilitation Programme. The Bank will also consider providing support for the most promising private banks.

- To help meet growing demand for new equity financing. The EBRD has contributed to a capital increase for the Ukraine Fund and has capitalised Euroventures Ukraine, a post-privatisation fund.

- To promote private investment in food processing and develop the agricultural sector. The EBRD will invest in market-oriented and private sector projects that contribute to the opening up of the agribusiness sector. The Bank plans to work in areas where such initiatives are under way in cooperation with private entre-preneurs and to support the development of distribution, marketing and processing pro-grammes. The EBRD will also consider ways to broaden its activities in line with the latest reform measures in land ownership, provided that its "sound banking" objectives can be achieved.

- To rationalise the energy sector. The EBRD focuses on renovating thermal power generation capacity and on improving the efficiency and environmental performance of the thermal power stations. The Bank aims to develop privately sponsored power generation schemes to improve gas transportation efficiency, support reform of the power market, and make investments to improve energy efficiency by increasing district heating network efficiency and creating energy service companies.

- To rehabilitate and reform key infrastructure sectors. With respect to municipal and environmental infrastructure, the EBRD is focusing on a priority investment programme to finance critical investments in the water supply and waste management sector in two large industrial cities. Other initiatives involve pre-investment studies for similar programmes in other cities, and assistance to local governments in commercialising and increasing private sector involvement in their municipal services

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investment profiles 2001

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Economic summary Reviews each country's macroeconomic reform credentials, including the main indicators from 1993 to 2001, with tables and charts showing trends and forecasts.

Investment climate Examines foreign direct investment to date, including details of major investments, their [illegible] investment policy and incentives including details of foreign [illegible] sections include progress on trade and price liberalisation, currency convertibility, international trade agreements, main foreign trading partners, the social and fiscal systems and their reform.

Major sectors of the economy Includes profiles of every major industry, examining size, growth and opportunities for foreign investors, and focused case studies of selected EBRD investments offering insights into the FDI process in each country.

Financial sector Covers recent financial sector reform, banking privatisations and mergers, foreign investment in the banking sector, capital markets and the stock exchange, investment funds and the insurance market.

EBRD activities Describes the EBRD's strategy and investments to date, with contact names.

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