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November 5, 2008

Ukraine: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

October 31, 2008

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The following item is a Letter of Intent of the government of Ukraine, which describes the policies that Ukraine intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Ukraine, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Kyiv, October 31, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington D.C. 20431 U.S.A.

Dear Mr. Strauss-Kahn:

The attached Memorandum of Economic and Financial Policies (MEFP) describes the economic policies and objectives of the Government of Ukraine for the remainder of 2008 and for 2009–10. Based on our balance of payments needs, and our strengthened policies described below, we request the approval of a Stand-By Arrangement (SBA) in an amount equivalent to SDR 11,000 million (800 percent of our quota) for the period November 2008 through October 2010.

We believe that the policies described in the memorandum will promote sustainable and equitable long-term growth, lower inflation and continued external viability, despite the current difficult external environment. The core elements of the program have been explained to the leaders of the main political parties, and they have committed to support them.

In addition to the policies outlined in the attached MEFP, the government stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives. We will consult with the Fund on adoption of new measures and provide the Fund with the information it requests for monitoring progress during program implementation. We will also consult with the Fund on our economic policies after the expiration of the arrangement, in line with the Fund's policies on such consultations, while we have outstanding purchases in the upper credit tranches. The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks. The reviews will be held first in January 2009, and quarterly thereafter for the duration of the arrangement.

Yours sincerely,

/s/
Viktor Pynzenyk
Minister of Finance

/s/
Volodymyr Stelmakh
Governor of the National Bank of Ukraine

/s/
Yulia Tymoshenko
Prime Minister of Ukraine

/s/
Victor Yushchenko
President of Ukraine

Memorandum of Economic and Financial Policies

I. BACKGROUND

1. **Ukraine's tremendous growth performance of late was unfortunately accompanied by rising vulnerabilities.** Growth averaged over 7 percent since 2000, rapidly lifting Ukrainian living standards. However, by late 2007 the economy was overheating, with a high inflation rate that we considered unacceptable, rapid growth of nominal wages and asset values, and a burgeoning current account deficit. Behind these developments lay a favorable external environment that saw our export prices rising to very high levels and capital inflows surge into Ukraine. Some of the capital inflow was foreign direct investment—attracted by Ukraine's enormous potential—but a significant portion was debt inflows, often at short-term maturities into the corporate sector and the banking system. The banking system onlent funds in foreign exchange to domestic borrowers, creating largely unhedged exposures.

2. **We recognized these problems, and by early 2008 began to vigorously address them.** The fixed exchange rate regime which served us well in the past was no longer well suited to address the new challenges. Thus the National Bank accelerated the planned transition to a flexible exchange rate: beginning in March 2008, the hryvnia was allowed to fluctuate within a wider band. The National Bank also took steps from late 2007 to eliminate incentives for banks to fund themselves abroad with short-term debt.

3. **However, the deepening global financial turmoil and plunge in commodity prices have undermined confidence and necessitated a more rapid adjustment than planned.** Substantial problems in our large steel sector (due to sharply lower external demand), growing concerns about ability of banks and corporates to roll over existing credit lines, and problems at Ukraine's sixth largest bank, have weakened confidence in our banking system and currency. We expect most of our banks' direct credit lines from foreign banks continue to be rolled over, but our access to international capital markets has become limited. We have stabilized the domestic situation by providing liquidity to the banking system and placing temporary restrictions on early withdrawal of term deposits. However, during the program period, we expect the combination of weaker demand in our trading partners, falling export prices and rising energy import prices, and reduced access to international financial markets to weaken growth prospects. Thus, overall financing needs for the program period are very large: after taking into account the planned strong policy measures under the program and prospective financing from the private sector and possibly other international financial institutions (such as the World Bank), there remains a residual gap of about \$16½ billion.

II. PROGRAM OBJECTIVES

4. **Our program aims to restore confidence in Ukraine's macroeconomic and financial stability.** The program will first address financial sector problems by: (i) appropriate liquidity support and expansion of deposit guarantees; (ii) a stronger bank resolution framework, including availability of public funds; and (iii) a stronger framework for resolution of household and enterprise sector debts. Second, the program will facilitate adjustment to potentially large external shocks and reduce inflation by adapting the

macroeconomic policy framework. This will be accomplished by: (i) a flexible exchange rate policy, supported by base money targets and an appropriate intervention strategy; (ii) planned transition to inflation targeting; (iii) bringing incomes policy in line with targeted inflation, while protecting the most vulnerable; (iv) maintain a prudent fiscal stance; and (v) bringing energy sector prices more in line with costs.

5. **For 2009 our macroeconomic objectives are set conservatively, reflecting the fact that due to external shocks, the Ukrainian economy, much like the rest of Europe, may face a recession.** We have calibrated expected impacts on growth from the experience of 2004–05, when we were hit with a similar set of shocks, albeit from a different base. We hope to do better than implied by that episode, particularly if the global environment improves, but also due to our confidence in the underlying dynamism of Ukraine’s rapidly transitioning economy. Our objective for 2009 will be to limit inflation to at most 17 percent, a target which will be shared by all government agencies and the National Bank. This target will be kept under review, particularly as the 2009 budget is prepared, since we hope to achieve a better result. The continued high inflation rate, notwithstanding the economic slowdown, reflects among other things our intention to bring gas prices paid by consumers more in line with costs. We expect the current account deficit to compress to 1–2 percent of GDP, particularly due to a slowdown in credit-sensitive imports like machinery. International reserves should remain around present levels.

6. **In the medium term, we expect the economy to gradually recover.** A recovery should start sometime in the second half of 2009, and we should be back at our estimated potential growth rate (5–6 percent) by mid-2010, driven in particular by rising investment ahead of the Euro 2012 football championships, and improvements in competitiveness fostered by continued implementation of a flexible exchange rate regime. Inflation should return to single digits by late-2010, helped by continued transition to inflation targeting and continued prudent incomes policies, and will be anchored around 5–7 percent from 2011. Current account deficits should remain small and readily financeable, helped by continued fiscal prudence, with reserves rising and at safe levels. The full macroeconomic and policy program for 2010 will be discussed during the fourth review, in October 2009.

7. **We are prepared to respond flexibly to economic developments.** Economic prospects for Ukraine depend on the depth and duration of the international deleveraging process and the accompanying global economic slowdown. If our balance of payments outcomes are better than projected, we would allow a build-up of foreign exchange reserves and adjust monetary policy to safeguard the inflation objective. Should the overperformance be large and persist, we would also be prepared to make repayments of Fund resources ahead of schedule, or refrain from drawing scheduled disbursements. In the event that developments are less favorable than expected, buffers built into our policy framework—including a flexible exchange rate and amounts available for bank recapitalization—provide a cushion, but we stand ready to take additional measures as necessary.

III. POLICIES FOR 2009

A. Monetary and Exchange Rate Policy

8. **We will implement a flexible exchange rate regime.** A flexible exchange rate will provide a buffer to the economy against external shocks and give us more scope to control inflation. To clarify this change in our policy regime we will revise the *Monetary Policy Guidelines* for 2009 to: (i) abolish the exchange rate band; (ii) base the official rate on the preceding day's market exchange rate (with intra-day adjustments if necessary to keep it within 2 percent of the market rate); and (iii) commit in revised *Guidelines* to a transparent intervention strategy via pre-announced regular auctions and guided by net international reserve targets (**quantitative performance criterion**), with separate provisions covering the NBU's role as an agent for government foreign exchange needs. We will not have an opportunity to issue revised guidelines until the cabinet revises the 2009 macro framework, but in the interim the NBU Council will take and publicize a decision eliminating the exchange rate band and the NBU Board will change the definition of the official rate (in the manner described in (ii) above) (**prior action**).

9. **NBU actions and regulations concerning the foreign exchange market will be designed to enhance the market mechanism.** Any foreign exchange operations with the government and private agents will be carried out at the market exchange rate. While we expect the exchange rate to fluctuate, we will not tolerate abrupt and disorderly movements. We will support the new policy regime with measures to improve the operation of the foreign exchange market, including cancellation of the foreign exchange transactions tax (**structural benchmark** for the second review). As part of our initial response to the crisis, we have imposed a number of exchange controls, including delays on transferability of hryvnia profits, limitations on early repayments of foreign exchange loans, and limitations on advance payments. We have eliminated the restriction on advance payments and we will discuss with IMF staff the removal of any remaining exchange restrictions and, following agreement on a timetable for removal, will request IMF Board approval at the time of the first review. We will consult with the Fund on any further measures that we may undertake regarding the working of the foreign exchange market.

10. **The main goal for monetary policy will be to reduce CPI inflation to 17 percent by end-2009.** The NBU will achieve this goal by using targets on the level of base money (**quantitative performance criterion**). In particular, we will target base money growth to be about 11 percent in 2009, in light of our expectation that nominal growth of the economy will amount to about 12 percent, and that money demand will decline slightly. In line with this target, but only as financial market stresses abate, we will need to withdraw liquidity. In part this will come by restoring previous reserve requirement rules, but we will also raise interest rates on deposits at the NBU, to bring them closer to the refinance rate. We will continue to conduct deposit auctions, at regular intervals. We will also aim to enhance the quality of the NBU's balance sheet by reviewing the list of acceptable collateral, notably rapidly phasing out bank shares from this list. Since the demand for base money is difficult to predict, during program reviews an assessment of base money demand will be a focus area, with targets adjusted should money demand show signs of deviating markedly from program projections.

In such assessments, indicators such as dollarization of deposits, velocity, and currency movements will be used.

11. **Our medium-term goal is to re-anchor monetary policy with an inflation targeting regime.** We are well advanced in work towards this, to continue progress we intend to enhance the NBU's regularly published Monetary Review by expanding it to also cover inflation developments and prospects (in line with international practice on Inflation Reports), and to reform internal NBU decision-making processes to refocus around inflation forecasts and risks. We also intend to strengthen NBU independence. To this end, we will: reform the NBU council, transforming it into a narrower technical body in line with best practice; prolong the term of the governor; and provide more financial flexibility to the NBU (government debt to the NBU will be securitized, all liquidity operations centralized in the NBU, and profit transfer arrangements brought into line with best international practice (**structural benchmark**)). We will implement a primary dealer system to facilitate the development of the government securities market. As part of the transition toward IT, we will enhance the NBU's communications with the public regarding its policy objectives and actions.

B. Financial Sector Policy

12. **Our key near-term priority is to restore stability and confidence.** To restore financial stability, our priorities are to (i) stabilize the banking system through a flexible provision of liquidity by the National Bank, (ii) enhance daily monitoring of banks' liquidity condition, and (iii) ensure bank solvency through strengthened on- and off-site supervision. To this end, we intend to move expeditiously in several areas:

- The National Bank's will implement safeguards in the provision of liquidity support, including by strengthened monitoring and supervision, to ensure that such support is adequately flexible, yet not excessive or unintentionally evolving into solvency support. Looking forward to 2009, the National Bank stands ready to refinance bank recapitalization bonds, and will ensure that this does not effect the overall system wide level of liquidity.
- The government will enact the proposal to raise deposit insurance (which covers both Hryvnia and foreign exchange deposits) to Hrv 150,000 from the current Hrv 50,000. As deposit outflows subside, we will remove administrative restrictions on early withdrawals of term deposits.
- We will establish a high-frequency bank-by-bank monitoring system of assets and liability maturity profiles, including deposits, liquid assets, interbank transactions, foreign credit lines, and debt rollovers. If financial conditions in any bank appear to be deteriorating, we will initiate a special on-site inspection, diagnose the causes of the financial difficulties, and agree with bank management on a restructuring plan to resolve the underlying problems.
- The National Bank of Ukraine banking supervision department will initiate close contacts with home supervisors of foreign banks and agree to share information on

the activities of the foreign banks under their supervision. In cooperation with foreign banks and home supervisors, it will also assess the parent bank funding to Ukrainian subsidiaries, and make joint contingency plans for debt rollover risks.

- We will promptly finalize the resolution of the Prominvestbank (**prior action**).
- The National Bank will enhance the disclosure of detailed bank-by-bank financial information to meet international best practices (**structural benchmark**). The financial information will include, among other items, detailed balance sheets and income statements at a monthly and quarterly frequency.
- We will address key recommendations of the May 2008 FSAP Update related to the shift of banking supervision to a consolidated basis, the licensing of cross-bank equity holdings, and the criteria for and transparency of bank investments in non-banks.

13. **We are also preparing a comprehensive bank resolution strategy.** In particular:

- We will conduct a diagnostic study and targeted examination of the banking sector, starting with the large and systemically important banks (comprising 60 percent of the banking system assets). The scope of the examination will be clearly defined to include assessment of asset quality, liquidity position, off-balance sheet items, risk management and capital position. The diagnostic work will be coordinated by the NBU with participation of several reputable audit firms (**structural performance criterion**). Upon completion of the diagnostic study, we will resolve problem banks, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated (**structural performance criterion**).
- We will provide financial support to viable banks in the form of recapitalization, to cushion the real economy from a potential credit crunch. The terms of this support will be laid out in a Law or in a Decree (**prior action**) and the details will be developed in a regulation to be issued by the NBU.
- We will make the necessary legal amendments to facilitate bank resolution (**prior action**). These changes will allow the NBU to undertake the necessary bank resolution processes, including, purchase and assumption, sale of part or whole of a bank, and reduction in the value of the existing shareholders' equity to absorb the losses incurred in the resolution process.

C. Fiscal Policy

14. **We intend to keep the general deficit at low levels in 2008 and 2009.** Achievement of our fiscal targets will be monitored by a **quantitative performance criterion**. In 2008, the deficit would not exceed 1 percent of GDP, a small deterioration from the existing budget position, which reflects already committed expenditures and a projected loss of tax revenues due to the sharp slowdown of the economy in the last quarter of the year. For 2009, we are targeting a general government budget with a zero overall balance (including an adjuster to allow for potential bank recapitalization operations). This represents a tightening of the fiscal

stance compared to previous years, given that the economy is slowing. However, we believe that fiscal policy, which can be targeted, should contribute to reduce domestic demand and imports to a level consistent with external financing constraints, rather than having all of the adjustment fall on the exchange rate.

15. **A combination of factors places us in a good position to meet our fiscal targets.** The starting position is sound: we have a close-to-balanced budget to-date in 2008. Moderating public sector wage growth and gradually passing through imported gas prices increases to consumers will generate savings. We will pass a 2009 budget consistent with our general government deficit target of a zero overall balance when parliament resumes (**structural performance criterion**), and until such time last year's budget will apply (constant expenditures in nominal terms). We will identify and legislate any additional fiscal measures that may be needed. We will keep fiscal targets as a special focus of each review, and may provide additional fiscal stimulus if financing through privatization or other sources becomes available. To strengthen our financing strategy, we will implement a primary dealer system to facilitate the development of the government securities market.

16. **We will change the course of our incomes policies.** Our recent minimum wage, pension, and social transfer increases helped to lift many out of poverty, an important achievement. However, the boom in our trade prices, which allowed us to fund these increases, is now expected to reverse. Still, the strong underlying trend of productivity growth in Ukraine offers some margin for us to adjust while broadly preserving past gains. Our adjustment strategy will thus be to limit the increase in both minimum and average public wage and pensions, and other social transfers, in line with projected inflation in 2009 (average and end-period basis). This will include the following measures: (i) in December 2008–January 2009, the wage level for the first grade public sector employees will remain constant; (ii) postponing for two years the planned equalization of the minimum wage with the much higher minimum subsistence level; and (iii) revising backward-looking indexation arrangements for various social transfers (and refocusing increases on forward-looking inflation measures).

17. **In the broader public sector, we consider it very important to secure greater transparency and financial stability in Naftogaz.** Naftogaz will publish audited 2007 accounts as soon as feasible, with the aim to eliminate the technical default on its eurobond. To assure sound finances going forward, and bring Naftogaz' financial relations with the budget onto a more orderly basis, we will unify the price of domestic and imported gas by end-2011. The gradual phasing of this process will start on December 1, 2008. In parallel, price subsidies for imported natural gas consumed by communal heating entities will be reduced through quarterly tariff adjustments and be eliminated by July 1, 2010. We believe this measure is also important from a macroeconomic adjustment perspective, as it will help slow consumption and encourage faster adjustment to the permanent increase in the price of imported energy. Looking further forward, we intend to put in place a stronger regulatory framework, so that the process of tariff setting can be depoliticized. We plan to undertake changes in consultation with the World Bank.

18. **We would like to reassure that we have in place an effective safety net to help vulnerable groups that may be affected by the macroeconomic adjustment.** We can

assist those adversely affected through a number of programs, including unemployment insurance; an income support scheme; housing and utilities subsidies; and lifeline utility tariffs. The latter two of these programs will in particular assist those affected by rising energy prices. We will continue to review the effectiveness of these programs, in consultation with the World Bank, in particular to ensure that they are well targeted.

D. Private Sector Support Policies

19. **Our program recognizes the possible need to facilitate resolution of corporate sector debts.** We are conducting an in depth analysis of the implications of different economic projections and policy scenarios for risks of extensive private sector default. We will facilitate the establishment of a voluntary framework for restructuring debts. And we are carefully reviewing bankruptcy legislation, with a view to making needed amendments to streamline the process and eliminate delays, while preserving due process. Finally, we will enhance monitoring of external debt developments to ensure that policymakers can respond early to the risk of emerging peaks in external debt service.

20. **It is also important to emphasize that we have not lost sight of Ukraine's pressing structural reform needs.** Indeed action in several areas is all-the-more crucial to help expand external financing from the private sector during the difficult period ahead. We see several measures as crucial in the near term, including (i) the creation of a functioning market in agricultural land; and (ii) agreeing on a list of companies to be privatized, transparently, in 2009. We are also discussing these issues in the context of our World-Bank supported program.

E. Safeguards Assessment

21. We recognize the importance of completing an update safeguards assessment of the NBU by the first review of the standby arrangement. To facilitate this we will authorize the NBU's external auditors to provide IMF staff with all necessary information, including management letters for 2005–07, and to hold discussions directly with Fund staff. We also commit to receiving a safeguards mission, and to provide that mission with all necessary information requested without delay, including information related to correspondent banks and foreign reserve placements.

E. Program Monitoring

22. **The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks.** The phasing of purchases under the arrangement and the review schedule are set out in Table 1 of this memorandum; the quantitative targets for end-December 2008, end-March 2009, end-June 2009, end-September 2009 and end-December 2009, and continuous performance criteria, are set out in Table 2; and the prior actions, structural performance criteria and structural benchmarks as set out in Table 3. The understandings between the Ukrainian authorities and IMF staff regarding the quantitative

performance criteria and the structural measures described in this memorandum are further specified in the TMU attached to this memorandum.

23. **In addition to the policies outlined in this MEFP, the government stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives.** We will consult with the Fund on adoption of new measures, and in advance of revisions to the policies contained in this memorandum, and provide the Fund with the information it requests for monitoring progress during program implementation. We will also consult with the Fund on our economic policies after the expiration of the arrangement, in line with the Fund's policies on such consultations.

Table 1. Ukraine: Access and Phasing Under a Proposed Stand-By Arrangement

Date Available	In millions of SDRs	In percent of quota	Conditions include
November 2008	3,000	218.7	Board approval of arrangement
15 February 2009	1,250	91.1	Observance of end-December performance criteria and completion of the first review
15 May 2009	2,500	182.2	Observance of end-March performance criteria and completion of the second review
15 August 2009	750	54.7	Observance of end-June performance criteria and completion of the third review
15 November 2009	2,000	145.8	Observance of end-September performance criteria and completion of the fourth review
15 February 2010	375	27.3	Observance of end-December performance criteria and completion of the fifth review
<i>Quantitative and structural performance criteria for remaining scheduled purchases in 2010 are expected to be established at the time of the third review.</i>			
15 May 2010	375	27.3	Observance of end-March performance criteria and completion of the sixth review
15 August 2010	375	27.3	Observance of end-June performance criteria and completion of the seventh review
15 October 2010	375	27.3	Observance of end-September performance criteria and completion of the eighth review
Total	<u>11,000</u>	<u>802</u>	

Table 2. Ukraine: Quantitative and Continuous Performance Criteria 1/
(End-of-period; in millions of hryvnia, unless otherwise indicated)

	Stock	2008		2009		
		End-Sept.	Dec Prog.	Mar Prog.	June Prog.	Sept Prog.
I. Performance criteria						
Ceiling on the cash deficit of the general government (- implies a surplus) 2/ 3/ 4/	-4,994	9,930	0	-2,000	-5,000	0
Floor on net international reserves of the NBU (in millions of U.S. dollars)	37,530	26,700	21,800	18,700	16,600	14,900
Ceiling on base money	170,835	190,000	192,000	197,500	203,000	211,000
II. Continuous performance criteria						
Prohibition on the imposition or intensification of restrictions on the making of payments and transfers for current international transactions						
Prohibition on the introduction or modification of multiple currency practices						
Prohibition on the conclusion of bilateral payments agreements that are inconsistent with Article VIII						
Prohibition on the imposition or intensification of import restrictions for balance of payments reasons						
III. Adjusters						
Project financing 2/	284	1,468	1,045	2,091	3,136	4,182
Cost of bank recapitalizations 3/	0	0	0	0	0	0

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

1/ Definitions are specified in the Technical Memorandum of Understanding (TMU). Targets for 2010 will be set at the time of the third review.

2/ The ceiling on the cash deficit of the general government will be adjusted downward by the amount that project financing falls short of the projections shown in Section II above. The quarterly ceilings are set taking into account the seasonality of the deficit.

3/ The floor on the cash balance of the general government will be adjusted downward by 100 percent of the fiscal cost of banks recapitalizations. This cost includes the upfront cost for the budget implied by the recapitalization as well as associated subsequent interest payments.

4/ Data are cumulative flows from January 1 of the corresponding year.

**Table 3: Prior Actions and Performance Criteria and Benchmarks
Under the Stand-by Arrangement**

<i>Prior Actions</i>	<i>Status</i>
A1. Implement a flexible exchange rate regime. NBU Council to take and publicize a decision to abolish the exchange rate band, and NBU Board to define the official rate as the preceding day's market exchange rate (with intra-day adjustments if necessary to keep it within 2 percent of the market rate) (MEFP ¶8).	Done
A2. Issue a Law or a Decree laying out the terms of financial support to banks (MEFP ¶13).	
A3. Make the necessary legal amendments authorizing the NBU to undertake the necessary bank resolution process, including (i) purchase and assumption, (ii) sales of part or whole bank, and (iii) reduction in the value of the existing shareholders' equity and voting rights to absorb the losses incurred in the resolution process (MEFP ¶13).	
A4. Finalize the resolution of the Prominvest Bank (MEFP ¶12).	
<i>Performance Criteria</i>	<i>Date</i>
B1. Complete a diagnostic study by December 15, 2008 covering NBU's group 1 banks, coordinated by NBU and with participation of several reputable audit firms (MEFP ¶13).	Mid-December 2008
B2. Resolve all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated (MEFP ¶13).	End-June 2009
B3. Pass a 2009 Budget consistent with our general government deficit target of a zero overall balance. Consistency will be monitored through the target for the state budget deficit and the budgets for the social funds (MEFP ¶14).	End-April 2009
<i>Structural Benchmarks</i>	<i>Date</i>
B4. Cancel the foreign exchange transactions tax (MEFP ¶9).	End-April 2009
B5. NBU to adopt framework for publication, on monthly and quarterly basis, of detailed bank-by-bank financial information in line with international best practices, to include among other items, detailed balance sheets and income statements, information on bank capitalization and asset quality, with separate information for domestic and foreign currency assets and liabilities (MEFP ¶12).	End-January 2009
B6. Strengthen NBU independence: reform the NBU council, transforming it into a narrower technical body in line with best practice; prolong the term of the governor; and provide more financial flexibility to the NBU (securitize government debt to the NBU, centralize all liquidity operations in the NBU, and bring profit transfer arrangements into line with best international practice) (MEFP ¶11).	End-June 2009

UKRAINE—TECHNICAL MEMORANDUM OF UNDERSTANDING**OCTOBER 31, 2008**

1. This memorandum sets out the understandings between the Ukrainian authorities and IMF staff regarding reporting requirements and definitions of quantitative targets and structural measures for the economic program supported under the standby arrangement, as described in the authorities' Letter of Intent dated October 31, 2008 and the attached Memorandum of Economic and Financial Policies (MEFP).
2. Quantitative performance criteria are shown in Table 2 of the MEFP. The definitions of these quantitative targets and the adjustment mechanisms are described in Section I below. Prior actions, structural performance criteria, and structural benchmarks are listed in Table 3 of the MEFP, with corresponding definitions in Section II below. Reporting requirements are specified in Section III.

I. QUANTITATIVE TARGETS**A. Floor on net International Reserves of the National Bank of Ukraine****Definition**

3. Net international reserves (NIR) of the National Bank of Ukraine (NBU) are defined as the difference between usable gross international reserve assets and reserve-related liabilities to nonresidents, evaluated at program exchange rates (see below). Usable gross international reserve assets comprise all reserve assets of the NBU (Table A, item 1), to the extent that they are readily available for intervention in the foreign exchange market and held in first-rank international banks or as securities issued by G-7 countries. Excluded from usable reserves, *inter alia*, are:

- any assets denominated in foreign currencies held at, or which are claims on, domestic institutions (i.e., institutions headquartered domestically, but located either domestically or abroad, or institutions headquartered abroad, but located domestically). Excluded are, *inter alia*, all foreign currency claims of the NBU on domestic banks, and NBU deposits held at the Interbank Foreign Currency Exchange Market and domestic banks for trading purposes;
- any precious metals or metal deposits, other than monetary gold, held by the NBU;
- any assets that correspond to claims of commercial banks in foreign currency on the NBU and any reserves assets that are: (i) encumbered; or (ii) pledged as collateral (in so far as not already included in foreign liabilities, or excluded from reserve assets); or (iii) frozen;
- any reserve assets that are not readily available for intervention in the foreign exchange market, *inter alia*, because of lack of quality or lack of liquidity that limits marketability at the book price.

4. For the purpose of this program, reserve-related liabilities comprise:
- all short-term liabilities of the NBU vis-à-vis non-residents with an original maturity of one year or less;
 - the stock of IMF credit outstanding;
 - the nominal value of all derivative positions¹ of the NBU and government, implying the sale of foreign currency or other reserve assets against domestic currency.

Table A. Components of Net International Reserves

Type of Foreign Reserve Asset or Liability ²	NBU Balance Sheet Accounts
1. Gross foreign reserves (in convertible currencies)	
Monetary gold in vault	1100, 1107
Foreign exchange in cash, including Russian rubles	1011, 1017
Demand deposits at foreign banks	1201, 1202
Short-term time deposits at foreign banks	1211
Long-term deposits at foreign banks	1212
SDR holdings and Reserve Position in the IMF	IMF, Finance Department ³
Securities issued by non-residents	1302, 1305, 1307, 1308, minus 1306
2. Short-term liabilities to nonresidents (in convertible currencies)	
Correspondent accounts of nonresident banks	3201
Short-term deposits of nonresident banks	3206, 3207, 3211
Operations with nonresident customers	3230, 3232, 3233, 3234
Use of IMF credit	IMF, Finance Department

5. For program purposes, the exchange rates used to evaluate reserve levels are the official exchange rates determined by the NBU as of September 30, 2008. In particular, the Swiss Franc is valued at 0.9056 dollar, the Euro is valued at 1.4349 dollars, Pound Sterling is valued at 1.8029 dollars, the Japanese yen at 106.1346 per dollar. The accounting exchange rate for the SDR will be 1.56407 per dollar. Official gold holdings were valued at 833.95 dollars per troy ounce. These program exchange rates are kept fixed over the program period. Therefore, the program exchange rate differs from the actual exchange rate set in the foreign exchange market. Furthermore, setting a program exchange rate for the purpose of computing

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

² The definitions used in this technical memorandum will be adjusted to reflect any changes in accounting classifications introduced during the period of the program. The definitions of the foreign accounts here correspond to the system of accounts in existence on September 30, 2008. The authorities will inform the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, and changes in the reporting forms.

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

monetary aggregates does not imply that there is any target exchange rate for policy purposes.

B. Ceiling on Monetary Base of the NBU (Base Money)

Definition

6. The NBU's monetary base comprises domestic currency outside banks and banks' reserves, including cash in vault of commercial banks,⁴ and funds of customers at the NBU. Currency outside banks is defined as: Currency—banknotes and coins—(NBU accounts 3000 (net)+3001 (net)-3007A-3009A-1001A-1004A-1007A-1008A-1009A) minus cash in vault at deposit money banks (DMBs) (DMB accounts 1001A:1005A and 1007A). Banks' reserves are defined as: cash in vault at deposit money banks (DMB accounts 1001A:1005A, and 1007A) plus DMB correspondent account deposits at the NBU in hryvnia (NBU liabilities accounts 3200, 3203, 3204, and 3206) plus funds of customers at the NBU in hryvnia (NBU liabilities accounts 3230, 3232, 3233, 3234, 4731, 4732, 4735, 4736, 4738, 4739, and 4750), plus accrued interest on time deposits of DMBs in national currency (NBU accounts 3208L), plus accrued interest on client's current accounts in national currency (NBU liability account 3238).

C. Ceiling on Cash Deficit of the General Government

Definition

7. The general government comprises the central government, all local governments, and all extrabudgetary funds, including the Pension, Employment, Social Insurance for Temporary Disability, State Material Reserve, Leasing, Occupational Accident and Sickness Insurance, and State Property funds. The consolidated budget of the general government comprises: (i) the state budget; (ii) all local government budgets; and (iii), if not already included in (i), the budgets of the extrabudgetary funds listed above, as well as any other extrabudgetary funds included in the monetary statistics compiled by the NBU. The cash deficit of the general government is measured from below the line as:

- total net treasury bill sales as measured by the information kept in the NBU registry of treasury bill sales (net treasury bill sales are defined as the cumulative total funds realized from the sales of treasury bills at the primary auction less the cumulative total redemption of principal on treasury bills); plus
- other net domestic banking system credit to government as measured by the monetary statistics provided by the NBU (this consists of all non-treasury-bill financing in either domestic or foreign currency extended to the government by banks less the change in all government deposits in the banking system); plus

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

- total receipts from privatization received by the SPF and local governments; plus
- the difference between disbursements and amortization on any bond issued by the government or the NBU to nonresidents for purposes of financing the deficit of the general government; plus
- the difference between disbursements of official foreign credits to the general government (including project loans on-lent to public enterprises) and the amortization of official foreign credits by the general government (including of on-lent project loans, and excluding offset-based amortization with Russia); plus
- the net change in government deposits in nonresident banks, or other nonresident institutions; plus
- net proceeds from any promissory note or other financial instruments issued by the general government.

8. For the purposes of measuring the deficit of the general government, all flows to/from the budget in foreign currency will be converted into hryvnia at the official exchange rate prevailing at close of business on the date of the transaction.

Adjustment mechanism

9. The ceiling on the cash deficit of the general government is subject to an automatic adjuster based on deviations of external project financing (defined as disbursements from bilateral and multilateral creditors to the state budget for specific project expenditure) from program projections (shown in Table 2 of the MEFP). Specifically, if the cumulative proceeds from external project financing (in hryvnia evaluated at actual exchange rates):

- a) exceed program projections, the ceiling on the consolidated general government deficit will be adjusted upward by 100 percent of the excess in external project financing;
- b) fall short of program projections, the ceiling on the consolidated general government deficit will be adjusted downward by 100 percent of the shortfall in external project financing.

10. The ceiling on the cash deficit of the general government is subject to an automatic adjuster corresponding to the budgetary costs associated with the recapitalization of banks. These costs affect the cash deficit of the general government as defined above in two ways: first, through the upfront cost for the budget of the recapitalization; second, via the associated subsequent interest payments. These costs are excluded from the calculation of the fiscal targets defined in the program. Specifically, the ceiling on the consolidated general government deficit will be adjusted upward by 100 percent of this cost.

II. PRIOR ACTIONS AND STRUCTURAL MEASURES

11. **Prior Action A1. Issue NBU resolutions laying out the specifics for implementing a flexible exchange rate regime (MEFP ¶8).**

12. The NBU council will abolish the exchange rate band and the NBU board will define the official rate as the preceding day's market exchange rate (with intraday adjustments if necessary to keep it within 2 percent of the market rate).

13. **Prior Action A2. Issue law or decree laying out the terms of financial support to banks (MEFP ¶12)**

14. The financial support will include the allocation of financial resources in the form of recapitalization bonds. Access to the recapitalization funds will be only for those banks evaluated as solvent and viable.

15. **Prior Action A3. Make the necessary legal amendments to facilitate bank resolution (MEFP ¶12).**

16. Adopt necessary legal amendments to facilitate bank resolution of viable but undercapitalized banks by authorizing the NBU to undertake the necessary bank resolution process, including purchase and assumption, sales of part or whole bank, and the reduction in the value of the existing shareholders' equity and voting rights to absorb the losses incurred in the resolution process.

17. **Prior Action A4. Finalize the resolution of the Prominvest Bank (MEFP ¶13).**

18. This measure requires a prompt resolution of Prominvest Bank following the intervention by the NBU in early October. The resolution requires either the sale of the bank to a strategic investor or a merger with a viable bank. However, if the ongoing deposit outflows were to impair its solvency, the bank should be rapidly liquidated.

19. **Structural Performance Criterion B1. Complete diagnostic study (MEFP ¶12).**

20. Complete diagnostic study of large systemic banks (NBU's group 1 banks) by December 15, 2008. NBU to initiate: (i) diagnostic studies and targeted examination of bank needs as a precondition for access to resources; (ii) the scope of such examination to include assessment of asset quality, liquidity position, off-balance sheet items, risk management and capital position; (iii) the coordination of the diagnosis by the NBU with participation of international experts and several reputable audit firms.

21. **Structural Performance Criterion B2. Complete resolution of problem banks (MEFP ¶12).**

22. Resolve all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are promptly liquidated.

23. **Structural Benchmark B5. Enhance the disclosure to the public and markets of detailed bank-by-bank financial information to meet international best practices (MEFP ¶11).**

24. NBU to adopt framework for publication, on monthly and quarterly basis, of detailed bank-by-bank financial information in line with international best practices, to include among other items, detailed balance sheets and income statements, information on bank capitalization and asset quality, with separate information for domestic and foreign currency assets and liabilities.

III. REPORTING REQUIREMENTS

A. National Bank of Ukraine

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

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

27. The NBU will continue to provide on its web site the weekly report on the primary treasury bill market, reports on each treasury bill auction, and provide to the IMF the monthly report on treasury bills.

28. The NBU will provide the IMF, no later than the 25th of each month, with data on the total financing (including refinancing) issued by the NBU to commercial banks, broken down by original maturity of the financing.

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

30. The NBU will continue to provide to the IMF on a daily basis the daily operational balance sheet of the NBU and commercial banks in the standard format, including detailed information on banking sector credit to the general government.

31. The NBU will provide to the IMF, on a monthly basis, a projection for external payments falling due in the next twelve months.

32. The NBU will provide to the IMF, on a quarterly basis, the stock of external debt for both public and private sector.

33. The NBU will provide to the IMF on a daily basis the standard daily data sheet on currency operations including Government foreign receipts and payments, breakdown of interbank market operations by currencies, explanations for main currency flows. The NBU will continue to provide daily information on exchange market transactions, including exchange rates.

34. The NBU will provide to the IMF reports N 381.25; 381.26 with information on reserve requirements and reports on CD operations when performed.

35. The NBU will continue to provide on a monthly basis, no later than 25 days after the end of the month, banking system monitoring indicators in an agreed format.

36. The NBU will provide to the IMF consolidated banking sector data and aggregated data (without specifying the names of the banks) for the largest banks (accounting for at least 80 percent of the total banking system assets) on a quarterly basis, no later than 30 days after the end of the quarter: (i) balance sheet; (ii) loan classification (standard, watch, sub-standard, doubtful, loss); (iii) provisions for all assets (required and actual) (iv) foreign currency denominated lending and deposits; (v) capital adequacy ratios for normative and regulatory capital (Tier II and I), normatives H2 and H3; weighted averages based on banks' total assets; (vi) liquidity normatives H5 and H6; weighted averages based on banks' total assets.

37. The NBU will continue to provide quarterly balance of payments data in electronic format.

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

39. The NBU will inform IMF staff if the Treasury does not pay interest or principal on treasury bills due to the NBU, deposit money banks, or non-bank entities and individuals. In such case, the NBU will provide information on outstanding interest and principal payments.

40. The NBU will inform IMF staff of any changes to reserve requirements for deposit money banks. The NBU will communicate in writing to the IMF staff any changes in accounting conventions and valuation principles incorporated into the balance sheet data and will notify the staff before introducing any change to the Charts of Accounts of the NBU and the Commercial Banks, as well as changes in the reporting forms.

B. Ministry of Finance

41. The Treasury will continue to provide to the IMF its report on daily operational budget execution indicators, on a 10-day basis data on revenue of the state, local government, and consolidated budget revenues.

42. The Treasury will continue to provide to the IMF in electronic form monthly treasury reports, including revenue and expenditure figures of the consolidated, state and local government, no later than 25 days after the end of the month. These reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications.

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

44. The Ministry of Finance will continue to report the final fiscal accounts at the end of each fiscal year, no later than March of the following year. These reports will provide expenditure data by programs and key spending units, as well as based on standard functional and economic classifications.

45. The Ministry of Finance will report any revisions to monthly and annual fiscal reports as well as any amendments to the state budget and local government budgets within a week after their approval.
46. The Ministry of Finance will report to the IMF on a monthly basis, no later than 15 days after the end of the month, the cash deficit of the general government, with details on budget execution data for privatization receipts of the state and local governments; disbursements of external credits (including budget support and project loans for on-lending) to the consolidated budget and amortization of external debt by the consolidated budget; net domestic borrowing of the general government, including net t-bill issuance, issuance of other government debt instruments, and change in government deposits.
47. The Ministry of Finance will also provide, on a monthly basis, information on the borrowing (disbursements, interests and amortization) for the following state-owned companies: Naftogaz, UrkAvtoDor, UkrZaliznytsya, Ukrtelecom and Heteroatom.
48. The Ministry of Finance will provide data on the stock of all budgetary arrears on a monthly basis, no more than 25 days after the end of the month, including separate line items for wages, pensions, social benefits, energy, communal services, and all other arrears on goods and services. The Treasury will report monthly data on accounts payable for state and local budgets (economic and functional classification).
49. The Ministry of Finance will provide monthly information, no later than 25 days after the end of each month, on the amounts and terms of all external debt contracted or guaranteed by the general government.
50. The Ministry of Finance will provide to the IMF in electronic form on a monthly basis, no later than 25 days after the end of the month, (a) data on the outstanding stock of domestic and external debt of the state and local budgets (including general and special funds), (b) the standard files planned and actual external debt disbursement, amortization, and interest payments (including general and special funds), broken down in detail by creditor categories as agreed with Fund staff, and (c) the report on external debt amortization and interest payments by days and currencies. The Ministry of Finance will also report the accumulation of any budgetary arrears on external and domestic debt service.
51. The Ministry of Finance and the NBU will provide data on external and domestic credit to nongovernment units that is guaranteed by the government or the NBU on a monthly basis, no later than 25 days after the end of the month.
52. The Ministry of Finance will provide data on the approved budgets and quarterly operational data (monthly for the Pension Fund only) on the revenue, expenditures, and arrears, and balance sheets of the Pension Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Social Insurance Fund, Employment Fund (detailed data on the breakdown of revenues and expenditure by main categories are expected for this Fund), Occupational Accident and Sickness Insurance Fund, and any other extrabudgetary funds managed at the state level no later than 25 days after the end of each quarter (each month in case of the Pension Fund). Any within-year amendments

to the budgets of these funds will be reported within a week after their approval. The Ministry of Finance will also report the annual financial statement including the final fiscal accounts of those funds at the end of each fiscal year, no later than April of the following year.

53. The Ministry of Finance will report semi-annual data on the number of employees of budgetary institutions financed from the central and local budgets, starting from January 2008. After any public sector wage increase, the Ministry of Finance will provide an estimate of its costs for the current and subsequent fiscal years, for the state and local government budgets.

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

C. State Tax Administration

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

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

56. The STA will provide monthly data, no later than 25 days after the end of the month, on the stock and flow of tax arrears in the energy industry, in total and separately for the electricity, gas and coal sectors; the list (identifying taxpayers) of the 10 largest accumulated stocks of tax liabilities at the end of the month, and the list (identifying taxpayers) of the 10 largest additions to the stock of arrears during that month (flow). These lists should be prepared separately for the electricity, gas and coal sectors.

57. The STA will provide on a quarterly basis, no later than 25 days after the end of the quarter, aggregate data on tax arrears in the above format for the 50 largest tax debtor enterprises, and their cumulative monthly tax payments since the beginning of the year.

58. The STA will continue to provide on a quarterly basis, no later than 2 months after the end of the quarter, a listing of all tax exemptions granted, specifying the beneficiary, the exemption provided, the duration, and the estimated subsequent revenue loss for the current fiscal year.

59. The STA will continue to provide monthly information, no later than 25 days after the end of the month, on VAT refunds in the following format: (i) beginning stock of refund

requests; (ii) refund requests paid in cash; (iii) netted out against obligations of the taxpayer; (iv) denied requests; (v) new refund requests; (vi) end-of-period stock; and (vii) stock of end-of-period requests that are overdue in accordance with the VAT law (currently, refunds are overdue after 1 month for exporters and 3 months for other VAT taxpayers). It is understood that while monthly data could be operational, quarterly figures will be subject to verification and will be final.

D. Ministry of Economy and Ministry of Fuel and Energy

60. The Ministry of Economy will provide quarterly information on actual levels of communal service tariffs in all regions for major services (heating, water supply, sewage and rent). In addition, the Ministry of Economy and European Integration, the State Housing Policy Committee, and the National Energy Regulatory Commission, will provide the methodology underlying the tariff calculations for full cost recovery, including electricity and gas.

61. For each month, no later than the 25th of the following month, the government (based on information by the Ministry of Fuel and Energy, the Ministry of Economy and European Integration, STA, MoF, NERC, and *Naftogaz*) will provide IMF staff with information in electronic form (in an agreed format) on financial indicators in the gas, electricity and coal sectors, including sales, tariffs, arrears, payments to the budget, subsidies, and debt.

E. State Statistics Committee

The state Statistics Committee and *Naftogaz* will provide to the IMF, on a monthly basis, no later than 45 days after the end of the month, data on prices, volumes, and payments for imported and exported oil and natural gas by country of origin and destination.