International Monetary Fund

Ukraine: Letter of Intent and Technical Memorandum of Understanding

July 23, 2009

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.

Ukraine and the IMF

Press Release:
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July 28, 2009

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UKRAINE: LETTER OF INTENT

Kyiv, July 23, 2009

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

Dear Mr. Strauss-Kahn:

1. Like most European economies, the economy of Ukraine has been affected by the negative effects of the global financial and economic crisis. Weak external demand, the low level of international steel prices, the sharp increase of our energy import prices, and tight global financing conditions as well as a reduction of credit provided by the banking system have taken a severe toll on economic activity. However, in the last few months, financial strains in Ukraine have moderated significantly and there are some signs that the economy is stabilizing. Our efforts remain geared towards supporting macroeconomic stability and generating a rapid yet sustainable rebound of our economy.

2. Despite the difficult environment, policy implementation since the first review has been in line with our commitments. The end-May 2009 quantitative performance criteria on base money, net international reserves, and the cash deficit of the general government have been met. We have made progress with the resolution of the systemic problem banks and in preparing legislation to improve the bank resolution framework. We have also strengthened our efforts to raise financing for the budget from domestic sources, including by offering market rates in our treasury bills auctions.

3. In light of this performance and our continued commitment to the program, we request completion of the Second Review under the Stand By Arrangement. Given the sharp reduction in economic activity and its impact on public finances as well as the deterioration in the financial situation of Naftogaz, we request a broadening of the fiscal deficit target to include the deficit of Naftogaz and a modification of the performance criterion on the fiscal deficit. We have maintained import restrictions for two product groups, but these restrictions will expire on September 7, 2009. Finally, we would like to request that the full amount of the next tranche be disbursed directly to the budget to finance the fiscal deficit, including the repayment of the external obligations by the Government. We commit to full accountability and to provide information on a regular basis as to how the resources are being used.

4. We believe that the policies set forth in the letters of October 31 2008; April 30 2009; and this letter are adequate to achieve the objectives of our economic program, but we stand ready to take additional measures as appropriate. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or adopting

new measures that would deviate from the goals of the program, and provide the IMF with the necessary information for program monitoring.

Yours sincerely,

/s/ Yulia Timoshenko Prime Minister of Ukraine	/s/ Victor Yushchenko President of Ukraine
/s/ Ihor Umanskiy Acting Minister of Finance	/s/ Volodymyr Stelmakh Governor of the National Bank of Ukraine

UKRAINE—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. Macroeconomic framework

1. Due to the deepening of the global recession in the first quarter of 2009, weakening terms of trade, and the deterioration of financial conditions, the outflow of deposits and the contraction of credit to economy turned out worse than expected. As a result, the decline in real GDP in 2009 is expected to be more pronounced than the 8 percent that was projected at the time of the first program review, possibly reaching approximately -14 percent. However, going forward, we believe that the improvement of global economic conditions and the implementation of the policies of our economic program will facilitate the strengthening of our banking sector and general confidence, allowing for a resumption of the flow of credit to enterprises and households and a rebound of our export sector and economy. We expect our economy to grow by around 3 percent in 2010.

2. Developments in inflation and our balance of payments have been better than expected. Continued effective implementation of anti-inflation policies, the strengthening of our anti-crisis efforts, the coordination of monetary and exchange rate policies of the NBU with the fiscal policy of the Government, and the commitments under the joint economic program supported by the IMF have allowed us to bring inflation down. We now expect inflation at around 13 percent by the end of the year compared to 16 percent at the time of the first program review. Our balance of payment has adjusted significantly. During the first 5 months of 2009, merchandise imports and exports contracted by 52 percent and 44 percent, respectively, compared to the same period in 2008. Until May, rollover rates for private external debt held up relatively well. Our current account is expected to record a surplus of about 0.5 percent of GDP in 2009.

B. Fiscal Policy

3. At end-May, the cash deficit of the general government was 1.8 percent of GDP, below the program ceiling of 2.4 percent of GDP. However, the outlook for public finances has worsened significantly since the first program review and without offsetting measures, the general government deficit according to the projections may increase from 4 percent to 6.5 percent of GDP in 2009 (excluding bank recapitalization costs). We believe that it is appropriate to broaden the fiscal aggregates monitored under the program to explicitly cover the deficit of Naftogaz, estimated at 2.7 percent of GDP (Hrv 25 billion).

4. To keep our public finances in a structurally sound position, we have announced corrective measures amounting to 0.6 percent of GDP to contain the general government deficit to 6 percent of GDP in 2009, excluding banks' recapitalization costs and the Naftogaz deficit to 2.6 percent of GDP.

5. These measures, together with the structural measures and reforms we plan to implement in 2010, will help us contain the general government deficit in 2010, based on

realistic macroeconomic assumptions and revenue projections. This will start the process of fiscal consolidation and ensure medium term debt sustainability. We have publicly committed to a 4 percent deficit target for 2010 and have taken the following measures:

- To improve the financial position of Naftogaz, we have capitalized Naftogaz by UAH 18.6 billion. We have also announced increases of gas tariffs paid by households (effective September 1, 2009) and utility companies (effective October 1, 2009) by 20 percent (prior action). This will bring these tariffs to the levels of 31 and 43 percent of import prices, respectively. We have also announced a schedule of 20 percent quarterly price increases for households and utility companies starting in January 2010 (prior action). We have formed a taskforce to enforce the existing social safety net to effectively protect poor households. Our objective is to achieve convergence of all tariffs with import prices, while maintaining effective safety nets to protect vulnerable groups.

- We have adjusted electricity tariffs (for consumption of electricity over 600 kw), taken measures to strengthen tax administration in line with IMF advice, and plan to reduce our expenditure by curtailing the expenditures for goods and services in non-priority areas. Social transfers will be better targeted as well.

- We have adopted and announced a time-bound road map describing the schedule and main steps in the design of pension and tax reform. We will issue, by end-September, a comprehensive analysis of the situation of the pension system and the tax system, on which basis we will recommend concrete policy actions by end-October 2009.

- We will contain local government expenditures, including payments to contractual workers, in line with the budgeted amounts and will not introduce any tax amnesty nor implement a moratorium on tax audits.

6. While we will continue to protect the most vulnerable groups of the population from the effects of the crisis, we are also aware that a quick adjustment of our economy to the large external shocks it is facing requires a temporary tightening of our incomes policies. Our strategy will thus be to continue to limit the increase in both minimum and average public wages and pensions, and other social transfers, in line with projected inflation in 2009 (average and end-period basis). We do not support the approval by the Parliament of the draft bills, which would envisage an increase in minimum wages and pensions to unsustainable levels for public finances, and any such bill will be vetoed.

7. We are fully committed to take structural measures to strengthen the financial situation, transparency, and governance of Naftogaz. By end-September, we will pass the legislative amendments in order to introduce the distribution accounts for the heating utilities by the independent regulator (NERC), and eliminate the ban on penalties for households who do not pay their gas and communal utility bills. We have adopted a revised 2009 financial plan and developed a 2010 projected financial plan (prior action) for the company which, in

addition to the gas price increases mentioned above, envisages measures to increase payment discipline by households and utility companies, and a strengthened heating tariff setting mechanism. We have commissioned a special audit of Naftogaz by an international audit firm, to put in place a monitoring framework for the cash result of the company and to establish a regular (monthly) and timely public reporting of key financial data (prior action).

8. Efforts made in recent months to develop domestic financing sources for the government have started to bear fruit. We have been able to place increasing amounts of domestic debt in recent weeks as the bonds carried interest rates more closely aligned with market rates. We are continuing to actively work on procedures and instruments to develop a domestic debt market. In parallel, we are strengthening our efforts to secure additional funding from multilateral and bilateral creditors.

9. Within one year, the Government and the State Property Fund will privatize a number of substantial enterprises, in particular oblast energy distribution companies. In addition, the privatization of the "Odessa sea-port plant" will be completed in September on a competitive basis with a broadest possible involvement of international investors.

C. Monetary, Exchange Rate and Financial Sector Policies

10. We are making efforts to improve the functioning of the foreign exchange market. The official exchange rate is aligned with the average rate on the interbank market on the previous day with a deviation not exceeding 2 percent of the market rate. We have been able to seize on the recent positive developments in the foreign exchange market to buy a small amount of reserves. We have stepped up our efforts to lift administrative controls on the foreign exchange market, including by amending NBU regulation 108 to lift the ban on foreign exchange forward and spot transactions (prior action), and by bringing regulations 107 and 109 in line with international good practices.

11. While inflation continues to fall and pressures on the hryvnia have recently eased, which allowed us to reduce policy rates, we stand ready to tighten policies if pressures on the exchange rate or inflation were to reemerge. The outflow of deposits from the banking system has come to a halt, which has allowed us to revoke the requirement which limited the possibility of withdrawal of deposits prior to maturity. Going forward, we will closely monitor developments in monetary aggregates and bank liquidity and avoid a build up of a large monetary overhang.

12. We have tightened the criteria for access to central bank liquidity, both for the regular refinancing operations and for the liquidity support to problem banks. The agreed- upon-procedures arrangement by Ernst and Young on the provision of refinance credit and foreign currency to banks in the fourth quarter of 2008 was concluded. The preliminary results suggest that the NBU followed approved procedures and authorization policies in conducting these operations. We have shared the results with the IMF, and will publish the main findings in accordance with the terms of reference for this arrangement that was agreed with the IMF.

13. With a view to strengthening the independence of the NBU we will, by end-September 2009, enact legislation to strengthen the overall governance structure of the NBU in line with our commitments under the program. We will also refrain from enacting legislation that impinges on NBU independence and will veto any initiatives to this effect.

14. To restore financial stability and the conditions for a resumption of bank lending, we intend to make rapid progress with our bank recapitalization and restructuring program. Shareholders of most systemic private banks have already brought in the capital and we will follow up closely with the shareholders of noncomplying banks to ensure that the remaining capital pledges materialize. To improve communications with the home supervisors of parent banks, we will aim to complete all pending MoUs by end-2009.

15. We will swiftly resolve the systemic problem banks. For the five systemic problem banks where shareholders are unable to bring in the necessary capital, we have finalized the resolution strategy and started implementation. Three of these banks have already been recapitalized and we expect to make a decision by end-July regarding the expediency of the state involvement in replenishing the capital of the other two banks. (prior action). This strategy includes identifying a fair value of shares, recapitalization by the government and appointment of a professional management. The banks will undergo a thorough due diligence that includes an assessment of restructuring options post-recapitalization. To ensure rapid progress, we have completed the setup and staffing of the relevant units at the MoF and in the NBU. In the implementation of the recapitalization program, we will avoid undue monetary expansion and safeguard the financial position of the NBU.

16. We have recapitalized the two state banks in line with the diagnostic results. By September 2009, we will develop a set of measures to strengthen their financial sustainability.

17. Preparations for the workouts of the non-systemic insolvent banks have been progressing apace. The diagnostic studies for the Group 3 and 4 banks have been completed, and banks have been informed about the needed capital increase by end-2009.

18. Legal amendments to identify ultimate controllers of banks and to strengthen the bank resolution process, which will form the basis for the workouts of the non-systemic insolvent banks, have been adopted (prior action). For these banks we will finalize the resolution strategy and start its implementation by end-September, 2009.

19. More broadly, to strengthen our supervision framework, we are preparing amendments to legislation with a view to implementing consolidated supervision and provide for supplementary supervision of financial conglomerates. We plan to have these amendments enacted by May 2010. Since April 2009, we have also required banks to disclose detailed financial information.

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

Date Available	Millions of SDRs	Percent of Quota	Conditions Include
November 2008	3,000	218.7	Board approval of arrangement
1 May 2009	1,875	136.7	Observance of end-March 2009 performance criteria, prior actions and completion of the first review
15 June 2009	2,125	154.9	Observance of end-May 2009 performance criteria, prior actions and completion of the second review
15 November 2009	2,500	182.3	Observance of end-September 2009 performance criteria and completion of the third review
15 February 2010	375	27.3	Observance of end-December 2009 performance criteria and completion of the fourth review
Quantitative and structural performance criteria for remaining scheduled purchases in 2010 are expected to be established at the time of the third review.			
15 May 2010	375	27.3	Observance of end-March 2010 performance criteria and completion of the fifth review
15 August 2010	375	27.3	Observance of end-June 2010 performance criteria and completion of the sixth review
15 October 2010	375	27.3	Observance of end-September 2010 performance criteria and completion of the seventh review
Total	11,000	802	

Source: IMF staff estimates.

1/ Reflects the rephasing of the second and third purchases requested in the LOI.

Appendix I. Table 2. Ukraine: Quantitative and Continuous Performance Criteria 1/

(End of period; millions of hryvnia, unless otherwise indicated)

	Dec. 2008	2009			
		Mar.	May.	Sep.	Dec.
	Stock (actual)			Prog.	Prog.
I. Performance criteria					
Ceiling on the cash deficit of the general government (- implies a surplus) 2/ 3/ 4/ 5/ 6/	30,026	11,040	22,500	40,000	55,000
Ceiling on the cash deficit of the general government including Naftogaz (- implies a surplus) 2/ 3/ 4/ 5/	30,026	10,097	21,847	58,600	79,100
Floor on net international reserves of the NBU (in millions of U.S. dollars)	27,811	22,238	20,799	16,600	14,900
Ceiling on base money	186,671	174,764	181,681	210,000	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/	799	324	1,050	1,568	2,091
Cost of bank recapitalization 3/	0	0	0	0	0
Stock of budgetary arrears on social payments 4/	76	...	100	100	100

Sources: Ukrainian authorities; and IMF 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 quarterly ceilings are set taking into account the seasonality of the deficit. 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 III above.

3/ The ceiling on the cash deficit of the general government will be adjusted upward by 100 percent of the fiscal cost of banks recapitalization. This cost includes both the upfront cost for the budget as well as associated subsequent interest payments.

4/ The ceiling on the cash deficit of the general government will be adjusted downward by the amount that budgetary arrears on social payments exceed the projections shown in Section III above; respect of the ceiling will be monitored on a quarterly basis.

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

6/ Excluding any bonds issued for capitalization of Naftogaz.

Appendix I. Table 3. Ukraine: Prior Actions for the Completion of the Second Review

Prior Actions for the Second Review

A1. Amend legislation to enable effective bank resolution. The amendments should include revaluation of shareholder capital, transfer of assets and liabilities without prior approval of creditors, simplifying and accelerating the process for bank mergers and acquisitions, enabling the government to provide funds for banks under resolution by the NBU, and definition and disclosure of ultimate controllers of banks.

A2. Finalize the resolution strategy for each of the systemic problem banks and start implementation. In particular, implement the recapitalization for the three banks for which the decision thereto has already been taken, and decide on the expediency of the state involvement in replenishing the capital of the other two banks.

A3. Announce an increase in the price of natural gas paid by households (effective September 1) and utility companies (effective October 1) by 20 percent to bring these tariffs at 31 and 43 percent of import prices, respectively, and announce a schedule of 20 percent quarterly price increases for households and utility companies starting in January 2010. Introduce mechanisms to enforce payment discipline of utility companies and households.

A4. To improve transparency of Naftogaz: approve a revised 2009 financial plan and develop a 2010 projected financial plan for Naftogaz, based on credible financing assumptions, and commission an independent review, by an international audit firm, to put in place a monitoring framework for the cash result of the company and to establish regular (monthly) and timely public reporting of key financial data.

A5. Improve the functioning of the foreign exchange market, including by amending NBU regulation 108 to lift the ban on foreign exchange forward and spot transactions.