COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

providing supplementary macro-financial assistance

for Ukraine

(presented by the Commission)

EXPLANATORY MEMORANDUM

ECONOMIC SITUATION AND PROGRESS WITH STABILISATION AND REFORM

The transition process in Ukraine accelerated following the election of President Kuchma in end-1994 and considerable progress has been achieved since, especially in the area of economic stabilisation and liberalisation. The framework of the transition process, together with important financial backing, was provided by a series of arrangements with the IMF (Systemic Transformation Facility, Stand-by Arrangements) and the World Bank (Rehabilitation Loan, Sectoral Adjustment Loans). In addition, Ukraine received complementary financial assistance from bilateral donors, including the European Community, Japan, the US, as well as Russia and Turkmenistan.

The economic situation in Ukraine remains difficult, with GDP declining by another 10% in 1996, so that it is now at approximately one third of the 1990 level. This does not though take into account the increasing activities in the unrecorded sector. Agricultural production fell by 10.3% and industrial production declined by 5.1% in 1996, with substantial variations across industries. Registered unemployment was only 1.3%, but estimates suggest that the true unemployment rate could be five to ten times as high.

External trade continued to grow rapidly in 1996. In dollar terms, merchandise exports grew by 14% and imports by 24%. However, the import growth figure is somewhat misleading, as a significant part of the increase of imports reflects a higher price for imported gaz, with correspondingly higher receipts by Ukraine for gaz transit fees. The current account deficit narrowed to 2.7% of GDP last year, compared to 4.4% of GDP in 1995.

The tight monetary policy has been an important factor in lowering inflation, stabilising the exchange rate and paving the way to the smooth introduction of a new currency, the Hryvnia (Hrv), in September 1996. The Governor of the National Bank of Ukraine (NBU), responsible for this policy, has been confirmed in his position for a second term.

The Ukrainian authorities successfully completed the stand-by arrangement (SBA) approved by the IMF in May 1996. They broadly observed its quantitative performance criteria and succeeded in reducing inflation to a rate of 40% in 1996 (compared to 182% in 1995, 400% in 1994 and even 10,000% in 1993). The budget deficit was contained to 3.2% of GDP. But since revenues were considerably lower than expected in the programme, the authorities accumulated significant general government arrears on wages, social benefits and pensions of Hrv 3 billion (equivalent to 3.7% of GDP).

There was some progress in structural reform in 1996 and especially there was a significant pick-up in the pace of mass privatisation and small-scale privatisation. All the remaining controls on prices and profit margins were removed by the end of the year and important reforms were undertaken in the energy sector. However, much more remains to be done in all these and other areas to stimulate domestic and foreign investment and rekindle growth.

Data for the first half of 1997 suggest that output has continued to decline, although at a slower pace, with real GDP falling by 7.5% compared to the same period in 1996. Inflation slowed down significantly in the same period and averaged less than 1% a month. The average monthly wage measured in USD increased to USD 83 in May 1997, from USD 49 in 1995. Monetary policy continued to be tight in the first six months of 1997 and an exchange band was introduced for Hrv at least until end-1997. The authorities also announced the current convertibility of the Hrv in May 1997.

Economic developments in the first half of 1997 were overshadowed by the struggle between the government and the Parliament on key elements of the adjustment program that the government had hoped to implement. The 1997 budget was caught up in this struggle and was not adopted until late June. However the authorities continued implementing a prudent fiscal policy, but with revenue collections remaining weak, further arrears on wages, benefits and pensions (of about Hrv 0.7 billion) were accumulated in the first half of 1997.

PREVIOUS MACRO-FINANCIAL ASSISTANCE TO UKRAINE

On 22 December 1994, the Council (Decision 94/940/EC) decided to provide a first macro-financial loan of up to ECU 85 million to support Ukraine's comprehensive adjustment and reform process that had started in the framework of an IMF Systemic Transformation Facility. The ECU 85 million loan was disbursed in one tranche in December 1995.

On 23 October 1995, the Council decided (Decision 95/442/CE) to provide Ukraine with a second macro-financial loan of up to ECU 200 million to back the continuation of Ukraine's reform and stabilisation efforts.

The first tranche (ECU 100 million) of this second loan facility was released in two successive payments of ECU 50 million each in the second half of 1996.

The release of the second tranche (ECU 100 million) took place in September 1997.

THE GOVERNMENT'S STABILISATION AND REFORM PROGRAMME FOR JULY 1997 - JUNE 1998

In 1996, the Ukrainian authorities negotiated with the IMF a comprehensive three-year macroeconomic and structural adjustment programme to be supported by an Extended Fund Facility (EFF). The programme which would build on the progress achieved in 1996 and expand the reforms in a medium-term context was submitted to Parliament for approval in November 1996. However, as already noted, no consensus could be reached between government and Parliament on several of the key elements of the programme and especially on a package of fiscal reform measures. Nevertheless, in the first half of 1997, the authorities broadly followed the spirit of the proposed EFF programme and continued making some progress with structural reforms.

The authorities prepared instead a one-year programme to be implemented during the period July 1997-June 1998 with the goal of preserving the stabilisation gains already achieved. Many of the policies that were originally envisaged under the EFF programme are also part of this one. The program is supported by a SBA of USD 549 million approved by the IMF Board on 25 August. Its key objectives are to lay the basis for the resumption of economic growth through structural reforms, consolidate the gains already achieved, further reduce inflation, and strengthen the external reserve position of the National Bank of Ukraine.

The programme aims to reduce inflation from 40% during 1996 to 15% during 1997 and to 12% during 1998. The fall in output is projected to level off in the second half of 1997, partly because of an expected recovery of agriculture, and to record modest growth in 1998. The programme also aims to increase gross international reserves from an equivalent of 5.2 weeks of imports of goods in 1996 to 6 weeks of imports in 1997, and to 7.4 weeks of imports in 1998.

To achieve these objectives, the consolidated budget deficit will be limited to 4.6% of GDP in 1997 and 4.5% of GDP in 1998. After adjusting for the arrears accumulation in 1996 and net payments of arrears in 1997 and 1998, the underlying budget deficit[1] will be reduced from over 6% in 1996 to 4.3% in 1997 and 2% in 1998. A major objective of fiscal policy will be to reduce existing arrears on wages, pensions, and social benefits, while avoiding new arrears. For this, the programme foresees measures to expand treasury operations and to better monitor expenditure commitments. On the monetary front, a key element will be the maintenance of a stable exchange rate with a narrow band.

FINANCING NEEDS FOR THE PROGRAMME

The balance of payments is expected to remain under considerable pressure during the programme (July 1997-June 1998) as a result of trade liberalisation and greater private sector investment and consumption. Import volumes are projected to continue to grow rapidly, while growth of exports to non-traditional partners (China, Germany) is expected to accelerate. The merchandise trade deficit is projected at USD 4.7 billion and the nonfactor services balance surplus at USD 3 billion, leading to an expected current account deficit of USD 1.9 billion.

Taking also into account the aim to build up official reserves by some USD 524 million to obtain a level equivalent to 6.7 weeks of imports, the gross financing needs are estimated at some USD 3.9 billion for the period of the programme. Once the expected capital inflows in the form of official transfers (USD 350 million), medium and long term credits (of about USD 919 million) and foreign direct investment (of USD 507 million) have been accounted for, the gross financing gap is estimated at USD 2,12 billion. The IMF is expected to provide USD 549 million under the SBA and the World Bank USD 700 million. Taking also into consideration undisbursed commitments of bilateral donors under previous programmes, the residual financing gap for the programme period is estimated at some USD 765 million.

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[1] Adjusted for the accumulation and payments of arrears on wages, pensions and benefits.

PROPOSED SUPPLEMENTARY MACRO-FINANCIAL ASSISTANCE AND MAIN FEATURES OF THE LOAN

The Commission is proposing that the Community would make available to Ukraine a third balance of payments loan of up to ECU 150 million with a maximum duration of ten years. After consultation of the Monetary Committee, the Commission announced this amount at the Consultative Group Meeting on Ukraine organised by the World Bank in December 1996. The Council approved in principle the granting of a third loan to Ukraine at the ECOFIN meeting of 27 January 1997 and requested the Commission to make the necessary proposals.

Although this commitment was made at the time of the EFF being negotiated between the Ukrainian authorities and the IMF, Ukraine's financing needs during the present SBA programme remain substantial. Therefore, the Commission still considers the proposed ECU 150 million as an appropriate reference amount for the Community's support to the balance of payments of Ukraine. This support would further consolidate the country's official reserves position and sustain the reform efforts of the authorities. It would contribute to the financing of the country's residual external financing needs, together with commitments from other bilateral donors (USA, Japan etc) and eventual recourse to the capital markets.

The proposed duration of the loan is identical to that of the previous two loans to Ukraine and consistent with the medium-term balance of payments outlook of the country, which is expected to face substantial financing needs for the years to come.

The assistance would be granted in the context of the SBA and would complement resources made available by the International Financial Institutions and bilateral donors. The Commission welcomes the intention of the Ukrainian authorities to consider the current programme (July 1997-June 1998) as an *interim* programme and to seek a domestic consensus on a comprehensive, medium-term, economic and structural reform programme that could firmly put the country onto the path of sustainable growth. The authorities intend to work in close collaboration with the IMF staff to finalise as soon as possible such a programme that can be supported by an Extended Fund Facility.

The proposed balance of payments loan of up to 150 MECU would be released in at least two tranches. The disbursement of the tranches would depend on:

- a satisfactory track record of Ukraine's macro-economic programme agreed with the IMF in the context of the SBA and/or any other successor arrangement with the IMF;

- progress with respect to structural reforms (including the observance of a number of performance criteria to be attached to this loan).

The effective amount of the assistance (with a maximum of ECU 150 million) would depend on the evolving financing needs of Ukraine during the critical period of the programme and thereafter, as evaluated by the Commission services in close collaboration with the Monetary Committee, the Ukrainian authorities and the IMF. Account will also be taken of the effective disbursements of other bilateral donors, possible new commitments and the capacity of the country to raise capital in the international capital markets.

It is worth noting that progress with stabilisation and reform in Ukraine has slowed down in recent months, as the Parliamentary elections (March 1998) draw closer. The end-August-performance criteria under the SBA were not observed owing to large expenditures on repaying wage arrears. The IMF has consequently held up the disbursement of the relevant tranche which will only be released when conditions are met. The Commission is closely monitoring the situation and takes the view that, despite the recent slippages, the authorities remain committed to stabilisation and reform over the medium-term. In line with the Council's earlier decision in principle, the Community should in this context stand ready to provide further macro-financial assistance to Ukraine to support the completion of the transition process and alleviate its social costs. Since the disbursement of this assistance would, as already underscored, be subject to the satisfactory track record of Ukraine's macro-economic programme it could indeed serve as an additional incentive for the effective implementation of the necessary reforms.

As in the case of similar operations in favour of third countries as well as of the previous two loans in favour of Ukraine, the Community would provide the funds through market borrowing with a guarantee by the general budget. Ukraine would subsequently borrow from the Community. The borrowing and lending operations would be perfectly matched and without any commercial risk for the Community.

In accordance with the Guarantee Fund mechanism, the budgetary implications of a decision to make available an assistance of up to ECU 150 million to Ukraine would imply an ECU 22.5 million provisioning of the Fund.

Proposal for a

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission[2],

Having regard to the opinion of the European Parliament[3],

Whereas the Commission has consulted the Monetary Committee before submitting its proposal;

Whereas Ukraine is undertaking fundamental political and economic reforms and is making substantial efforts to implement a market economy model;

Whereas Ukraine and the European Communities and their Member States have signed a Partnership and Co-operation Agreement which will help the development of a full co-operation relationship;

Whereas the authorities of Ukraine have requested financial assistance from the International Financial Institutions, the Community and other bilateral donors;

Whereas Ukraine has agreed with the International Monetary Fund (IMF) on a macro-economic programme for the period July 1997-June 1998 supported by a "stand-by arrangement" of approximately USD 542 million; whereas policy based loans to Ukraine in the order of USD 500 and 700 million are also expected from the World Bank in 1997 and 1998, respectively;

Whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, and after undisbursed commitments of bilateral donors under previous programmes have been deducted, a residual financing gap of some USD 765 million remains to be covered during the programme period in order to support the policy objectives attached to the government's reform effort; whereas complementary contributions are also expected from the United States, Japan and other bilateral donors;

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[2] OJ N°

[3]

Whereas by Decisions 94/940/EC[4] and 95/442/EC[5], the Council approved macro-financial assistance for Ukraine of up to a total amount of ECU 285 million for support to previous macro-economic programmes; whereas, however, further official support is required in the context of the present programme to support the balance of payments, consolidate the reserve position and facilitate the necessary structural adjustment of that country;

Whereas the Ukrainian authorities are committed to pursuing with the implementation of the plan for the closure of the Chernobyl nuclear power plant, in accordance with the modalities supported by the Group of Seven and the European Union;

Whereas an additional Community long-term loan to Ukraine is an appropriate measure to help easing the country's external financial constraints;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall make available to Ukraine a long-term loan facility of a maximum principal amount of ECU 150 million with a maximum maturity of ten years, with a view to ensuring a sustainable balance-of-payments situation, strengthening the country's reserve position and comforting the implementation of the necessary structural reforms.

2. To this end, the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of Ukraine in the form of a loan.

3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and Ukraine.

Article 2

1. The Commission is empowered to agree with the Ukrainian authorities, after consulting the Monetary Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in Article 1(3).

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4 OJ N° L366, 31.12.94, p. 32

5 OJ N° L258, 28.10.1995, p. 63.

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close co-ordination with the IMF, that the economic policy in Ukraine is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to Ukraine in at least two instalments. Subject to Article 2, the first instalment is to be released on the basis of a satisfactory track record of Ukraine's macro-economic programme agreed with the IMF in the context of the present "stand-by arrangement" or of a successor upper credit tranche arrangement.

2. Subject to Article 2, the later instalment(s) shall be released on the basis of a satisfactory continuation of the arrangements referred to in paragraph 1 and not before a period of three months has elapsed after the release of the previous instalment.

3. The funds shall be paid to the National Bank of Ukraine.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Ukraine so requests, to ensure that an early repayment clause is included in the loan terms and conditions and that it may be exercised.

3. At the request of Ukraine, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Ukraine.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation of the implementation of this Decision.

Done at ....,

For the Council

The President

FINANCIAL RECORD

1. Title of operation

Supplementary macro-financial assistance to Ukraine

2. Budget heading involved

Heading B0-213 reflecting the budget guarantee for the Community loan facility to Ukraine (entered in the 1998 Draft Budget).

3. Legal basis

Article 235 of the Treaty

4. Description and Justification for the action

a) Description of the action

Provision of a Community loan (to be financed by Community borrowing on the international capital markets) in the amount of up to ECU 150 million with a view to supporting Ukraine's adjustment and reform efforts.

b) Justification for the action

The viability of Ukraine's external accounts heavily depends on external financial assistance from official sources.

5. Classification of the Expenditure

Obligatory.

6. Nature of the expenditure

Potential activation of budget guarantee for the Community borrowing aimed to fund the loan to Ukraine.

7. Financial Impact

a) Method of calculation

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

b) Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.

c) Financing of intervention expenditure

In case of call on the budget guarantee:

- Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) n° 2728 of 31 October 1994.
- In case the Guarantee Fund did not contain sufficient resources, additional payments would be called up from the budget by transfer:
  - of any margin remaining in the Reserve for guarantees;
  - of any late payments to the budget for which the budget guarantee has been activated (under article 27(3) of the Financial Regulation);
  - of any margin available under the ceiling of category 4 of the financial perspectives or redeployment therein.
- In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, Euratom) n° 1552/89 of 29.5.1989 will apply.

8. Fraud prevention measures

The funds will be paid directly to the Central Bank of the beneficiary country only after verification by the Commission Services, in consultation with the Monetary Committee and in liaison with the IMF and World Bank services, that the macroeconomic policies implemented in this country are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. Elements of cost-effectiveness analysis

a) Grounds for the operation and specific objectives

By supporting the beneficiary country's macroeconomic reform efforts and complementing financing provided to this country by the International Community in the context of an IMF agreed programme, this assistance would underpin the country's transition towards a market economy, improve growth prospects and alleviate social unrest.

b) Monitoring and evaluation

This assistance is of a macroeconomic nature and its monitoring and evaluation is undertaken in the framework of the IMF-supported adjustment and reform programme that the beneficiary country is implementing.

The Commission services will monitor the action on the basis of a genuine system of macroeconomic and structural policy indicators to be agreed with the authorities of the beneficiary country. They will also remain in close contact with the IMF and World Bank services and will benefit from their assessment of the recipient country's stabilisation and reform achievements.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation.

10. Administrative expenditure

This action is exceptional in nature and will not involve an increase in the number of Commission staff.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1997 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOAN GUARANTEES IN FAVOUR OF THIRD COUNTRIES

(IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of the Fund [1]	Reserve Margin
			329.0 [2]
Decided operations [3]			
Project-related assistance			
EIB/MED (correction mechanism 1996/1997)	-14	-1.71	330.7
EIB/PVDALA (correction mechanism 1996/1997)	-38	-5.32	336.0
EIB/SOUTH AFR.	55	8.25	327.8
EIB/Renewal of mandates [4]	1585.5	237.83	90.0
Macro-financial assistance			
Slovakia (Cancellation)	-130	-18.20	108.2
Belarus (Suspension)	-25	-3.75	111.9
FYROM	40	6.00	105.9
Bulgaria	250	37.50	68.4
Proposed operations			
Macro-financial assistance			
Georgia, Armenia and, if appropriate, Tajikistan [5]	170	25.50	42.9
Ukraine-III [6]	150	22.50	20.4
Project-related assistance			
EIB/FYROM [7]	35	5.25	15.2
EIB/Turkey [8] [10]	105	p.m.	15.2
EIB/ Croatia [9] [10]	49	p.m.	15.2

[1] According to the provisioning rules provided in the Council regulation (EC, Euratom) n° 2728/94 of 31 October 1994. After a first drawing of the Guarantee Fund, and in compliance with Article 5 of the Regulation, the rate of provisioning for new operations has been increased from 14 % to 15% in 1995. New macro-financial assistance operations are currently being provisioned with a 15% rate.

[2] Reserve amount in 1997 under the financial perspective.

[3] Corrections of the amounts to be transfered to the Fund in compliance with annex to Council regulation n° 2728/94.

[4] Council Decision of 14 April 1997.

[5] Exceptional financial assistance. Commission proposal (COM(97) 24 final) of 3 February 1997.

[6] Commission proposal.

[7] Proposal for a Council decision concerning the conclusion of a cooperation agreement with FYROM (COM(96) 533 final) of 25 November 1996.

[8] Proposal for a Council regulation relative to a special action of financial cooperation in favour of Turkey (COM(95) 389 final). European Parliament opinion is still expected.

[9] Cooperation agreement EC/Croatia (SEC(95) 180/final). Negotiations suspended since Summer 1995.

[10] No provisioning of the Fund is indicated for these two operations, as they are currently blocked.

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