COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal

for a Council Decision

providing macro-financial assistance

to Ukraine

(presented by the Commission)

EXPLANATORY MEMORANDUM

Ukraine's request for Community macro-financial support

In June 1994, the Corfu European Council invited the Council to continue its work on the formulation of an overall policy towards Ukraine, drawing on the full range of Community instruments to support, inter alia, the achievement of market oriented economic reforms and the acceptance by Ukraine of internationally accepted nuclear safety standards. The European Council also underlined the Union's readiness to support, in the context of a G-7 initiative, a nuclear safety plan for Ukraine with ECU 400 million in EURATOM loans and ECU 100 million grant over three years under TACIS. This approach was confirmed at the G-7 Naples Summit in July.

In early October, the General Affairs Council agreed on a strategy paper for Ukraine stressing again the need for the Union, together with other donors, to encourage the Ukrainian authorities to design and implement a comprehensive stabilization and reform programme in agreement with the IMF and to pursue with the EU/G-7 action plan for the closure of Chernobyl.

On 14 October 1994, Mr Kuchma, the new President of Ukraine, addressed to the Commission a request for urgent Community macro-financial assistance. This request was made in the context of a comprehensive reform and macro-economic stabilization and reform programme on which the Ukrainian authorities have reached an understanding with the International Monetary Fund. This programme is to be supported by the Systemic Transformation Facility (STF) already in 1994 and by a stand-by arrangement in 1995, yet to be negotiated. Balance of payments support and adjustment lending is also expected from the World Bank aimed at financing critical imports and supporting a new strategy in the energy sector However, despite substantial contributions from the international financial institutions and rescheduling of existing arrears towards Russia and Turkmenistan, substantial residual financing gaps remain to be filled by official support to ensure the viability of the IMF programme.

On 10 October, the ECOFIN Council, recognizing the political importance of timely support to Ukraine's emerging reform effort has indicated that it would contemplate conditional macro-financial assistance to Ukraine from the Community.

During a donors pledging session held on 18 October by the IMF and World Bank in Washington, the Commission announced its intention to make a proposal for Community macro-financial assistance to Ukraine. During this session, Russia and Turkmenistan confirmed their support in the form of rescheduling of arrears (some US$ 350 million in 1994). The United States committed US$ 70 to US$ 100 million of balance of payments assistance (most in the form of grants) and indicated its intention to provide further financing to help cover the 1995 financing gap. The US contribution is expected to reach roughly a fifth of the resources needed to cover Ukraine's residual external financing needs during the 15-month period to be covered by the combined STF/SBA programme. Canada also gave strong assurances and Japan made clear its support to the Ukrainian reform efforts but could not at this stage commit any specific amounts.

On the basis of the financing assurances given at the donors' meeting and on account of the steps undertaken by the Ukrainian authorities at the outset of the programme, the IMF Executive Board was able to approve the first tranche of the STF (US$ 365 mio) on 26 October. Subject to further progress with economic stabilisation and reform, it is expected that disbursements of the second tranche of the STF of an equal amount will be made in 1995, together with disbursements under a stand-by arrangement currently under negotiation.

The Ukraine's economic programme

Already difficult at the time of independence, Ukraine's macro-economic situation has steadily worsened during the period 1990-93 owing mainly to the continued absence of sufficient political support for any strategy to deal with the disintegration of economic structures and links with the former Soviet Union. Real GDP fell by roughly 35%, hyper inflationary conditions were predominant until the end of 1993 and severe balance of payments problems continued, in large part because prices of energy imported from Russia and Turkmenistan have been moving towards world levels. Over the period as a whole, general lack of confidence in the domestic currency led to a growing demonetization of the economy and the implementation of incoherent foreign exchange policies and regulations.

Following the election of Mr Kuchma as Ukraine's new President, the Government and the National Bank of Ukraine have reached an understanding with the IMF on a comprehensive macro-economic stabilization and policy-reform programme.

In accordance with this programme, a number of measures have already been implemented. In the area of economic liberalization, the authorities have reduced the role of government in the setting of prices. In particular, subsidies on coal and electricity prices to industrial uses were cut. The authorities are committed to fully pass the implied increase in the cost of imported energy to industrial and agricultural users. In addition, a number of export controls were abolished. Finally, the interbank auction market for foreign exchange was reopened and the government's official exchange rate for the surrender of foreign exchange rate was abolished.

Regarding stabilization, the Government and the Central Bank are committed to conducting the monetary and fiscal policies necessary to bring about a lasting decline in inflation, which exceeded 10.000% in the course of 1993 and remains high even after a substantial decline in the first half of 1994. The programme also foresees a curtailment of budgetary expenditures in particular for coal subsidies and support to the agricultural sector. A revised budget for 1994 has been presented to Parliament in this context. For 1995, the Government plans to reduce the budget deficit relative to GDP by at least one half.

With regard to structural reform, the Government has already approved an action plan to remove the legal obstacles to the ability of enterprises and individuals to own and transfer land. It is also committed to speed up privatization, to strengthen the governance of enterprises remaining under state ownership and to tackle the problem of monopoly abuse. In addition, the authorities pledge to begin addressing the problem of non-performing loans of commercial banks and to strengthen banking supervision and regulation in 1995.

The reform and stabilization efforts in Ukraine should be enhanced further in the context of the IMF stand-by arrangement for 1995.

External outlook and financing needs

With the move of energy prices towards world market levels starting in 1992, Ukraine suffered severe terms of trade shocks both in 1992 and 1993. Given the heavy dependence of its production on energy, Ukraine was forced to reduce import volumes both for energy and other goods, adding further to the economic decline. The current account deficit widened somewhat to US$ 1 bn in 1993. Given the continued capital outflow, this was made possible by debt conversion agreements mainly with Russia.

In 1994, the current account balance has deteriorated further to an estimated deficit of US$ 1.8 bn, with the accumulation of external arrears providing the financing for the balance of payments in the first three quarters. For the fourth quarter of 1994, the IMF expects a residual financing gap of US$ 600, after contributions of the IMF (first tranche of the STF in the order of US$ 365 mio) are taken into account. After taking into account the rescheduling of arrears (some US$ 350 mio) committed by Russia and Turkmenistan, the remaining gap is reduced to US$ 255 mio.

Unless this gap can be closed, Ukraine's ability to secure stable energy supplies and to meet its external financial commitments would be put into question. Hence, the success of the whole stabilization and reform programme to which the Government and the Central Bank are committed could be undermined before its expected positive effects on the balance of payments (revival of exports, reversal of short-term capital flows and pick-up in foreign direct investment) could be realized.

For 1995, the IMF expects that in the context of the envisaged stand-by arrangement, backing strengthened stabilization and reform efforts, the residual financing gap (after IMF and World Bank contributions are taken into account) will amount to US$ 3.5 bn. Allowing for the expected rescheduling of arrears by Russia and Turkmenistan and for a build-up in reserves, the final residual needs for 1995 are estimated in the order of US$ 1.5 bn.

Main features of the loan

The Commission is proposing that the Community would make available to Ukraine a balance of payments loan of ECU 85 million with a maximum duration of ten years.

The assistance would be granted on the basis of the adoption of the STF arrangement. It would complement the resources made available by the International Financial Institutions and would be subject to the following conditions:

- the regularization of Ukraine's external financial relations with the Community;

- strong commitments by the Ukrainian authorities to implement the EU/G-7 plan for the closure of Chernobyl;

- assurances that a stand-by arrangement between Ukraine and the IMF is within reach;

- satisfactory burdensharing among the major donors (especially US and Japan).

The assistance would be released in a single tranche after verification of the conditionality attached to it. The proposed duration of the loan (ten years) is consistent with the medium-term balance of payments outlook for Ukraine, which is expected to face substantial financing needs for the years to come.

As in the case of similar operations in favour of third countries, 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 will 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 assistance of up to ECU 85 million to Ukraine would imply an ECU 12 million provisioning of the Fund.

On the basis of a proper assessment of the residual financing needs of Ukraine for 1995 and subject to further pledges from the other major donor countries, the Commission may consider proposing supplementary macro-financial assistance for this country.

Proposal for a

COUNCIL DECISION

providing macro-financial assistance

for Ukraine

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[1] submitted after consulting the Monetary Committee,

Having regard to the opinion of the European Parliament[2],

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 Union have signed on a Partnership and Cooperation Agreement which will help the development of a full co-operation relationship;

Whereas Ukraine has agreed with the International Monetary Fund (IMF) on a comprehensive set of stabilization and policy reform measures to be supported by a purchase under the IMF's "systemic transformation facility"; whereas this facility was approved by the IMF Board on 26 October 1994 and whereas further discussions are under way between the Ukrainian authorities and the IMF on a macro-economic adjustment and reform programme to be supported by a "stand-by arrangement";

Whereas the authorities of Ukraine have requested financial assistance from the international financial institutions, the Community and other bilateral donors; whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, important residual financing gaps remain to be covered in the remainder of 1994 and 1995 in order to strengthen Ukraine's reserve position and support the policy objectives attached to the government's reform effort;

Whereas the Ukrainian authorities have committed : to pursue promptly with the implementation of the action plan for nuclear safety supported by the European Union and the G-7; to reach rapidly an understanding with the IMF on the "stand-by arrangement"; and to fully and timely service their external financial obligations towards the Community;

1

2

Whereas a Community long-term loan to Ukraine is an appropriate measure to help easing the countries' external financial constraints, supporting the balance of payments and strengthening the reserve position;

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 amount of ECU 85 million in principal with a maximum maturity of ten years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the country's reserve position.

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 negotiate with the Ukrainian authorities, after consultation with 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).

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 a single tranche to be released as soon as possible, subject to the provisions of Article 2.

2. 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 wishes, 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, on the implementation of this Decision.

Done at ....,

For the Council

The President

FINANCIAL RECORD

1. Budget line concerned

   Article (...)guarantee for the Community loan facility to Ukraine (to be created through an amending and/or a supplementary budget).

2. References(legal base)

   Article 235 of the Treaty

3. Classification of the Expenditure

   Obligatory

4. Description and Justification for the action

   a) Description of the action

      The budget entry reflects the commitment of the budget guarantee associated with the Community loan to Ukraine designed to ensure a sustainable balance-of-payments position and strengthening international reserves of this country.

   b) Justification for the action

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

5. Nature of the expenditure and method of calculation

   a) Nature of the expenditure

      Guarantee for the Community loan to Ukraine.

   b) 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.

6. Effect of the action on intervention credits

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

7. Financing of intervention expenditure

   - Endowment of the line by transfer, by reutilization of reimbursed amounts (Article 27(3) of the Financial Regulation of 1977), or by amending and/or supplementary Budget.

   - 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) no. 1552/89 of 29.5.1989 will apply.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1994 AND NOTIONAL MARGIN UNDER THE RESERVE FOR GUARANTEES (IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of The Fund (1)	Reserve Margin
			318(2)
Project related assistance			
EIB/CEEC	765	107	211
EIB/MED	100(3)	14	197
EIB/PVDLA	500(4)	70	127
EURATOM	150	21	106
Macro-financial assistance			
Moldova	45	6	100
Bulgaria	40(5)	6	94
Romania	125	18	76
Algeria	200(6)	28	48
Slovakia	130(6)	18	30
Ukraine	86(6)	12	18

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(1) According to the provisioning rules agreed in the Council's common position of 13 September 1993
(2) Reserve amount in 1994 under the financial perspective
(3) Including amounts of estimated disbursements in 1993 and operations for Cyprus and Malta
(4) Including amounts of estimated disbursements in 1993
(5) Commission proposal to increase the amount of assistance (ECU 110 million) decided in 1992
(6) Commission proposal

10

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