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# REPORT AND RECOMMENDATION
# OF THE
# PRESIDENT OF THE
# INTERNATIONAL BANK FOR
# RECONSTRUCTION AND DEVELOPMENT
# TO THE
# EXECUTIVE DIRECTORS
# ON A
# PROPOSED SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN
# IN AN AMOUNT OF US$300 MILLION
# TO
# UKRAINE

February 25, 1998

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**CURRENCY EQUIVALENTS**
(as of February 18, 1998)

| | | |
|---|---|---|
| Currency Unit | = | Hrivnya |
| US$1 | = | 1.9541 Hrivnya |
| 1 Hrivnya | = | US$0.5117 |

**WEIGHTS AND MEASURES**
Metric System

**FISCAL YEAR**
January 1 - December 31

**ABBREVIATIONS AND ACRONYMS**

| | |
|---|---|
| AGSECAL | Agricultural Sector Adjustment Loan |
| ASB | Accounting Standards Board |
| CAS | Country Assistance Strategy |
| CMA | Change Management Assistance |
| CMP | Capital Markets Participant |
| CPAR | Country Procurement Assessment Report |
| CSO | Clearing and Settlement Organization |
| EDAL | Enterprise Development Adjustment Loan |
| EDP | Export Development Project |
| EFF | Extended Financing Facility |
| EU/TACIS | European Union Program of Technical Assistance for the CIS |
| FIDL | Financial Institutions Development Loan |
| GATT | General Agreement on Tariffs and Trade |
| GDP | Gross Domestic Product |
| IBRD | International Bank for Reconstruction and Development |
| ICB | International Competitive Bidding |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| IAS | International Accounting Standards |
| IOSCO | International Organization of Securities Commissions |
| IPO | Initial Public Offering |
| ISA | International Standards of Auditing |
| MFERT | Ministry of Foreign Economic Relations and Trade |
| MFS | Interbank Depository System |
| MINED | Ministry of Education |
| MOE | Ministry of Economy |
| MOF | Ministry of Finance |
| MOS | Ministry of Statistics |
| MPP | Mass Privatization Program |
| MU | Monitoring Unit |

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|---|---|
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| Sector Director: | Lajos Bokros, ECSPF |
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| | |
|---|---|
| NAS | National Accounting System |
| NASDAQ | National Association of Securities Dealers Automated Quotations |
| NBU | National Bank of Ukraine |
| NDS | National Depositary System |
| NSA | National System on Auditing |
| OTC | Over the Counter |
| PARD | Professional Association of Registrars and Depositories |
| PFTS | Over the Counter Trading System |
| PIF | Privatization Investment Fund |
| PIU | Project Implementation Unit |
| SBA | Standby Arrangement |
| SEC | Securities and Exchange Commission |
| SPF | State Property Fund |
| SOE | State Owned Enterprise |
| SRO | Self Regulatory Organization |
| SSMC | Securities and Stock Markets Commission |
| STA | State Tax Administration |
| STF | Systemic Transformation Facility |
| TA | Technical Assistance |
| TOR | Terms of Reference |
| UFPAA | Ukrainian Federation of Professional Accountants and Auditors |
| UNCTAD | United Nations Conference on Trade and Development |
| UCPPS | Ukrainian Center for Post-Privatization Support |
| USAID | United States Agency for International Development |
| USE | Ukrainian Stock Exchange |
| VER | Voluntary Export Restraint |
| WTO | World Trade Organization |

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# UKRAINE:
# SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

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**ANNEXES**

# UKRAINE: SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

## Loan and Project Summary

| | |
|---|---|
| **Borrower:** | Ukraine |
| **Implementing Agency:** | Ministry of Economy |
| **Amount:** | US$300 million |
| **Terms:** | Single Currency Loan, at the Bank's standard US$ LIBOR-based interest rate, with a proposed 5-year grace period and a 20-year maturity. |
| **Commitment Fee:** | 0.75 percent on undisbursed credit balances, beginning 60 days after signing, less any waiver. |
| **Objectives and Description:** | The main objective of the loan is to support the Government's privatization, capital markets development, accounting reform, bankruptcy reform and deregulation programs. Other objectives are to: (i) provide foreign exchange for the purchase of critical imports and (ii) support the development of the foreign exchange markets. The reform program to be supported by the Loan will include the completion of a mass privatization program of 9,500 medium and large enterprises as well as continuing the individual privatization of large attractive enterprises. It will include the consolidation of the legislative framework and institutions to regulate the capital markets including the Securities and Stock Markets Commission, self-regulatory organizations for market intermediaries and an effective trading, depository and clearing and settlement infrastructure. The program will support the implementation of international accounting and auditing standards throughout the enterprise sector and the implementation of an effective modern bankruptcy process in Ukraine. It will also support measures to simplify and speed up the processes for private business licensing, registration and inspections, and the institutionalization of the deregulation processes including public/private consultative mechanisms. |
| **Benefits:** | The reforms would ensure the primary ownership transfer of most enterprises from the public to the private sectors and accelerate the secondary ownership changes already underway, promoting private initiative as the main engine of economic development and growth and providing a competitive deregulated environment within which the private sector can flourish. The loan would support the strengthening of well regulated capital markets, promoting securities trading after privatization, encouraging further ownership consolidation and other post-privatization restructuring and governance improvements and the mobilization of domestic and foreign resources for equity investment.<br><br>The loan would also promote improved accountability in the enterprise sector and the capital markets, directly encouraging foreign and local |

investment, and would promote an orderly bankruptcy process which would ensure effective enterprise exit and asset reallocation mechanisms.

**Risks:** The main risk is the possible loss of political commitment to reform due to opposition from vested interests. Experience elsewhere and also during the first EDAL program, however, has shown that effective and rapid privatization creates a momentum that is very difficult to reverse, especially if the program is designed, as this one has been, to promote rapid change and enterprise restructuring and adaptation to the market after privatization. A second risk is that the implementing agencies will not be able to handle a program of this magnitude. This risk has been effectively minimized by promoting a bottom-up approach to privatization which harnesses the dynamics at work at the enterprise level and by ensuring that the enterprise employees and population at large are able to participate fully in the program. The experience of the first EDAL showed that judicious use of technical assistance, largely in the form of grants from other donors, very effectively helped to ease implementation bottlenecks and this technical assistance will continue during the EDAL II period. The third major risk is that the level of donor support needed to maintain the reform program in Ukraine may not be maintained. This risk has increased recently with some of the failures in other parts of the reform program. This risk will be minimized if the program supported by the Loan is successful but the Bank will also keep up its donor coordination efforts to try to ensure continued support for Ukrainian privatization, capital markets development, accounting reform, bankruptcy reform and deregulation, as the program proceeds.

**Schedule of Disbursement:** Three tranche disbursement, the first immediately after loan effectiveness (expected in March 1998); the second and third--provided the macroeconomic framework remains satisfactory--when the policy actions specified in this document have been implemented (expected in July 1998 and December 1998, respectively).

**Economic Rate of Return:** N/A

**Project ID Number:** UA-PE-49502

**Poverty Category:** N/A

This report is based on the work of missions that visited Ukraine between January 1997 and November 1997 comprising Messrs./Mmes. Bernard Drum, Nikolai Korol, Beth Shair, Igor Artemiev, Gregory Jedrzejczak, Lilia Burunciuc, Sandra Durham, Nena Manley, Andrew Stone and Arlene Mirsky. Messrs/Mmes Vesna Petrovic, Rizalino Zamora and Chau Bui provided administrative support and helped process the documentation. The peer reviewers were Mr./Mme. John Nellis and Cheryl Gray. Messrs. Paul Siegelbaum and Lajos Bokros are the Country Director and Sector Director, respectively.

# REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN TO UKRAINE

INTRODUCTION

I submit for your approval the following report on a proposed Second Enterprise Development Adjustment Loan to Ukraine for US$300 million. The Loan would be at the Bank's standard US$ LIBOR-based interest rate with a maturity of twenty years, including five years of grace.

## I. BACKGROUND

### Recent Economic Performance

1. Transforming Ukraine's economy from a centrally planned system to a market-oriented one has proven to be a daunting challenge. Policy failures during the first three years of Ukraine's independence, combined with major external shocks compounded the macroeconomic instability. By 1994, officially recorded output had fallen by 50 percent since 1990 and inflation, while coming down from hyperinflationary levels, was still in triple digits. And, although the fiscal deficit was reduced, the current account deficit widened and the external situation became increasingly tenuous with a large accumulation of payment arrears (mainly on gas imports from the former Soviet Union (FSU)). Living standards deteriorated sharply and poverty increased.

2. In October 1994, a clear break was made from past policies as Ukraine began to lay the foundations for macroeconomic stabilization and structural reforms. An IMF-supported stabilization program (through a systemic transformation facility, and three stand-by arrangements) entailed tight fiscal and monetary policies with the aim of lowering inflation to about 1 percent monthly. The World Bank has supported a wide-ranging series of measures aimed at reducing Government intervention in the economy, developing competitive markets and introducing elements of a social safety net through a Rehabilitation Loan followed by adjustment loans in the enterprise, agricultural and energy sectors.

3. Much has been accomplished over the last three years. Inflation has been sharply reduced (to 40 percent annually in 1996 and 16 percent in 1997); the exchange rate was unified and a substantial degree of current account convertibility established; a new currency was successfully introduced; the trade regime has been liberalized; domestic prices have been largely decontrolled, consumer subsidies reduced and energy prices increased to world levels for non-household users (and substantially raised for household users); tax reform has been initiated; the state order system has been abolished; a mass privatization program is being implemented successfully; agricultural land reform is being initiated; and a radical restructuring of the electricity and coal sectors is underway.

4. There are, however, a number of factors that point to the fragility of these early successes and indicate the considerable challenges ahead in securing macroeconomic stability and restoring growth. First, the stabilization effort is fragile. Tight monetary policy has not been accompanied by sufficient structural measures to reduce expenditures. In effect, the fiscal situation appears better than it is; the cash deficit was contained to a substantial extent by running up arrears and postponing expenditures. Such a stance is clearly not sustainable even in the short-term and the Government needs to address the immediate precarious fiscal situation in addition to key structural causes of the fiscal imbalance. Second, economic activity remains weak. Officially recorded GDP fell by a further 10 percent in 1996 and continued to fall, albeit at a slower rate, during 1997. But much private sector activity appears to be channeled into the unofficial economy which is large and growing. Although the informal economy has cushioned the impact of the decline in officially recorded GDP, it has negative sides too: it reduces the tax and foreign exchange base and makes macroeconomic stability that much harder to sustain. Third, there have been setbacks in several areas of the reform program, notably in the slow progress in tax reform, the inability to achieve greater cost recovery in the energy sector, in the slow progress in agricultural sector reform, and in a tendency to create or reinforce monopolistic state structures, notably in agriculture, to handle market activities.

**Government's Economic Reform Priorities**

5. Today, the major challenge facing Ukraine is how to restore the confidence of its financiers, domestic and international, as well as multilateral. Plainly, a program of broad and deep structural reforms is needed to do this, complementing a dramatic fiscal austerity program to deal with the immediate fiscal pressures. The government recognizes this need, yet is forced to balance it against the political realities of seeking consensus with a fragmented and increasingly hostile Parliament in an election year. Avoiding fiscal crisis, restoring a sustainable fiscal balance and positioning the economy to restore growth all depend on the government's ability to manage this challenge.

6. For the medium term, achieving sustained economic growth and accelerating the transition to a market economy will be the Government's overriding priorities. The development of a dynamic private sector is intended to play a key role in the achievement of these priorities and both macro and micro level reforms will be aimed at promoting a stable business environment in which private sector activity can flourish. The reform program will include monetary and fiscal policies aimed at achieving low and stable inflation. The tax burden on enterprises will be reduced and a more stable legal framework created. Continued privatization and enterprise restructuring, maintaining a competitive trade environment and implementing financial sector reforms are planned to be accompanied by reducing the burden of regulation on enterprises and streamlining the public administration to make it more market friendly. These measures will be accompanied by targeted assistance to the poor.

7. In terms of macroeconomic objectives, the aim is to halt the decline in output and for growth to recover to around 4-6 percent annually over the next few years. Inflation fell to around 16 percent in 1997 and is expected to continue decreasing over the next few years. The annual deficit for 1998 is targeted at 3.7 percent of GDP and at 2.5 percent of GDP by the year 2000. To achieve this, there will be a strong emphasis on fiscal reform including better budgeting and reform of the taxation system. The social safety net will be rationalized, the pension system will be reformed. Measures will be taken to overhaul the tax administration. Fiscal reforms will be accompanied by improved monetary policies and development of better financial relations between Government and the National Bank, while the

payments system will also be improved. The structures within Government for developing and implementing economic policies will also be improved.

8. Systemic reforms will continue, including completion of the mass privatization program by the end of 1998 and the individual privatization of large infrastructure and other enterprises. Post privatization enterprise reforms will continue. International accounting standards will be introduced. New business start-ups will be encouraged by dramatically streamlining the regulatory processes, and exit mechanisms will be improved with the creation of a modern framework and process for bankruptcy. Reforms will continue in the structure of the capital markets necessary to mobilize new investment capital for enterprises and to facilitate further ownership transfer in the secondary markets. In the agricultural sector the focus will be on land privatization and farm reform, restructuring and demonopolization of agro-industry, marketing and input supply, reduction of subsidies and liberalization of international trade. In energy the emphasis will be on privatization, price liberalization and cost recovery.

## II. PROGRESS UNDER THE FIRST ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

9. The first Enterprise Development Adjustment Loan (EDAL) was approved by the Bank's Board on June 27, 1996. Its main objectives were to support the Government's trade and price liberalization, privatization, capital markets development and post-privatization restructuring programs. It consisted of an adjustment component of US$300 million to be disbursed in three tranches against satisfactory implementation of the agreed program and conditions, and a technical assistance component of US$10 million intended to assist primarily post-privatization restructuring of the enterprise sector. The first tranche was released in July 1996 based on satisfactory implementation of the pre-Board action program. The second tranche was released in March, 1997 and the third tranche in October, 1997.

### Trade and Price Liberalization

10. The trade and price liberalization measures supported by the EDAL program consisted largely of the completion of the actions initiated in 1994 under Bank's Rehabilitation Loan program. Prior to early 1996, Ukraine had accomplished much in the area of trade and price liberalization. The exchange rate had been unified and convertibility established for most current account transactions. Import and export quotas had been eliminated and export contract registration almost completely eliminated. Most domestic prices had been completely liberalized. Energy prices at that time had been adjusted to world equivalent levels. Subsidies to households had been substantially reduced and cost recovery on public services increased. The system of state purchases had been abolished except for budgetary organizations, and the majority of ceilings on price markups and profit margins had been abolished.

11. However, a number of impediments to a competitive environment still remained in place in early 1996. The Special Export Regime (SER), which required the granting of permission to export certain commodities, still applied to around six percent of Ukraine's exports. Export registration was still required for goods subject to the SER and to goods sensitive to anti-dumping requirements, and subject to international agreements and voluntary export restraints (VERs). Minimum prices on exports (indicative prices) were applied to around half of Ukraine's exports despite the official removal of this restriction during the previous year. Ukraine still applied the system of import quality certification inherited from the Soviet Union and this required extensive certification of imported goods. Price and profit margin controls were still applied to "artificial monopolies" and the price inspection units were actively enforcing these restrictions. Also despite the earlier formal removal of many trade and price restrictions there had been many instances where branch ministries and local administrations tried to reimpose them, usually illegally but sometimes successfully in an informal manner.

12. Under the EDAL pre-Board action program, a Presidential decree limited the application of indicative prices to exports of 14 narrowly defined commodities, and profit and trade margins on bread and bread products were removed. Import tariffs were maintained at less than 30 percent. Most of the EDAL trade and price liberalization conditions were for second tranche and despite difficulties most of them were effectively met. The main obstacle was Parliamentary refusal to rescind the SER and to remove export duties on live animals and skins. However, the Government was able to neutralize the SER without new legislation. Export registration was also neutralized by issuing an order that registration was to be for statistical purposes only and could not be used as a means of preventing exports. Indicative prices on metals and scrap were removed. Remaining price controls on artificial monopolies were removed and the activities of the price inspection units were limited, as agreed, to

goods whose prices are administratively set. The Bank waived the condition to abolish import quality certification and replaced it with a requirement for satisfactory progress towards compliance with international norms as determined by the World Trade Organization. The second tranche condition to abolish remaining export duties (and these are applied only to live animals and skins) were transferred to third tranche but could not be met since Parliament refused four times to take the necessary action. This condition, and the related condition requiring removal of indicative prices on these products, were waived since they were not central to the EDAL privatization and capital markets programs which had been implemented successfully. They were, however, maintained as second tranche release conditions of the Agricultural Sector Adjustment Loan (AGSECAL).

13. Despite good progress since 1994, protectionist lobbies, some branch ministries and local level officials have put up a strong resistance to trade and price liberalization and this resistance continues. Trade and price liberalization strike at the heart of the old order and at the opportunities for rents and bribes that the old restrictions provided. It will be some time before the reality at the customs posts and the behavior of local bureaucrats fully reflect the liberalizing policy actions taken by the central Government.

**Privatization**

14. The privatization program supported by the EDAL has been one of the most notable successes of economic reform in Ukraine. Privatization had made a painfully slow start during the early 1990s, with many delays and much initial hostility from Parliament, including the creation of a negative list of 6,000 enterprises not subject to privatization. However, the framework for mass privatization in Ukraine was dramatically streamlined under the Rehabilitation Loan program in late 1994/early 1995. The previously tortuous and complicated procedures for enterprise preparation and share sales were simplified at that time by a series of decrees and regulations. For the 8,000 medium/large enterprises required by decree to be subject to mass privatization, the requirement for detailed valuation was removed and simple book value applied in its place. Transparent share allocation plans for these enterprises were required by decree. Sales of at least 70 percent of the shares of large enterprises and 100 percent of the shares of medium-sized enterprises were also required. The procedures and membership of privatization commissions were greatly simplified. Tight deadlines were set for every stage of the mass privatization process. The State Property Fund (SPF) of Ukraine was given full authority to implement privatization. Incentives were given to enterprise managers who cooperated with the privatization process. Standard document packages for preparing enterprises for privatization were prepared and distributed to all enterprises on the privatization list.

15. Paper privatization certificates were introduced and distributed to the population free of charge. During 1995, an auction center network with over 1,000 bid collection sites throughout Ukraine was created. A country wide public information campaign was implemented. Later in 1995, a new form of privatization certificate known as a compensation certificate was introduced. Compensation certificates were intended to compensate citizens for the loss of their savings due to inflation during the early 1990s. These certificates, unlike privatization certificates, are tradable between individuals and are also able to clear the privatization auctions with no floor price restrictions. They are, therefore, a very useful means of speeding up privatization in that their use guarantees that all shares offered for sale for compensation certificates will actually be sold.

16. The streamlined methodology proved very effective. The EDAL pre-Board condition of 2,000 medium/large enterprises transferred at least 70 percent to private hands was met on schedule. The second and third tranche conditions of 3,500 and then 5,000 medium/large enterprises privatized were met ahead of schedule. The second tranche condition that procedures for agro-industrial enterprises be simplified and brought into line with those for enterprises in other sectors was met. This required considerable political will and action by the President. Agro-industrial enterprises, as a percent of the total number of enterprises privatized, consistently exceeded the targets agreed under the EDAL program. The Cabinet of Ministers identified a number of large monopoly enterprises for individual privatization and work has begun on the privatization of these enterprises.

17. Small scale enterprise privatization had also suffered in the early 1990s from overcomplicated procedures and lack of political will, especially at the local level. During the pre-Board period of the EDAL, however, a number of actions were taken that strengthened the authority of the SPF to implement the program, including taking disciplinary measures against local officials. The signing of new leases by workers collectives was stopped. Measures were taken to simplify the small scale enterprise privatization procedures and improve incentives for local authorities to sell small businesses and for employees to go through the privatization process. The donors, in particular IFC, provided effective support to cities willing to implement the small scale privatization program. As a result of all of the above measures, and the hard budget constraint on local authorities which pushed them to sell small enterprises to generate revenues, the speed of small scale privatization accelerated dramatically towards the end of 1995. By early 1996, small scale privatization was proceeding at the rate of about 1,500 enterprises per month. This rate continued throughout the period of the EDAL program and small scale privatization is now virtually complete in all major cities throughout Ukraine and around 90 percent complete throughout most of the country.

18. The agreed EDAL privatization program was therefore successfully completed and surpassed in all areas. The Chairman of the SPF has on several occasions stated that this success could not have occurred without the strong incentive of the EDAL's policy conditionality which kept the spotlight on the need to meet the agreed privatization targets on time.

**Capital Markets Development**

19. By 1995, experience in other transitional countries had shown that for mass privatization to realize its full potential there was a strong need to create a capital markets infrastructure which could permit and promote further ownership transfer through the secondary trading of enterprise shares. Furthermore, a number of highly visible frauds had occurred in neighboring countries, where unregulated financial intermediaries had taken advantage of small investors. Ukraine learned from these lessons, and worked on developing its capital markets infrastructure before the mass privatization program was able to deliver large volumes of shares to the market. The pre-Board action program of EDAL included the creation of a new Securities and Stock Markets Commission and the transfer to the Commission of responsibility for supervising investment funds, investment companies, registrars and depositories. Work also began, with help from the donors, on the development of self-regulatory organizations (SROs) of market participants. The intention was eventually to transfer some responsibility for market regulation to these SROs, as in advanced market economies.

20. The EDAL program required that the Commission be given a full mandate to supervise all aspects of the securities markets, by decree or by Law. This was to include implementation of all aspects

of investor protection, creation and licensing of independent registrars, depositories and custodians, licensing of broker/dealers, investment advisors, portfolio managers and their SROs, and licensing of market trading systems. The program also required that membership of SROs be made compulsory for all professional market participants, that there should be unimpeded transfer of share registries to independent registrars, and that the national depository system for securities should begin operations.

21. Progress in implementing the agreed program surpassed expectations. The strategy of developing the necessary market supervision mechanisms and infrastructure before a large volume of shares became available proved very effective. In the absence of large trading volumes, the capital markets reform program was relatively non-controversial and was implemented with little opposition, particularly in the early stages of the program. Parliament approved a Law in late 1996 giving the Commission most of the power it needed and the Commission was then able to issue regulations to give effect to its mandate. In the later stages of the EDAL program period, as securities trading started to accelerate, there were unsuccessful efforts from opponents of the program to undermine the role and authority of the Securities Commission, and even some reluctance by the Commission itself to empower SROs. However, pre-Board, second and third tranche capital markets conditions were met on time and the program was completed during the first half of 1997.

22. As a result of the effective mass privatization program, there has been a rapid build up in share trading, on the over-the-counter (OTC) market and through the stock exchanges. There are already an estimated US$3 billion of securities in circulation in Ukraine and of these, enterprise shares account for around 75 percent. Trading on the Kiev OTC market increased very rapidly during the first half of 1997 and reached US$22 million in July, 1997 alone before slowing down during the second half of the year following the decline in the international securities markets. The Securities Commission has already been playing its enforcement role, canceling several operating licenses of market participants following investor complaints.

**Technical Assistance Component**

23. The EDAL technical assistance (TA) component was subject to predictable delays in implementation, due mainly to the lack of experience in Ukraine in implementing externally financed TA programs. Nevertheless, the lessons learned from the Institution Building Loan proved effective, particularly the need to avoid too many bureaucratic approvals in the procurement and implementation processes. The creation of a project implementation unit (PIU) within the SPF and the innovative implementation agreement between the PIU and the autonomous Ukrainian Center for Post-Privatization Support (UCPPS) avoided the kinds of initial implementation problems that the IBL and some other Bank projects in Ukraine have suffered.

24. EDAL-financed personnel are in place both in the UCPPS and PIU, office accommodation and facilities are now adequate, a long term procurement advisor has completed a one year assignment, operational manuals have been prepared, the two first major enterprise restructuring sub-components are already under implementation and procurement is almost complete for a further three sub-components.

## III. PROPOSED ACTION PROGRAM

25. Constraints to private sector activity such as punitive and arbitrarily applied taxation, over-regulation, corruption, ambiguous, complex and constantly changing laws, and the poor state of development of the financial sector, will be addressed in a number of proposed Bank lending operations. These include the proposed Public Resources Management Loan, the Public Administration Reform Loan, the Financial Sector Adjustment Loan and the two financial sector credit lines. The proposed EDAL II will complement these loans as well as donor financed activities and focus on completing the privatization process which is now well underway, consolidating capital markets reform, beginning "second generation" enterprise reforms in the areas of accounting and bankruptcy to promote competitive activity and enterprise restructuring in the post-privatization environment, and initiating an action program in deregulation and improved public/private consultation.

### Enterprise Privatization

26. In early 1997, the privatization program supported by the first EDAL was reaching completion. However, a number of issues were giving cause for concern. Mass privatization, although only half completed, was losing momentum and appeared in danger of grinding to a halt. The pace of new corporatization had decreased, the numbers of enterprises reaching the 70 percent privatization target each month were steadily falling, the number and value of share packages offered for sale by the SPF were falling and there was increasing use of non-transparent methods of privatization such as non-commercial tenders. There were a number of factors contributing to these negative developments, including (i) serious undermining of the use of compensation certificates after Parliament, in late 1996, offered cash compensation for certificates to the citizens as an alternative to using the certificates for privatization, (ii) delay by Parliament in adopting the 1997 Privatization Program, (iii) the complexity and size of enterprises remaining in the privatization pipeline, (iv) moves by branch ministries to create state holding companies to maintain state ownership in "privatized" firms, and (v) a change in leadership in the State Property Fund, followed by rejection by Parliament of the new Chairman, which created an effective vacuum in SPF leadership for several weeks.

27. In a joint letter to the Prime Minister in April, 1997, the IMF, World Bank, USAID and EU/TACIS voiced their concerns about these problems. They warned of the likely negative impact on international support for Ukraine that a slowdown in privatization would cause, and made a set of recommendations aimed at bringing the privatization program back on track and up to speed. In summary, the major recommendations were (i) restoring the volume of enterprise shares offered for sale each month and re-confirming the Government's commitment to reach the end-1997 target of privatizing at least 70 percent of the shares of 8,000 medium/large enterprises since January 1, 1995; (ii) vigorously promoting the use of compensation certificates as a privatization instrument, since these certificates can clear the auctions with no floor price restrictions, and de-linking the use of these certificates from the loss of any possible cash compensation; (iii) offering shares in highly attractive, large and "strategic" enterprises for sale in the compensation certificate auctions with the aim of privatizing 40 percent of the statutory funds and 80 percent of the numbers of these enterprises by the end of 1997; (iv) halting the use of non-transparent methods for privatization; (v) committing to an annual privatization plan for 1997 that clearly sets forth the targets agreed with the donors; (vi) stopping the creation of state holding companies or the enlarging of the negative list; (vii) ensuring that agro-industrial privatization proceeds according to the agreed streamlined procedures; and (viii) allowing all registered securities market structures to

participate in the privatization process. In subsequent discussions, the new acting Chairman of the State Property Fund gave his endorsement to the recommendations and took rapid and decisive action to implement them. Parliament approved, and President Kuchma later signed into Law, a 1997 Privatization Program which gave strong support to most of these recommendations.

28. In September, 1997, the Parliament approved in first reading a bill to reduce the negative list of enterprises not subject to privatization from around 6,000 enterprises to only 2,541 enterprises and in November, 1997, approved the bill in second reading. Many of the "enterprises" which would remain on the list would be non-commercial entities such as libraries, museums, etc., that are not readily privatizable and are not really enterprises as commonly understood. Other initiatives taken by the SPF Chairman include measures to streamline the organization structure and functioning of the SPF itself and to improve information flows on the privatization process, particularly with respect to the use of privatization proceeds. The Acting SPF Chairman has encountered much hostility from Parliament and it remains to be seen whether he will be able to achieve his ambitious goals but his results to date are impressive and he has asked for and has been promised the full commitment of the donors to continue supporting his program.

29. The proposed program to be supported by EDAL II is outlined in the attached policy matrix. By the end of the EDAL II program, estimated for late 1998, the mass privatization process will be virtually completed in Ukraine. Current estimates are that the total universe of privatizable medium/large enterprises was not much more than 12,000. By the end of 1998 close to 11,000 of these medium/large enterprises will have been at least 70 percent transferred since privatization began in 1992. Numerical targets have been established as tranche release conditions. In addition to the 11,000, several hundred more medium/large enterprises will be more than 50 percent privatized and several hundreds more already corporatized and on the way to privatization. Targets have also been established for privatization of residual government shareholdings in medium/large enterprises. By the end of 1998, more than half of the total workforce in Ukraine will be working in privatized medium/large enterprises. In addition to this, around 44,000 small scale enterprises will have been privatized since independence and small scale privatization in Ukraine will be to all intents and purposes complete.

30. Substantial progress will also have been made in privatizing grain storage and distribution facilities, which, up to recently had been virtually untouched by privatization. The Government issued a decree in November, 1997, demonopolizing the Khlib Ukrainy grain conglomerate and targets for privatization of grain marketing and distribution enterprises have been agreed to be implemented as tranche release conditions. The program also includes actions to privatize monopoly, infrastructure and other enterprises not suitable for mass privatization. Prior to Board presentation, the Government initiated the privatization of ten large enterprises which will be privatized through IPOs and trade sales in 1998 and the action program will include rapid progress in the implementation of these transactions. It is also planned to continue rapid privatization of unfinished construction sites. These sites are a potentially valuable resource to the new private sector and so far they have been largely unavailable for development. The EDAL II program includes quantitative targets for privatization of unfinished construction sites. Finally, improvements will continue to be made in the quality of information reporting on the results of privatization.

**Capital Markets Development**

31. Under the first EDAL program, the Government took important first steps in establishing a capital markets infrastructure in Ukraine so that the markets would not be inundated by a large volume of unregulated securities trading resulting from the mass privatization program. The window of opportunity offered by the late start of mass privatization also allowed action to be taken while the reforms were still relatively non-controversial and had not attracted opposition. As a result, the capital markets in Ukraine are now relatively well regulated compared with other FSU countries. But the achievements to date need to be consolidated and more needs to be done before Ukraine's capital markets infrastructure can provide the basis for secure and efficient secondary securities trading and mobilization of new equity flows necessary for Ukraine's development.

32. Despite the already established legal mandate of the Securities Commission to regulate the markets, the Commission is still relatively weak in terms of implementation capacity. However, following intensive efforts with donor support to help create self-regulatory organizations (SROs) of market participants, three SROs have now been licensed. Much more remains to be done in improving the legal and regulatory environment for market operations and in encouraging the creation of a well-functioning, privately-owned market infrastructure.

33. The program proposed to be supported by EDAL II is outlined below and summarized in the attached matrix. The process of creation of a network of private independent registrars, begun under the first EDAL, will be continued. The role of SROs will be strengthened and the requirement for compulsory membership in SROs for all professional market participants will be enforced. The national depository system for securities will be made fully operational and improvements will be made in market transparency by improving disclosure requirements. The Commission itself will be strengthened to allow it to exercise its regulatory functions but at the same time there will be a commitment from Government not to own any interest in market structures or to discriminate in any way against or between market participants. Further improvements will be made to the legal and regulatory environment, and reforms in the securities taxation will be implemented. To stimulate investor interest in the markets, initial public offerings (IPOs) will be made for ten attractive state enterprises. This initiative will be taken in conjunction with the State Property Fund's case by case privatization program. By the end of the EDAL II program, Ukraine should be well on its way to having the structures and supervision mechanisms necessary to allow the capital markets to realize their full potential in mobilizing private capital flows within Ukraine and into Ukraine from abroad.

*Consolidation of the Regulatory Functions of a State Securities and Stock Market Commission (SSMC)*

34. In July 1996, the Parliament adopted a Law on the State Regulation of Securities Markets. The Law strengthened the position of the SSMC (previously established by a Presidential Decree) as a truly independent regulatory body and transferred to the Commission all regulatory authority in the areas of licensing professional market participants and issuing and trading in securities, previously scattered among various governmental bodies. The Chairman of the Commission and its Commissioners were appointed according to the new Law and started their statutory activities. The Commission issued a number of its own regulations which, together with the new Law on Regulation and an old Law on Securities and Stock Exchanges, create a comprehensive temporary base for regulation of capital markets activities.

35. The Commission has since advanced in building its professional capacity in the areas of review and approval of prospectuses, licensing and inspection of market participants, and imposition of sanctions for violation of securities legislation and regulations (in a number of cases successfully defending it in court). Under the EDAL II program, the Government will further strengthen the mandate of the SSMC as a principal supervisory body of all activities related to securities markets. Firstly the division of responsibilities for licensing and supervisory responsibilities between the Commission and the National Bank of Ukraine has recently been agreed. Banks will establish their activities in securities markets (trading, custodian, etc.) as separate internal departments--with their own management and staff, accounting, and financial reporting. This is a necessary prerequisite for the Commission to supervise banks' activities in securities markets and to establish clear separation between capital market and lending activities of the banks, according to international standards. Government is also committed throughout the EDAL II period to refrain from giving a supervisory mandate on capital markets issues to any organization other than the Securities Commission, thereby further consolidating its role and functions.

*Promotion of Self-Regulatory Organizations*

36. The Government's program recognizes SROs of market participants as essential for the SSMC to be able to regulate the markets. SROs will also be essential in improving the professional standards of their participants. A number of measures have been taken to encourage establishment of SROs -- initially for traders and registrars -- as strong partners for the Commission. Trading systems are the best, "natural" candidates for the SRO function. A Ukrainian Interbank Currency Exchange and a USAID-sponsored OTC system (PFTS) have received licenses for trading in securities. Three SROs have so far been licensed. The Commission issued a regulation in mid-1997 requiring mandatory membership of all market participants in an SRO of their choice. This was the best way to eliminate weak or inactive participants who had received their license before the Commission was established. Part of the resources available under the TA component of the first EDAL will be used to strengthen the SROs, and to provide expertise to the Commission necessary for its supervision of the SROs. By the end of the EDAL II program period, all licensed professional market participants will either have become members of SROs or their licenses will have been revoked.

*Regulation*

37. A significant effort has been made to improve legislation directly or indirectly influencing capital markets, and to bring it into line with EU and IOSCO standards. Improvements will continue during the EDAL II program. Specifically:

38. *Disclosure.* Regulations have been approved requiring reporting to the Commission and subsequent publication of all block share transactions of more than 10 percent of a company's total share capital. Listing procedures by trading systems will be required and enforced by the Commission and international and EU standards will be applied to all new share issues.

39. *Securities Law.* The Commission, assisted by foreign experts and in consultation with the World Bank, drafted a completely new comprehensive Securities Law. The Law was submitted to the Parliament and is expected to be approved soon. The new Securities Law regulates, in compliance with the EU standards, initial public offering of securities, stock exchanges and OTC markets, broker/dealers

and other intermediaries, transactions with large blocks of shares, margin and short transactions, unfair and disorderly market activities. It also provides effective enforcement tools for the Commission.

40. *National Depository System Law (NDS Law) and Regulations.* The Parliament has approved in second reading the NDS Law setting standards for an integrated system for depositing dematerialized securities. The law has been supplemented by specific SSMC regulations for depositories, custodians and clearance and settlement. The National Depository System and clearance and settlement systems for corporate securities will become fully operational during the EDAL II program and regulations conforming to IOSCO and EU standards will be issued for their operation.

41. *Investment Fund Law.* To protect investors against the kinds of massive frauds which recently affected some transition economies, the Government has given a high priority to preparing a new Investment Fund Law. The draft, following relevant EU Directives, was submitted to the Parliament for consideration and adoption is expected soon.

42. *Company Law.* Amendments to the Law on Business Associations (a Company Law) have been submitted to Parliament. These amendments will improve and streamline corporate governance of publicly traded companies and strengthen shareholders protection in a manner which meets EU standards.

*Taxation*

43. The EDAL II program includes reform of the tax system to encourage growth of regulated securities markets. First, for tax purposes, transactions concluded at any of regulated trading systems--stock exchanges and OTC markets--will be treated equally. Second, an analysis has been prepared by the Securities Commission of taxation of market services related to and revenues from corporate securities in comparison with state securities and bank products (deposits, certificates of deposits, etc.). Efforts have been maintained to secure Parliamentary approval to remove the transaction tax (stamp duty) for all transactions concluded through regulated markets. Changes have also been proposed in the tax law which would result in all forms of financial investments (corporate stock and bonds, Treasury bills and bonds, banks deposits and certificates, investment funds, etc.) being treated in a tax-neutral way.

*Market Infrastructure*

44. There has been good progress, compared with other FSU countries, in registration of share ownership of mass privatized companies. About 75 percent of privatized companies have consolidated the lists of their original shareholders and transferred them to registrars. Some 330 registrars have been operational, of which about 130 operated by banks or financial groups. The rest, some 200 registrars, have been organized and financed by issuers. There has been a visible progress in building depository capacity. In particular, a depository called MFS, established by the major banks and traders has a real chance of becoming an all-Ukrainian depository for shares. The MFS has been supported by technical assistance from USAID. An SRO of registrars, custodians and depositories (PARD) was organized during 1997 and presently has 102 members and is becoming a partner to the SSMC in regulating its members. The EDAL II program includes targets on the transfer of share registries to independent registrars and requirements on the publication of shareholder information with imposition of sanctions for non-compliance.

45. There have been positive developments in building the capacity for regulated secondary trading in shares. Three regulated market places operate in Kiev and at least one regional universal exchange trades in shares (Donetsk). These, however, still handle only the minority of total corporate securities trade in Ukraine. Government has encouraged greater transparency in the secondary markets by creating incentives for concentration of trade in regulated markets and requiring public disclosure of trades of large blocks of shares. The Commission has started to build a monitoring system to enforce these recommendations.

46. Despite progress, there is still much work to be done to create well functioning, transparent and robust securities markets. One need is to establish adequate clearing and settlement infrastructure. At present, transactions are settled on an individual basis. Re-registration (transfer) of shares and payment arrangements are left to contracting parties. This apparently has hampered the trade of small blocks of shares and trade between regions and added to market fragmentation and lack of transparency. Establishment of a consolidated depository system should solve the problems in settlement of securities (transfer of ownership). The payment side of settlement will require involvement of the NBU. Building of the necessary market infrastructure requires financing, not always available from private sources. Clearing and settlement is one area where public money is often used in emerging markets to build necessary infrastructure. The National Depository System may be another area where the Government financing is necessary. The SSMC has prepared a proposal for necessary investments to be financed from the budget and by foreign aid.

*Attractive Share Offerings*

47. Capital markets with even the best regulated institutions cannot flourish without attractive products to trade. The Mass Privatization Program created a very large number of shares owned by employees and the public at large. At present, however, only a relatively small fraction of shares of privatized companies are attractive enough for small investors, in terms of dividends and available information (disclosure). To give regulated markets an additional incentive, the SPF has progressed with IPOs of shares of ten attractive companies. Under the EDAL II program These IPOs will be implemented as a part of the case-by-case privatization transactions, including offerings to strategic and foreign portfolio investors.

**Enterprise Accounting Reform**

48. The early imperative for the enterprise sector in Ukraine was the rapid withdrawal of the state from enterprise ownership and management. The focus was on primary ownership change through privatization, secondary ownership change through capital markets development and on creating a favorable post privatization environment through trade and price liberalization. The emphasis will need to be maintained in these areas until the processes are complete. However, as the privatization program continues to create thousands of private enterprises, the focus will need to be increasingly on the "second generation" of systemic enterprise reforms intended to transform Ukraine into a modern market economy. Enterprises in Ukraine are operating at present in an environment which lacks transparency, little disclosure of financial information and virtually no accountability. It is almost impossible to hold managers accountable for performance. Enterprise managers themselves have no effective means of making financially sound management decisions or monitoring their impact. There is little trust in reported information and investors have little basis on which to make investment decisions or monitor investment performance. The EDAL II program includes the implementation of International

Accounting Standards (IAS) in Ukraine. Accounting reform will be an indispensable element of the array of second generation market reforms necessary over the coming years in Ukraine.

49. Work has already begun, with help from the donors, in initiating the application of IAS. Most work so far has been in the banking sector. An accounting reform unit was set up during 1996 within the National Bank of Ukraine (NBU). The general ledger accounts of the NBU's central operations were revised to incorporate IAS based principles in late 1996 and the consolidated balance sheet is now under preparation. IAS conversion for the NBU is almost complete. Work has also started on conversion of commercial banks to IAS. The process is proceeding in two steps, the creation of IAS consistent reporting forms and then the actual conversion to IAS. 20-30 commercial banks are piloting a new chart of accounts and reporting forms and official conversion to IAS of all banks took place in January 1998.

50. Work has also been done on accounting reform in the enterprise sector. A USAID sponsored accounting reform project started in early 1995. Work has been done with pilot enterprises on the implementation and training of personnel in IAS, and on the creation of a national association of accountants and auditors. But much more remains to be done. Short- and medium-term priorities will include the implementation of the legal and regulatory reforms needed to give full effect to IAS and this will need to be accompanied by an increased level of technical assistance to train practitioners in IAS.

51. The proposed EDAL II accounting reform program outlined in detail below and in the matrix would apply policy conditionality to support and accelerate the adoption and implementation of IAS for the enterprise sector. As with all other aspects of the proposed EDAL II program, it could not be successful without large amounts of technical assistance from the donors. During our preparation missions, we helped create a working group on accounting reform consisting of representatives of all interested parties from Government, the donors and the private sector. The reform program includes the recent creation of an Accounting Standards Board, which will oversee the development and implementation of IAS in the enterprise sector in Ukraine.

52. One component of the reform program will use the mandate of the Securities Commission to determine accounting methodologies, financial statement presentation formats and disclosure requirements for capital markets participants (including all publicly held joint stock companies). The Commission will initially work with pilot enterprises but will later require reporting according to IAS from all publicly quoted companies. International Standards on Auditing (ISA) will also be implemented during the program. Education and Training curricula incorporating IAS and ISA will be developed, implemented and incorporated into programs for testing, certification and licensing. The recently-created association of accountants and auditors, the Ukrainian Federation of Professional Accountants and Auditors (UFPAA) which already has over 1,000 members in 18 regions, will be fully involved in all aspects of the reform program.

53. The main elements of the accounting reform program to be supported by EDAL II are as follows:

*Establish an institutional framework for the adoption of International Accounting Standards (IAS)*

54. An authoritative Accounting Standards Board (ASB) has been created. The ASB will provide for the development of accounting standards in conformity with International Accounting Standards (IAS) and will approve these standards. The ASB will use the self-regulatory professional body UFPAA to create a prioritized timetable for the development of Ukrainian accounting standards in compliance with IAS. The ASB will also provide for the development and issuance of regulations and instructions on IAS compliance. The creation of the ASB will serve to further the separation of financial reporting methodologies and presentation formats from tax reporting requirements. The ASB, comprised of a cross-sector representation, could also serve as a body to coordinate accounting reform initiatives across sectors and institutions (e.g. banking, tax, Securities Commission, etc.).

*Adopt financial disclosure requirements in compliance with IAS for joint stock companies*

55. The mass privatization program has resulted in the rapid creation of new joint stock companies. An important element in the EDAL II accounting reform program will be the issuing of a requirement by the Securities Commission that these joint stock companies and all capital markets participants prepare their financial reports according to IAS. This will create a strong momentum for the rapid country-wide adoption of IAS.

*Improve Auditing Standards*

56. Ukrainian auditing procedures and guidelines, currently oriented towards compliance with a statutory based system, will need to be revised for compliance with ISA. In terms of priorities, as capital market development is critical to the economic growth of Ukraine, auditing standards could be initially developed to protect stock market participants (i.e., joint stock companies will be the initial target requiring use of ISA). The Chamber of Auditors, together with UFPAA, has provided a timetable for the development and adoption of auditing standards in compliance with ISA. Requiring the use of ISA by the SSMC will accelerate the country-wide pace of adopting ISA.

*Implement Educational programs*

57. With the introduction and adoption of IAS and ISA based accounting and auditing frameworks, new educational programs and materials will be needed to bring these concepts to the classroom. At present, selected accounting courses are offered in university curricula but accounting is not recognized as a specific degree. The Ministry of Education, in coordination with UFPAA, has worked with a local university in developing a pilot program to establish an accredited accounting program in conformity with IAS and ISA at the undergraduate and graduate levels and will require implementation of that program. Requiring the development and implementation of accredited university curricula on accounting will contribute to generating a supply of qualified accountants necessary to meet the demand for IAS-based financial reporting, as generated by the requirements of the Securities Commission.

*Professional Quality Control*

58. For adequate quality assurance of the accounting profession, further developments are needed in training, testing, certification and licensing. To address these needs, the Chamber of Auditors, in conjunction with UFPAA, will develop a program and implementation timetable for the provision of training courses, testing programs and adoption of certification requirements and licensing criteria which incorporate IAS- and ISA-based concepts.

**Bankruptcy Reform**

59. Bankruptcy law lies at the foundation of a market economy and, in the area of business activity, has come to serve three principal functions: an exit mechanism for failed enterprises, terminating the non-productive use of business assets (liquidation); a mechanism for rehabilitating enterprises which, although at risk of failure, are worth more as a going concern than liquidated, and have the potential to recover where such rehabilitation involves or requires financial restructuring (reorganization); and as a final debt collection mechanism for creditors.

60. As Ukraine moves forward with the transition to a market economy, procedures for restructuring and liquidation will come to play an increasingly important role. The system of bankruptcy in Ukraine is starting from a low base. Immediate attention is needed if it is to come to fulfill the demands that are being made of it at this time and will be made of it in the coming years.

61. The bankruptcy process in Ukraine is governed, generally, by one of the earlier pieces of economic legislation adopted after independence, the Law of Ukraine "On Bankruptcy" enacted on May 14, 1992. The Law has been amended several times, most recently on March 14, 1995, and governs the liquidation and "sanation" of insolvent legal entities. "Sanation" is a sub-set of reorganization-type procedures, directed at finding a party to assume all of a debtor's debts. In its current form, the "Sanation" procedures are an inefficient and cumbersome mechanism to achieve the financial restructuring of a financially distressed enterprise. Although containing an outline of the principal provisions one would expect to find in a bankruptcy law, the existing Ukraine Law is brief, vague and contains conflicts both internally and with other legislation.

62. Although the use of bankruptcy proceedings is increasing, for a country of Ukraine's size, with the large number of enterprises experiencing economic distress, the number of proceedings is still comparatively small and few successful "sanations" have occurred. Additionally, the Law has been used predominantly for the liquidation of small, undercapitalized companies in the private sector and rarely in the public sector. The most frequent use of the Law is by the State taxing authorities as a debt collection device, rather than for bankruptcy's more appropriate role as the start of a collective procedure for the benefit of all creditors.

63. *Inadequate Legal Framework.* Among the many reasons that the current legal framework is inadequate to accommodate the efficient implementation of bankruptcy proceedings are the following:

- Existence of a patchwork of frequently changing and often inconsistent laws, regulations and decrees related to bankruptcy issues; additionally, different governmental agencies have overlapping and often conflicting authority in the bankruptcy field, as well as different opinions on how to proceed, causing endless delays and backlogs in the system. In addition to the Courts of Arbitration, which have jurisdiction over bankruptcy cases, examples of other governmental agencies involved in the process include: the State Property Fund; the Agency to Prevent Bankruptcy; the State Tax Inspectorate and the Anti-Monopoly Committee;

- Restructuring mechanisms in the existing Law are weak and cumbersome; and

- A set of confusing and overlapping procedures govern the duties and/or responsibilities of the various participants in the bankruptcy process, with the case overseen by the court, managed by the trustee and then the liquidation commission with supervision by the creditors, their committee and, in the case of state-owned enterprises, certain government or municipal bodies and employees.

64. *Lack of Implementation Capacity.* The Courts have been greatly overburdened with the implementation of the bankruptcy law and lack the necessary infrastructure to assist them with the task. This burden could be at least partially alleviated by the development and more extensive use of supporting professions, such as bankruptcy trustees and liquidators, as well as the development of the professions of accounting, investment banking, appraisers, auctioneers and lawyers knowledgeable about the bankruptcy process.

65. *Lack of Incentives.* At present, there are few incentives and many disincentives for using the bankruptcy system. For example:

- Initiation of bankruptcy proceedings is too expensive and time-consuming; e.g., before a debtor can initiate a bankruptcy case, it must obtain audited financial statements, a process which is expensive and cumbersome; a creditor's need to pay a filing fee of 5% of the face value of its debt in order to obtain a judgment and the subsequent long procedure required before it can obtain "certified" documents in order to be eligible to file a bankruptcy petition, are significant disincentives to creditors to utilize the bankruptcy system;

- The banks' better hope of avoiding loan losses is through government support, and fear of regulatory problems has been assuaged by soft application of capital adequacy requirements (although full loan loss provisioning will be a condition of the proposed FSAL program); and

- The prospect of any recovery is very uncertain; the procedures tend to take very long, especially asset sales; as a consequence, the liquidation commission often stops working once it has realized that inflation has eroded asset values.

*Government's Bankruptcy Reform Program*

66. Many of the problems of the bankruptcy system might be solved by the enactment of a new bankruptcy law. The proposed bankruptcy law pending before the Parliament, if enacted, would go some way to solving these problems but not all the way. Given the current difficulties in the Ukrainian legislative process, the passing of an appropriate new bankruptcy law will take significant additional

work and is probably not imminent. An interim solution, which is being supported by the EDAL II program, is the preparation and dissemination, by the Presidium of the Highest Arbitration Court of Ukraine, of extensive written explanations on the existing Law. The most extensive of those Explanations was issued by the Presidium, in draft, in April, 1997 (the "Draft Explanations"). These Draft Explanations recognized that at this early stage in the use of bankruptcy laws in Ukraine, the full complement of supporting legislation is not yet in place or harmonized and that written explanations are needed to fill in gaps in the existing law and to deal with the conflicts within it and with other Ukrainian legislation.

67. In addition to having prepared the Draft Explanations, representatives of the Highest Arbitration Court held conferences in March, April, May and September, 1997 (with donor technical and financial support), at which times they discussed the Draft Explanations and solicited and received written comments from the many different Ukrainian constituencies involved in the development and implementation of the bankruptcy system, such as, by way of example only, the Ukrainian Bankers Association, the National Bank of Ukraine, the State Property Fund, the tax authorities, the relevant Ministries, the law schools, legal practitioners, sitting bankruptcy judges throughout Ukraine, and donor-sponsored consultants.

68. These Explanations were finalized and formally issued in November, 1997. This was an important pre-Board action of the EDAL II bankruptcy component.

69. In addition to extensive written comments on the Draft Explanations in July, 1997, donor consultants delivered a comprehensive new draft bankruptcy law (the "New Draft Law") to the bankruptcy working group formed to implement the bankruptcy reform component of EDAL II which draws heavily on existing Ukrainian legislation and legal practice. References are made at the end of each section of the New Draft Law to the law's Ukrainian sources. Wherever possible, the New Draft Law incorporates the Explanations. The New Draft Law, together with the final Presidium Explanations, could form the basis for amending the existing Law.

70. Another recent development was the enactment, on June 5, 1997, of the law "On Write-Offs and Restructuring of Taxpayers' Liabilities as of March 31,1997." Among other things, this law permits the restructuring of an enterprise's tax arrears (including pension fund liabilities) over a 10-year period (with payments on this restructured debt being due monthly beginning in January, 1998) and permits the write-off of certain historic tax liabilities incurred before June 30, 1994 (i.e., tax and pension arrears accumulated during the early transition period), as well as the write-off of interest and penalties incurred through March 31, 1997. If the restructured tax debt remains unpaid for 3 months, the taxing authority is required to commence bankruptcy proceedings against the delinquent enterprise. This new law, which permits real debt forgiveness as well as realistic debt rescheduling on the part of state budget creditors, should facilitate the financial restructuring of enterprises under the existing bankruptcy law and, if enforced, work towards improving financial discipline.

71. The excessive special powers of collection provided to state budget creditors, however, including the right to sequester assets and cash held at an enterprise's bank, still need to be reviewed and revised so that the state, as creditor, is not permitted to act in a manner detrimental to the normal business operations of debtor enterprises or in a manner which is potentially harmful to other creditors. Actions by state budget creditors should also be governed by the "rule of law," including requirements for notice of a proposed collection action to all interested parties and an opportunity for those parties to respond in

a court of law. In such a way, both the debtor enterprise and other creditors of the debtor will be able to determine whether the commencement of a bankruptcy proceeding, leading to either a financial restructuring or to liquidation, may be a more appropriate route to ensure fairness to all parties. One of the important roles of bankruptcy law in a market economy is as a collective procedure for debt collection for the benefit of all creditors. If, as now appears to be the case, state budget creditors are permitted to seize and/or control all of a debtor's assets without adequate notice to the debtor or to other creditors, there is little or no opportunity for the parties to avail themselves of the bankruptcy law's protections and intended function. As a consequence, one of the elements of the proposed bankruptcy reform program is to clarify and resolve the conflicting rules relating to the excessive special powers of collection provided to state budget creditors in order to insure the proper functioning of the bankruptcy laws.

72. Another important element of the bankruptcy program to be supported by EDAL II is the work to be performed to support and encourage the development of the profession of bankruptcy trustees and liquidators to assist the courts in the implementation of the Law. This aspect of the program will include the preparation and enactment of professional criteria and requirements for licensing of bankruptcy trustees and liquidators, the creation of a trustee/liquidator SRO; and the development of an ongoing education program to support these professionals.

73. The bankruptcy program to be supported by EDAL II will be implemented by the Ministry of Economy in conjunction with the Highest Court of Arbitration through the newly formed Inter-Agency Committee for Bankruptcy Reform, which includes representatives of all interested Ukrainian and donor parties. The summary bankruptcy action plan consists of eight main points: (i) improving existing court procedures to facilitate restructuring of financially viable enterprises, or parts thereof, and the liquidation of non-viable enterprises; (ii) the clarification and streamlining of procedures for initiating bankruptcy proceedings and for ensuring notice to all creditors at the time of initial filing of the bankruptcy petition; (iii) the clarification of mechanisms to permit writing off and writing down debt, to allow creditors to accept less than 100% of debt recovery; (iv) the clarification of mechanisms under existing law which would provide for a court-enforced moratorium on payments to creditors for pre-petition debts and a stay or cessation of all creditor proceedings against the debtor and its assets as soon as a petition is filed; (v) the clarification and resolution of the conflicting rules relating to the excessive special powers of collection provided to state budget creditors and the proper functioning of the bankruptcy laws; (vi) the development of training programs, professional standards, payment mechanisms and a self-regulatory organization for bankruptcy trustees and liquidators; and (vii) following the reform of the bankruptcy procedures described above, the initiation of court-led bankruptcy law proceedings for four post-privatized former state-owned enterprises; two as liquidations and two as restructurings, initiated by either private or public sector creditors, with the aim of identifying additional problems remaining in the bankruptcy system for further reform.

## Deregulation

*The Need for Deregulation*

74. Due to excessive government control and regulation of the economy, Ukraine has a high cost, uncertain business environment that is preventing its private sector from growing and competing domestically and internationally. Business environment cost and uncertainty is discouraging the establishment of new businesses, the expansion of existing businesses, and foreign investment. If entrepreneurs in privatized and new private enterprises are to lead Ukraine's economic recovery, they require the incentives and flexibility to pursue profitable opportunities within a reliable structure of law that permits fair competition and efficient resolution of disputes. Yet throughout their short and recent history, Ukrainian private enterprises have suffered from complex, costly, unclear and inconsistent regulations; as well as invasive and arbitrary regulatory enforcement.

75. Recent analysis suggests that Ukrainian firms are severely hampered by excessive regulation and taxation of their formal activities. Proprietors and managers spend almost 30% of their time simply dealing with requirements imposed by the government, such as filling out myriad forms and negotiating with numerous officials at different levels of government. This is about three times as high as countries with well functioning tax and regulatory administration. It is not surprising that many businesses engage in substantial informal activity or under-reporting to avoid a portion of this burden, while others operate completely unofficially. Furthermore, harsh, unclear and inconsistent laws combined with weak administrative discipline give bureaucrats substantial discretion. Heavy state controls, unclear rules and bureaucratic discretion result in similar firms being treated differently, based on their willingness and ability to negotiate. Furthermore, its costs fall disproportionately on small firms, deterring new firms from starting up and informal firms from joining the official economy.

76. The complex web of regulation in the form rules, forms, inspections and other procedures divides into several key areas, including:

- tax administration,
- business registration and start-up procedures;
- business licensing;
- customs and trade regulation;
- regulation of financial transactions;
- regulations on property;
- business inspections procedures (by multiple agencies of government).

This complex set of issues is proposed to be addressed in a number of forthcoming Bank loans including the proposed Financial Sector Adjustment Loan (FSAL), the Public Administration Reform Loan (PARL) and the Public Resource Management Loan (PRML). Meanwhile, since initial action on deregulation cannot wait until all these loans are processed, it has been agreed with the Government that some of the most urgent measures needed to launch the deregulation process, most of which are included as pre-appraisal actions in the proposed PARL deregulation program, will be included also in the EDAL II program.

*Recent Government Initiatives*

77. The Government's December, 1996 legislative reform package went far in addressing some of the constraints, including proposals to simplify business registration; reduce dramatically the number of activities subject to licensing, expand and secure private property rights, remove restrictive financial regulations, simplify and reduce payroll taxes, improve customs and import quality certification administration, and remove restrictions on employee residence. However, the "package" has made little progress in Parliament.

78. As part of its April 11, 1997 anti-corruption package of proposals, the Ministry of Justice also proposed certain regulatory reforms, including a national registry of laws and legal acts, a reduction in the numbers of licenses and permits issued by government Ministries, and closer scrutiny of tax and customs administration. At the same time, the anti-corruption program contained an element of stricter business regulation, to check all businesses on the legitimacy of their activities in conjunction with current legislation (a challenging task, given the complexity and internal contradictions of existing laws and regulations).

79. In addition, as part of its new focus on small business, the Ministry of Economy is initiating a "program of small-scale business development in 1997-98," designed to "turn the small business sector into a leading branch" of the Ukrainian economy. This includes new laws on state support of small-scale entrepreneurship, on private property, on leasing, on licensing, and on credit unions; and amendments to laws on entrepreneurship, on enterprises in Ukraine, on Property,' and on economic societies. It also provides for the launching of a Congress on Entrepreneurship to discuss problems confronted by entrepreneurs.

80. An Expert Council on Deregulation has been created under the Vice-Prime Minister for Economic Reform. A State Committee for Entrepreneurship has been created and given a mandate by Presidential decree for deregulation and other measures for creating a more friendly business environment. These two entities have prepared and adopted a draft Government strategy for deregulation. The Parliament recently approved and the President enacted changes to the Law on Entrepreneurship, which lowers from more than 100 to 41 the number of licenses required for different enterprise activities.

81. Finally, the President has recently created an Advisory Board on Foreign Investments in Ukraine of which he is the Chairman. Major goals of the Board are as follows:

- an analysis of the problems blocking the process of foreign investment inflow into the country;
- preparation of proposals aimed at streamlining forms and methods of economy management;
- development of attractive image of Ukraine among potential foreign investors.

82. In spite of these efforts, the Government lacks any way to systematically review laws and regulations to determine their consistency with government or parliamentary intent, their effect on private business development, or their relative costs and benefits.

*The EDAL II Deregulation Program*

83. The following high priority actions have been agreed with Government for inclusion in the EDAL II program. These actions will also pave the way for further reforms under the proposed PARL:

- *Deregulation Strategy.* The Government has formally adopted the deregulation strategy developed by the Expert Council on Deregulation and the State Committee for Entrepreneurship.
- *Business Licensing.* Legislation has already been approved by Parliament that reduces the number of business activities subject to licensing from 101 to 41. The Government has completed its analysis of licensing problems and will take action to solve any licensing problems that it has the power to deal with. Analysis will also be completed on the problems relating to obtaining permits other than licenses and measures will be prepared to deal with them. For those licenses that will remain in place, measures to simplify and accelerate them will be prepared. Institutional mechanisms will be prepared that will automatically screen and limit any new proposals to extend licensing to new activities.

84. *Business Registration.* Legislation has already been drafted to simplify documentation and permissions required for business registration and start-up and to make it a ten-day, one-stop process. Detailed implementation proposals for this legislation have already been prepared.

85. *Business Inspections.* Under EDAL II, analytical work will be completed on the complex web of inspection procedures at the central and local levels. Comprehensive measures will be proposed that will eliminate unnecessary inspections and standardize inspections that will remain. These measures will include the enforcement of uniform standards for inspections in terms of frequency, transparency, accountability, due cause for seizures, and appeals process.

86. *Institutionalization of Deregulation.* Institutional mechanisms will be created for continuing the process of deregulation and subjecting any new regulations to consistent critical review. A consultative process with the private sector will also be established and will be made fully functional on a permanent basis. The public/private consultative group will regularly submit recommendations to the Cabinet for action on high priority deregulation issues.

## IV. DONOR COORDINATION

### General

87. Over the two to three years leading up to the initiation of the first EDAL, there was a very close dialogue between the Bank and the donors supporting privatization and capital markets reform in Ukraine. It was marked by a series of donor meetings in Washington, London and Kiev and, in February, 1994, by the signature of a joint Memorandum of Understanding by the major donors and the Government on the future direction of the mass privatization program and on the external support that could be provided for it. Bi-weekly meetings are held in Kiev to discuss privatization and capital markets reform issues. These meetings are attended by the major donors and by their contractors and sometimes by key Ukrainian counterparts. There have been a number of joint donor initiatives to approach the Government on critical privatization and capital markets issues over the implementation period of the first EDAL. This combined action has proven extremely effective in bringing about necessary policy changes. It has continued during the preparation of EDAL II and it will continue as required over the EDAL II implementation period.

88. The combination of policy analysis and conditionality from the Bank and the IMF with grant financed technical assistance from other donors has worked particularly well in the Ukrainian context. The Program supported by this loan has therefore been designed in full cooperation with the other major donors, in particular the IMF, USAID and EU/TACIS, and has their full support. The latter two donors will continue to provide most of the technical assistance necessary to complete the mass privatization program, to move on to case by case privatization, to continue capital markets reforms, to work on accounting reform, bankruptcy reform and deregulation and to promote the post-privatization restructuring and growth that will be the major objectives and benefits of the program. They are depending on the Bank and have asked the Bank to maintain, through EDAL II, the leverage of conditionality that has achieved policy reforms that their TA alone could not have brought about. Conversely, the detailed work carried out by donor financed TA personnel has done much to enhance the design of the reform program to be supported by EDAL II. Inter-agency working groups, including donor representatives, were created to prepare each component of the EDAL II program and they will continue to monitor implementation progress during the program period.

89. The long standing productive cooperation between the Bank and IFC will be maintained. IFC intends to continue its support for privatization implementation throughout the EDAL II period.

### EU/TACIS

90. The conditions for disbursement of the EU's ECU 200 million program loan to Ukraine were closely linked to the implementation of the policy conditionality of the first EDAL. EU/TACIS has been actively supporting the privatization process in Ukraine since independence. Early support was for the SPF and for pilot privatization transactions. Since 1994, the programs have focused more on mass privatization and on the development of the capital markets. EU/TACIS consultants have helped with the implementation of the privatization auction process in several oblasts and also with the institutional strengthening of new investment funds. EU/TACIS completed an organizational review of the SPF during 1997 and made recommendations for streamlining its structure. EU/TACIS were also instrumental in creating the capacity of the Ukrainian Center for Post-Privatization Support (UCPPS),

which is the main implementing agency for the first EDAL's TA component. As mass privatization moves to completion, EU/TACIS operational support has begun for case-by-case privatization through the SPF and also for further post-privatization assistance programs similar to the one implemented by the UCPPS. Work has been done by EU/TACIS on the methodology for divestment of social assets by enterprises and support is also planned for improving the bankruptcy process.

**USAID**

91. USAID has financed major costs associated with the mass privatization program, including printing and distribution of the privatization certificates, the operational costs of the enterprise auction centers and the public information campaign for privatization in the national and local media. USAID was also the major source of finance for IFC's support to the small scale privatization process in several cities throughout Ukraine and will continue to finance IFC's forthcoming program of help in the privatization of unfinished construction. Other USAID initiatives include support for the development of private investment funds and for the creation of a self-regulatory organizations for market intermediaries, creation and running of a capital markets monitoring unit, support for US SEC staff from Washington and other securities markets professionals to advise the Government on creating new capital markets legislation and supervisory bodies, and support for creating a share registry and a clearing and settlement organization. The Bank has provided high level advisors on privatization directly to the Chairman of the SPF and financing for these advisors has now been taken over by USAID. USAID has also provided consulting and other support to the creation of the Ukrainian Federation of Professional Accountants and Auditors. USAID has provided legal expertise in drafting a proposed new bankruptcy law and in drafting the explanations recently adopted by the Presidium of the Highest Arbitration Court in streamlining the bankruptcy process. USAID has also provided help to the Government in identifying a strategy for deregulation.

**Other Donors**

92. The Bank and many donors, including EU/TACIS and USAID have provided city and enterprise level support for privatization and private sector development programs. The EDAL's TA component will provide support for professional associations and self-regulatory organizations in the capital markets. IFC has been particularly active in promoting small scale enterprise privatization at city level and also some large scale pilot privatization transactions, support to mass privatization in some oblasts, land privatization and post-privatization support, and intends to work during the coming year on privatization of unfinished construction. The EBRD was active early in supporting the SPF and is beginning to replicate in Ukraine the Regional Venture Fund concept that been a vehicle for direct EBRD equity investments in newly privatized enterprises in several Russian cities. Bi-lateral donors such as Switzerland, Netherlands, UK Know-How Fund and Japan have also been active in supporting the privatization process in Ukraine and the UK Know-how Fund has worked on training of accountants. A Japanese technical assistance grant and a grant from the Irish Government, both managed by the Bank, helped in the preparation of the first EDAL. EDAL II has been prepared in close cooperation with the IMF and many of the actions proposed under EDAL II are also included in the IMF's Standby program.

## V. THE PROPOSED LOAN

**Background and Rationale for Bank Involvement**

93. This project is consistent with the Bank's Country Assistance Strategy for Ukraine (CAS) discussed by the Executives Directors on June 1996, and the CAS Progress Report being presented together with this operation which puts the promotion of private sector development, including accelerating the shift to private ownership, as a top priority. The proposed loan will provide a significant portion of the external balance of payments support necessary to maintain the Ukrainian economy during the economic transition period while at the same time, supporting through policy conditionality, reforms critical to the success of this transition. It will continue the balance of payments support initiated by the IMF in its Standby Arrangements and Systemic Transformation Facility and the Bank through its Rehabilitation Loan and existing and proposed sector adjustment loans. The Loan design has followed the successful formula, demonstrated clearly in the Ukrainian context, of focused Bank-financed policy conditionality working alongside the IMF program and grant financed technical assistance from other donors.

**Loan Objectives and Description**

94. The main objectives of the proposed EDAL II will be to continue the support for the Government's privatization and capital markets development programs begun under the first EDAL and the more recently initiated accounting, bankruptcy reform and deregulation programs. It is intended, through policy conditionality and donor financed technical assistance, to complete the economic transformation of the enterprise sector from a primarily state owned to a primarily private ownership structure, to realize the necessary enterprise governance improvements and accelerate the restructuring and enhance the efficiency of the enterprise sector following privatization. It will therefore complement the reforms supported by the Bank's other existing and proposed sector adjustment loans.

95. Given the urgent need for balance of payments support, the loan, consisting of three equal tranches of US$100 million each, is expected to disburse quickly and the completion date will therefore be December 31, 1999. The proceeds of the loan will be disbursed in three tranches upon evidence that the agreed adjustment measures have been satisfactorily implemented. Non-eligible imports would comprise only those goods on the World Bank's standard negative list. As agreed with the Government, disbursements will be made through the NBU and an account of the Ministry of Finance at the NBU will be credited with the Hrivnya equivalent at the market exchange rate as determined on the interbank exchange market. The foreign exchange receipts of the loan will be sold by the NBU in the interbank exchange market or will be held in reserve in accordance with the objectives of monetary policy. The Government will therefore receive non-inflationary budget support.

**Project Implementation and Key Measures for Disbursement**

96. Implementation of the policy reforms began during early 1997, as the third tranche conditions of the first EDAL began to be met, and has continued throughout 1997. The first tranche will be disbursed based on satisfactory implementation of the pre-Board action program described below. The Ministry of Economy is the coordinating agency for the action program but the reforms will be implemented by a number of agencies including the State Property Fund, the Securities and Stock Markets Commission,

the Ministry of Finance, the Highest Arbitration Court of Ukraine, and the State Committee for Entrepreneurship.

**The following measures have been completed and constituted the pre-Board action program and conditions for release of the first tranche of the proposed loan:**

(a) *Privatization*

(i) the SPF has completed the privatization of more than least 7,500 medium/large enterprises (i.e., transfer of at least 70 percent of the shares of each enterprise to private hands) since January 1, 1995;

(ii) an order demonopolizing the grain marketing conglomerate Khlib was issued, share sales of more than 150 grain marketing and distribution enterprises have begun;

(iii) at least 70 percent of the shares of each of more than 40 grain marketing and distribution enterprises have been transferred to private hands;

(iv) a list of all large enterprises to be included in the privatization and a schedule for their privatization have been prepared;

(v) at least 40 percent of the shares of each of 50 large enterprises have been transferred to private hands;

(vi) 100 percent of the shares in each of more than 3,750 medium/large enterprises have been transferred to private hands since January 1, 1995;

(vii) regulations for transparent procedures for issuing tenders and selecting advisors for case-by-case privatization transactions have been drafted;

(viii) ten major case-by-case privatization transactions have been initiated, providing for eventual privatization of at least 51 percent of the shares in each enterprise to strategic investors;

(ix) there has been and will be no reversal of the favorable environment for small scale enterprise privatization in Ukraine throughout the loan period;

(x) more than 1,500 unfinished construction sites have been transferred to private hands; and

(xi) lists of all privatized medium and large enterprises have been made publicly available and this will continue throughout the period of the loan.

(b) *Capital Markets*

(i) during the pre-Board period and throughout the period of the Loan, the Government will refrain from empowering any institutions other than the Securities and Stock Markets Commission to regulate securities markets;

(ii) the Securities Commission and the National Bank of Ukraine have reached agreement confirming the Securities Commission as the primary regulator of banks' activities in securities markets;

(iii) membership in self-regulatory organizations is now required for all professional capital markets participants;

(iv) the Securities Commission has approved a regulation requiring reporting to the Commission of all transactions for blocks of shares greater than 10 percent of an enterprise's share capital and public announcement by the Commission of the details of the transaction;

(v) the Law on the National Depository System has already been approved by Parliament and one depository has already been licensed;

(vi) the Securities Commission completed an analysis of the taxation of securities and issued an interpretation to the tax authorities for equal tax treatment of the stock exchanges and over the counter securities markets; and

(vii) throughout the Loan period, the Government has not and will not create unequal conditions for market participants and will not own controlling or blocking interests in commercially viable capital markets institutions.

(c) *Accounting Reform*

(i) the Government has established an Accounting Standards Board, which has met and decided on its operational procedures and agenda;

(ii) the Securities Commission has amended annual reporting formats for issuers to follow IAS;

(iii) pilot issuers have been selected to adopt disclosure requirements in compliance with IAS;

(iv) the Chamber of Auditors, in cooperation with the Securities Commission and all significant accounting associations has provided a timetable for the implementation of ISA; and

(v) the Ministry of Education and a leading University have developed accounting curricula to provide training in IAS and ISA at the undergraduate and graduate levels, and the Ukrainian Federation of Accountants and Auditors has already conducted training of accountants incorporating IAS concepts.

(d) *Bankruptcy Reform*

(i) the Highest Arbitration Court has issued "Explanations" of the existing Bankruptcy Law which will give practical legal effect to all the elements included in the EDAL II bankruptcy reform program;

(ii) the "Explanations" are being and will be implemented throughout the period of EDAL II;

(iii) special powers of state budget creditors have been identified and a plan prepared to remove those that do not conform with international practice;

(iv) a professional working group has been established and this group has prepared draft professional criteria for licensing bankruptcy professionals; and

(v) draft procedures clarifying compensation rules for bankruptcy professionals have been prepared.

(e) *Deregulation*

(i) the Government has adopted a deregulation strategy;

(ii) an analysis of business licensing problems has been completed, identifying problems that are within Government's authority to solve;

(iii) a detailed proposal to make business registration a ten-day, one-stop process has been prepared; and

(iv) the Committee on Entrepreneurship has developed criteria to review the impact of all new and existing legislation for its impact on private sector development.

**The following measures will be implemented prior to release of the second tranche:**

(a) *Privatization*

(i) at least 70 percent of the shares of at least 8,500 medium/large enterprises will have been transferred to private hands since January 1, 1995;

(ii) share sales of at least 300 grain marketing enterprises will have begun;

(iii) at least 70 percent of the shares of at least 60 grain marketing and distribution enterprises will have been transferred to private hands;

(iv) at least 40 percent of the shares in at least 60 large enterprises will have been transferred to private hands;

(v) 100 percent of the shares in at least 4,250 medium/large enterprises will have been transferred to private hands since January 1, 1995;

(vi) documents and IPO distribution channels for three case by case privatization transactions will have been finalized;

(vii) 2,500 unfinished construction sites will have been transferred to private hands; and

(viii) a full set of regulations for transparent procedures for case-by-case privatization transactions will have been approved.

(b) *Capital Markets*

(i) shareholder lists for all privatized enterprises will be consolidated and made available to the public;

(ii) the Securities Commission and the National Bank will have adopted rules for the organization of capital markets activities within commercial banks;

(iii) all securities markets trading systems will have been either licensed or closed;

(iv) regulations meeting EU standards for depositories, custodians, and clearance and settlement will have been issued;

(v) all privatization IPOs will use dematerialized shares placed in a depository and sold through regulated trading systems;

(vi) changes to the taxation structure for securities will be submitted to Parliament; and

(vii) stock exchanges and over the counter markets will be treated equally for tax purposes.

(c) *Accounting Reform*

(i) A timetable for adopting a National Accounting System in compliance with IAS will be prepared;

(ii) instructions for annual reporting according to IAS will be disseminated to issuers by the Securities Commission; and

(iii) the Chamber of Auditors in conjunction with all significant accounting associations will prepare a program and timetable for staffing, testing and certification to increase professional capacity in the use of NAS and NSA.

(d) *Deregulation*

(i) a plan to take all deregulation measures that are within Government's power to implement will have been adopted;

(ii) proposals for simplifying obtaining permits other than licenses will have been prepared;

(iii) draft measures to simplify licensing procedures remaining in place will have been prepared;

(iv) analysis of problems relating to inspection procedures will have been completed; and

(v) institutional arrangements to continuously review legislation and also to consult formally with the private sector will be fully operational.

**The following measures will be implemented prior to release of the third tranche:**

(a) *Privatization*

(i) At least 70 percent of the shares in at least 9,500 medium/large enterprises will have been transferred to private hands since January 1, 1995;

(ii) share sales of at least 450 grain marketing and distribution enterprises will have begun;

(iii) 70 percent of the shares in at least 100 grain marketing and distribution enterprises will have been transferred to private hands;

(iv) 40 percent of the shares in at least 100 large enterprises will have been transferred to private hands;

(v) 100 percent of the shares in at least 4,750 medium/large enterprises will have been transferred to private hands;

(vi) three case by case privatization transactions will have been brought to the stage of final negotiations with investors, three prospectuses will have been registered with the Securities Commission and a further 10 case by case privatization transactions will have been initiated; and

(vii) 3,600 unfinished construction sites will have been transferred to private hands.

(b) *Capital Markets*

(i) The Securities Commission will have started to impose sanctions on enterprises which have not transferred their share registries to independent registrars as required;

(ii) banks will have organized their capital markets activities in organizationally and financially separate internal departments or subsidiaries;

(iii) all broker dealers and registrars will have either become members of a SRO or will have had their licenses revoked;

(iv) SROs will have been delegated full responsibility for issuing rules of conduct and out-of-court arbitration between investors and their members;

(v) EU standards will be applied for disclosure of information on all new share offerings; and

(vi) a depository system, clearance and settlement system and settlement payment system (with NBU participation) for all regulated trading systems will become operational.

(c) *Accounting Reform*

(i) An accounting education program incorporating IAS and ISA in at least one graduate level institution will be underway; and

(d) *Deregulation*

(i) principles and procedures for reducing problems and abuses with inspections will have been specified and a plan prepared for dealing with these problems at the central and local levels.

(ii) regulations to simplify the licensing procedures remaining in place will have been enacted.

**Loan Administration, Procurement, Disbursement, Reporting and Auditing**

97. Administration of the adjustment component will be the responsibility of the EDAL II *Monitoring Unit* (MU) located in the Ministry of Economy which reports through the Chief of the Division for Collaboration with International Financial Institutions in the Cabinet of Ministers to the Deputy Prime Minister for Economics. The MU's main responsibility will be to monitor implementation of the Loan program and provide progress reports to the Government and the Bank every three months after Board approval. The progress reports will contain an evaluation of the progress made on the policy reform program and will indicate progress made towards fulfilling tranche release conditions. These

reports will be sent to the Bank every three months in English. The MU will also prepare Ukraine's contribution to the Project Completion Report within six months of the closing date.

98. In accordance with the February 8, 1996 Operational Directive on the Simplification of Disbursement Rules under Structural Adjustment and Sectoral Adjustment Loans, the proposed EDAL II proceeds will be disbursed against satisfactory implementation of the adjustment program, including compliance with stipulated tranche release conditions and achievement of a satisfactory macroeconomic framework. Disbursements will not be linked to any specific purchases: hence, evidence will not be needed to support disbursements, nor will procurement requirements be needed. The standard negative list will be applied.

99. Once the Loan is approved by the Board, the Borrower will be required to open and maintain a Deposit Account in its central bank. As each tranche is released, the Borrower will submit a simplified withdrawal application, against which the Bank will disburse the Loan proceeds into the Deposit Account for Borrower's use. If any portion of the Loan is used for ineligible purposes as defined in the Loan Agreement, the Bank requires the Borrower to either (a) return that amount the Deposit Account for use for eligible purposes, or (b) refund the amount directly to the Bank, in which case the Bank will cancel an equivalent undisbursed amount of the Loan.

100. The project manager will be located in the Ministry of Finance and will be responsible for submitting to the Bank the simplified Application for Withdrawal form upon receiving clearance from the MU and the Bank that all conditions have been met for a tranche release, and the Project Manager will maintain the project accounts. Although the Bank will not routinely require an audit of the use of Loan proceeds, it reserves the right to do so.

**Project Sustainability**

101. The main objectives of the Loan are to bring to completion the primary stages of transformation in the ownership structure and management of Ukrainian enterprises, to accelerate the development of the private sector through deregulation measures, to create capital markets infrastructure that will serve Ukraine indefinitely in the future, to promote the use of International Accounting Standards which will improve enterprise accountability and financial discipline and to create a modern bankruptcy process which will promote further restructuring of the enterprise sector. By definition these objectives are to bring about sustainable change.

**Lessons Learned from Previous Bank Involvement**

102. The experiences of the Rehabilitation Loan and the first EDAL have shown that well designed policy conditionality in the area of privatization and capital markets reform can bring about dramatic reforms that were previously unobtainable. The experience of the first EDAL has also shown that the weak implementation capacity that has held up the implementation of other projects does not have to be a major constraint, if the program is designed, as is the EDAL II program, to minimize the burden on existing institutions and to work in close coordination with grant financed technical assistance from other donors. Very close cooperation has been and will continue to be maintained with the other donors during loan preparation and execution. The major donors have participated, along with Government, in the design of the project and have expressed their strong support for it. Experience under the first EDAL as

well as experience gained during the preparation of this loan have also shown that project preparation is a valuable opportunity to deliver hands on assistance to Government authorities in defining and dealing with operational issues in both design and implementation. Experience has also shown that Ukraine does not wish to borrow large amounts for TA and is able to mobilize substantial grant funds for this purpose. The TA component of the first EDAL will continue disbursing through the end of 1998. For these reasons, we are not proposing any additional Bank-financed TA to work along with this loan although we shall continue to mobilize donor financed grants where appropriate.

**Environmental Aspects**

103. The loan will have no direct environmental impact. Therefore, the project has been classified as a Category "C" project.

**Program Objective Categories**

104. The proposed project supports the Bank's program objectives of development of a policy framework conducive to fiscal and macroeconomic stability, and to private sector development.

**Benefits and Risks**

105. *Benefits*. The continued implementation under EDAL II of the reform program initiated under the first EDAL would end the dominance of the state enterprise sector in Ukraine and help create a dynamic private enterprise sector. It would pave the way for the informal sector to move into the economic mainstream and move Ukraine substantially through the transition to a market economy. It would consolidate the basis for well-functioning capital markets and create a critical mass of private enterprises that will be a main driving force for economic recovery. The implementation of International Accounting Standards and a modern bankruptcy process in Ukraine would further promote enterprise accountability and restructuring and, along with the proposed deregulation measures, would also improve the climate for private investment, domestic and foreign. Given Ukraine's human and physical potential the economic benefits to be obtained from these reforms will be enormous. The Loan would also provide critical balance of payments support to finance imports needed for economic recovery. The channeling of the Loan funds would support the foreign exchange markets in Ukraine.

106. *Risks*. The successful implementation of the first EDAL showed that its benefits justified taking the risks. However, the same risks will apply to EDAL II. The most important risk is the possibility of loss of policy commitment due to lack of consensus and possible growing opposition among key constituencies. This opposition was evident throughout the period of the first EDAL but the Government was able to overcome it. The next stages of privatization and restructuring of the enterprise sector are already involving some of Ukraine's largest state enterprises. Powerful interests are being challenged. The changes, although necessary and very urgent, could be painful to certain sections of the population, particularly in those areas where large enterprise closures could occur. The risk of policy reversal will be higher if lost employment opportunities are not quickly replaced by new ones. The relationship between Parliament and Government is no easier than it was at the beginning of the first EDAL program and sections of Parliament continue to declare themselves openly hostile to privatization and market reforms in general. The most important factor mitigating the risk of loss of political commitment is the likelihood, based on the experience of other countries as well as Ukraine, that once market reforms have taken hold and a critical mass of enterprises has passed through the privatization process the reform

process will be seen to benefit the population, gather momentum and be difficult to reverse. There is much evidence that this point has already been reached in Ukraine and that there can be no going back.

107. Another important risk is that the SPF and other agencies responsible for implementing the program will not have the capacity to do so. Few countries in history have attempted to implement such an ambitious program and there is little experience anywhere in completing one successfully. This risk has been taken into account in the program design by keeping it simple and maximizing bottom up incentives and initiatives, capitalizing on the dynamics that already exist within the enterprise sector. The experience of the first EDAL confirmed the effectiveness of these principles. The use of external technical assistance has also been planned to help in key implementation areas and relieve bottlenecks such as running the auction centers, drafting of laws and procedures, setting up capital markets institutions and training of accountants and bankruptcy specialists. The experience of the first EDAL showed that limited implementation capacity did not seriously hold up the program. However there will be a need for continued massive technical assistance in the areas of privatization and capital markets reform and also in the new areas of accounting and bankruptcy reform and deregulation.

108. The third risk is that the benefits of the program may not appear immediately, that economic recovery may be delayed and that donor and government commitment may start to wane. Bad publicity received by Ukraine during 1997 from a number of foreign investors and the international media, combined with recent failures in a number of other areas of economic reform, have already produced negative reactions from western governments. Reductions in external support would make the inevitable adjustment process in Ukraine even more painful. This was also an identified risk under the first EDAL but in the event it did not prove to be a problem. The Bank will attempt to reduce this risk through continuing the dialogue with Government on the need to improve the climate for private investment and also through maintaining its donor coordination activities.

109. A fourth risk is that mass privatization, with its built in bias towards insider and fragmented ownership, may not bring about the degree of restructuring of enterprises after privatization, necessary for economic recovery. The evidence so far is limited but it suggests that enterprise restructuring is taking place after and even before privatization. Secondary trading in enterprise shares is increasing rapidly, many individuals have preferred to trade their privatization certificates for shares in investment funds rather than for individual shares, thereby promoting block ownership of shares by these funds; and anecdotal evidence from the enterprise level shows that there is considerable restructuring taking place in terms of employment reduction, seeking and finding new markets and adapting product mixes. However, EDAL II and other planned Bank operations as well as activities of other donors will be increasingly focusing on improving the post-privatized enterprise environment and governance so that enterprise restructuring continues.

## VI. RECOMMENDATION

110. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

by Caio K. Koch-Weser

Washington, D.C.
February 25, 1998

# CABINET OF MINISTERS OF UKRAINE

*M. Hrushevsky St., 12/2, Kyiv-008, Ukraine Tel.: (380 44) 293 5227, Fax: (380 44) 293 2093*

24 February, 1998 No.27-504/9

*Translation from Ukrainian*

Paul Siegelbaum
Country Director for Ukraine and Belarus
The World Bank

Dear Mr. Siegelbaum,

Please find enclosed the Memorandum of the policies for enterprise development and the Memorandum of the financial sector strategy, which highlight our program of privatization, capital markets reform, accounting, bankruptcy, deregulation, banking sector reform.

Provisions of the memoranda confirm the continuation of Ukrainian strategy for the consolidation of a stable macroeconomic environment, as an important prerequisite of the economic reform program implementation.

We ask the World Bank to support our enterprise and financial sector reform programs through the allocation of the Second Enterprise Sector Adjustment Loan, in the amount of US $ 300 million and the Financial Sector Adjustment Loan, in the amount of US $ 300 million.

Sincerely,

Vice Prime Minister of Ukraine
S. Tigipko

**КАБІНЕТ МІНІСТРІВ УКРАЇНИ**

**CABINET OF MINISTERS OF UKRAINE**

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"24" лютого 1998 № 27-504/9

**Директорові Світового банку
по Україні та Білорусі
регіон Європи і Середньої Азії
панові Полу Сігельбауму**

**Шановний пане Пол Сігельбаум!**

До Вашої уваги подаються Меморандум про політику в галузі розвитку підприємств та Меморандум про стратегію розвитку фінансового сектору, які висвітлюють нашу програму приватизації, реформ ринків капіталу, бухгалтерського обліку, банкрутства, дерегуляції, реформування банківського сектору.

Наміри, викладені в Меморандумах, підтверджують продовження курсу України на зміцнення стабільного макроекономічного середовища як важливої передумови успішного втілення програми економічних реформ.

Ми звертаємося до Світового банку з проханням підтримати нашу програму реформ в галузі розвитку підприємств та банківського сектору шляхом надання другої позики на розвиток підприємств у розмірі 300 млн. доларів США та позики на реформування фінансового сектору в розмірі 300 млн. доларів США.

З повагою

**Віце-прем'єр-міністр України С. Тігіпко**

## UKRAINE: SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

### Memorandum on Enterprise Sector Development Policy

In late 1994, Ukraine began a radical and far-reaching economic reform program. A main component of this program was the promotion of the private sector as the main engine of market led economic growth. Important elements of this have included: (i) implementing an ambitious program of privatization of small, medium and large enterprises, (ii) developing the capital markets supervisory structures and infrastructure that have promoted further ownership change and governance improvements in the secondary markets as well as mobilized new equity finance for enterprises, and (iii) maintaining a liberalized trade and pricing environment to ensure that Ukrainian enterprises are subjected to market forces. The first stage of this program has been very successful. The Cabinet of Ministers (hereafter referred to as the Government) intends to continue the momentum of these reforms until the enterprise privatization process is complete and Ukraine has solid, well functioning capital markets. The Government also intends to extend the program to include second generation enterprise reforms in the areas of accounting and bankruptcy reform and to promote the development of the newly privatized and new private enterprises by removing unnecessary restrictions on business activities. These reforms will ensure greater transparency and accountability in enterprise activities, will ensure easier mechanisms for enterprise exit, restructuring and reallocation of resources, and will continue moving Ukraine along the path to becoming a modern market economy. As an essential underpinning to these actions, we intend to maintain a stable macroeconomic environment conducive to economic growth.

**Privatization**

Since Presidential Decree No. 699 of November, 1994 radically streamlined the procedures for mass privatization in Ukraine, the privatization process has gathered speed and public support, and this momentum continues today. The Government remains committed to continuing enterprise privatization until it is complete. Measures implemented during 1995 and 1996 to ensure rapid privatization included granting a full mandate to the SPF to implement the program, reducing the role of branch ministries in the privatization process, providing for simplified standard enterprise preparation packages to be completed by each enterprise according to tight deadlines, mandating that book value and most recent inventory should be taken as the valuation of the enterprise, requiring standard allocation of blocks of shares to the auction process and providing for a simple bidding system.

A widespread public information program was initiated in early 1995 and continues today. An auction center network was created throughout Ukraine. Enterprise auctions started in January, 1995 and the numbers of enterprise shares put up for auction has steadily increased. Fully clearing auctions were introduced in 1996 using the compensation certificates that were made available to the population to compensate them for the loss in value of their savings due to inflation since independence. Procedures for the privatization of agro-industrial enterprises were streamlined in late 1996 to bring them into line with those for other enterprises and privatization of the agro-industrial sector has proceeded rapidly on target. By January 1997, more than 5,000 medium/large enterprises had been transferred at least 70 percent to private hands since the mass privatization program began in early 1995. Of these enterprises, more than one half were from the agro-industrial sector.

During 1997, the Government renewed efforts to speed up mass privatization. We have been giving increased publicity to the use of compensation certificates, as a means of rapidly clearing the auctions, ensuring that all shares offered are sold. We also began increasing the numbers of shares made available at the auctions and began offering shares in very large attractive enterprises. The President of Ukraine signed into Law the 1997 Privatization Program approved by Parliament, which provides for rapid implementation of privatization. We submitted a bill to Parliament to reduce the negative list of enterprises not subject to privatization from 6,000 enterprises to only 2,541 enterprises and the bill was approved in two readings. We have also developed an accelerated implementation plan for the completion of mass privatization during 1998. We have taken steps to improve the structure of the State Property Fund and to improve information availability on the results of privatization.

These efforts have been rewarded by excellent results. As of December, 1997, more than 7,000 medium/large enterprises have been transferred at least 70 percent to private hands since January 1, 1995 and more than 8,200 since privatization began in 1992. About ninety percent of the population has collected their privatization certificates and over 80 percent of those collected have been invested, demonstrating the massive public support for the program. During 1997, we began selling shares in the largest and most attractive enterprises in Ukraine.

The Government accelerated small-scale privatization during 1995 and maintained the pace at around 1,500 enterprises per month throughout 1996 and into early 1997. Small-scale privatization in Ukraine is now virtually complete and will continue until it is completed.

The Government's intention is to complete mass privatization of medium and large enterprises during 1998. By the end of 1998, around 11,000 medium/large enterprises will have been transferred at least 70 per cent and around 44,000 small scale enterprises transferred 100 percent to private hands since privatization began in 1992. We intend to continue divesting residual shareholdings in those enterprises not yet completely privatized. During 1998, we intend to continue increasing the depth of privatization by including large and strategic "Group D" enterprises in the program, to privatize the enterprises involved in grain marketing and distribution and to continue rapid privatization of unfinished construction sites. In addition to mass privatization for certificates, we shall approve new regulations for case by case privatization of large infrastructure and other strategic enterprises and will launch initial public offerings for 10-20 of these enterprises with the intention of attracting core private investors and raising revenues for the budget.

**Capital Markets Reform**

In mid-1995, the capital markets trading infrastructure and regulatory framework in Ukraine was only rudimentary in comparison with the large number of enterprise shares that were already in private hands and available for trading, the growing number of shares being issued every week as a result of the mass privatization program and the growing number of investment companies and other market players who had become active. The Government took action to create efficient, well-regulated capital markets as a means of enabling enterprise ownership changes, promoting restructuring and better governance in the period following mass privatization as well as in mobilizing new equity investments. We also took action to protect Ukrainian and foreign investors in Ukraine from capital markets frauds.

From 1995 to mid-1997, we built a legal and institutional structure for capital markets operation and supervision in Ukraine. This included the creation of the Securities and Stock Market Commission (SSMC) and the transfer to the SSMC for the regulation of activities of all capital markets participants. We also took action to ensure the transfer of joint stock company share registries from the issuers to independent share registrars and to create a depository system for securities. We took steps to promote the development of self-regulatory organizations (SROs) of professional market participants and made membership in these SROs mandatory for all professional market participants. As expected, secondary trading in corporate securities generated by the mass privatization program increased very rapidly during 1997. The Ukrainian capital markets supervisory structures and infrastructure were prepared for this in advance.

During 1998, the Government intends to consolidate and strengthen the supervisory mechanisms and market infrastructure, ensuring that we lay the foundations for capital markets institutions and operations appropriate for a developed market economy. The transfer of share registries for medium and large enterprises to independent share registrars will be completed and shareholder lists will be made available to the public. Reporting will be required of all block transactions involving sales of more than 10 percent of the shares of an enterprise. By mid-1998, at least 90 percent of issuers with more than 500 shareholders will have completed the transfer of registries to independent share registrars. The Securities Commission's mandate will be strengthened to regulate all capital markets activities of banking institutions and no mandate will be given to any other institution to regulate the capital markets. Mandatory membership of market participants in SROs will be fully implemented and the role of SROs further strengthened. Regulations improving disclosure of information on new share issues and secondary share trades will be implemented and EU standards will be applied to all new share issues. Depository and clearance and settlement mechanisms will be further developed and strengthened and rules issued for their operation complying with EU and IOSCO norms. Improvements in securities taxation will be implemented to ensure equal treatment of earnings from the stock exchanges and OTC markets and Government will refrain from creating unequal conditions for different groups of market participants or from owning a controlling or blocking vote in any commercially viable capital markets institution.

**Accounting Reform**

The Government is aware that there is an urgent need for Ukraine to improve the accountability of enterprises which, at present, are operating with very little transparency. Ukraine needs to harmonize the existing accounting system with International Accounting Standards (IAS) to provide an adequate basis for monitoring financial performance and making investment decisions, also promoting foreign investment flows. Since January 1998, the Ukrainian banking system has been using IAS. Work will also begin on implementing IAS throughout the enterprise sector. The first step was the recent establishment of a Methodological Council on Accounting comprised of representatives of all the main agencies involved in accounting reform, including the professional associations of practitioners, to function as a body to facilitate the development and adoption of a national accounting system in compliance with IAS. In coordination with the Methodological Council on Accounting, the Securities Commission will require professional capital markets participants (e.g. brokers and dealers) and joint stock companies, shares of which are traded on regulated markets, to provide financial statements in compliance with IAS. In addition, pilot companies have been selected by the Securities Commission to introduce and implement IAS. Furthermore, steps have been taken, in part with the recently approved Tax Law, to provide a comprehensive basis of tax accounting separate from financial accounting standards (i.e., tax laws will no longer be the only determinant of financial reporting). Audit standards, which are in compliance with International Standards on Auditing (ISA), will be adopted. Full and successful implementation of the above will require several years and the Government, together with professional accounting associations, will begin immediately developing training, testing, certification and licensing programs and educational curricula incorporating IAS and ISA to strengthen the accounting profession.

**Bankruptcy Reform**

The Government is aware that the present bankruptcy process in Ukraine is inadequate. It does not provide an adequate exit mechanism for failed enterprises, nor does it allow for restructuring of enterprises at risk of failure without liquidating them, nor does it serve adequately as a final debt collection mechanism for creditors. The existing law contains internal inconsistencies and also conflicts with other legislation. So far, the Law has been used almost exclusively by the tax authorities to collect overdue tax payments rather than as the start of a collective procedure for all creditors. In addition to shortcomings in the law, there is little implementation capacity in Ukraine for bankruptcy proceedings. Also, there are few incentives to initiate bankruptcy in Ukraine and many reasons not to do so, including the complexity and cost of the process, the soft capital adequacy requirements on the banking sector which provide an alternative to debt recovery, and the very uncertain prospects of success after initiating the bankruptcy process.

The Government will attempt to obtain improvements in the bankruptcy legislation during 1998. But the process of changing the law is likely to be lengthy and its outcome in the short term uncertain. We shall proceed in the interim with the effective solution of working with the Highest Arbitration Court of Ukraine to implement the recently issued Presidium explanations to the existing law. These explanations were prepared with help from international donors and will be put into effect throughout the period of the EDAL II program. They provide for adequate court procedures for restructuring enterprises, adequate procedures for initiating bankruptcy proceedings, clarification of mechanisms for writing off and writing down debt, a stay on payments as soon as documents to initiate bankruptcy proceedings are filed, and resolution of problems concerning excessive powers of state creditors. During 1998, the government will take necessary action to revise enforcement procedures for state budget creditors. Also, during 1998, the government will take necessary action to adopt professional criteria and requirements for licensing bankruptcy trustees and liquidators. The Government will also promote the development of training programs, professional standards, payment mechanisms and the creation of a SRO for trustees in bankruptcy, and will initiate several pilot bankruptcy processes to identify any remaining problems and their solutions. Before the end of the EDAL II period, the Government will prepare a report based on the experience of the pilot bankruptcy proceedings with suggestions of possible solutions to the problems identified.

**Deregulation**

We are aware of the high economic costs of the unfriendly investment climate in Ukraine, caused by the many constraints imposed on the private sector by excessive regulation. The Government intends to implement a comprehensive program of deregulation that will address problems such as excessive taxation, difficulties in starting up new businesses, excessive customs and trade restrictions, burdensome regulations on financial transactions and on property, and the excessive number of inspections imposed on businesses by a myriad of government agencies. This comprehensive deregulation program will be implemented with the support of the donors and from several proposed World Bank loans.

In the context of the EDAL II program, the Government will take specific measures aimed at simplifying business licensing, registration and inspections and will institutionalize the deregulation process. We have already taken the first steps. These have included the creation of an Expert Council on Deregulation under the Vice-Prime Minister for Economic Reform, and the creation of a State Committee for Entrepreneurship Development intended to promote deregulation and a more hospitable business environment. The Supreme Rada has approved and the President of Ukraine signed changes to the Law on Entrepreneurship, which lowers to 41 the number of licenses required for different activities and simplifies the registration of enterprises. We have begun analyzing the complex web of permits required from central and local level government agencies in order to operate a business. An ombudsman for international investors has been appointed, a Foreign Investment Advisory Council has been created and the State Committee for Entrepreneurship Development has already begun consulting with the private sector to identify constraints to private business activities in Ukraine.

The President of Ukraine has signed a decree removing constraints to the development of entrepreneurship, which provides a framework for the implementation of the deregulation process in Ukraine. We have analyzed which business licensing problems are within the Government's authority to solve and shall solve them quickly. We shall extend our analysis to cover problems relating to permits other than licenses. We shall simplify and accelerate those licensing procedures that will remain in place and, in mid-1998, we shall propose measures to limit the extension of licensing to new activities. We shall prepare a plan for a comprehensive rationalization of inspection procedures at the central and local levels. Finally, we shall ensure that the deregulation process is perpetuated by creating permanent mechanisms for deregulation and for consultation between the public and private sectors on deregulation issues.

## UKRAINE: PROPOSED SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN ACTION PROGRAM

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| **Macroeconomic Stabilization** | | | |
| Maintain a stable macroeconomic environment conducive to economic growth. | Satisfactory progress in implementing the Standby Arrangement with the IMF and in preparing an EFF. | Satisfactory implementation of the Stabilization Program. | Satisfactory implementation of the Stabilization Program. |
| **Privatization of Small, Medium and Large Enterprises and Unfinished Construction sites** | | | |
| Increase the pipeline and maintain the momentum of mass privatization of medium and large enterprises (Groups B, C and D). | Since 1992 9,650 medium/large enterprises have entered the corporatization/privatization process.<br><br>Parliament has approved in third reading a bill to reduce the negative list to 2,541 enterprises.<br><br>Over 7,500 medium/large enterprises have been at least 70 percent privatized since January 1, 1995.<br><br>The deadline for the use of privatization and compensation certificates has been extended to the end of 1998. | Privatize at least 70 percent of the shares of at least 8,500 medium/large enterprises since January 1, 1995. | Privatize at least 70 percent of the shares of at least 9,500 medium/large enterprises since January 1, 1995. |
| Privatize the enterprises involved in grain marketing and distribution including processing plants, mixed | An order has been issued to reduce the number of enterprises within the grain marketing monopoly | | |

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| fodder plants, grain storage and grain procurement sites and grain elevators. | "Khlib Ukrainiy" to only 100 by the end of 1998 and to privatize all the rest.<br><br>Share sales of 150 grain marketing and distribution enterprises have begun.<br><br>At least 70 percent of the shares of 40 grain marketing and distribution enterprises have been privatized. | Begin the share sales of at least 300 grain marketing and distribution enterprises.<br><br>Privatize at least 70 percent of the shares of at least 60 grain marketing and distribution enterprises. | Begin the share sales of at least 450 grain marketing and distribution enterprises.<br><br>Privatize at least 70 percent of the shares of at least 100 grain marketing and distribution enterprises. |
| Increase the depth of privatization by selling the shares of large enterprises (enterprises with an indexed fixed asset value of at least UAH 170 million as of January 1, 1997). | Sales of shares in large enterprises began to accelerate in mid-1997.<br><br>A list of all large enterprises to be included in the privatization program and a schedule for their privatization have been prepared.<br><br>At least 40 percent of the shares of at least 50 large enterprises have been privatized. | Privatize at least 40 percent of the shares of at least 60 large enterprises. | Privatize at least 40 percent of the shares of at least 100 large enterprises. |
| Divest residual share holdings in medium/large enterprises. | More than 3,750 medium/large enterprises have been 100 percent privatized since January 1, 1995. | At least 4,250 medium/large enterprises to be 100 percent privatized since January 1, 1995. | At least 4,750 medium/large enterprises to be 100 percent privatized since January 1, 1995. |
| Complete major privatization transactions. | Draft regulations have been prepared for transparent procedures for (i) tenders and (ii) selection of advisors, for case-by-case tender transactions including an IPO component for cash for a significant percentage of shares. | Issue all necessary remaining regulations to ensure that case by case privatization procedures are in line with international best practice. | |

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| | 10 major case-by-case privatization transactions have been initiated with share allocation plans that provide for at least 51 percent of shares to be purchased by strategic investors. | Finalize documents for at least 3 cases and prepare prospectuses, and organize distribution channels for the IPO component. | Bring the three cases to the stage of negotiations with strategic investors.<br><br>Register 3 prospectuses with the Securities Commission.<br><br>Select and initiate 10 additional case-by-case privatization transactions. |
| Complete small scale enterprise privatization (Group A objects). | Small scale enterprise privatization is 90 percent complete throughout Ukraine.<br><br>The rapid rate of small scale enterprise privatization will continue and an environment will be maintained favorable for the completion of the process throughout Ukraine during 1998. | | |
| Accelerate the privatization of unfinished construction sites. | The proposed 1997 Privatization Program includes the objective of accelerating privatization of unfinished construction sites.<br><br>The procedures and environment for privatization of unfinished construction sites will remain favorable for rapid implementation throughout the EDAL II period.<br><br>1,500 unfinished construction sites have been privatized. | Privatize 2,500 unfinished construction sites. | Privatize 3,600 unfinished construction sites. |

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| Improve the availability of information on privatization. | Regular reports are available from the SPF on privatization results and the SPF has begun including information on numbers of employees, size of fixed assets and a complete breakdown of sales by various methods in statistics on privatized enterprises.<br><br>Lists of all privatized medium and large enterprises are now being made publicly available. | | |
| **Capital Markets Reform** | | | |
| Improve the registration of stock ownership of privatized companies. | Instructions were issued in late 1996 that all issuers with more than 500 shareholders should transfer their share registries to independent registrars and the transfer is continuing. | Consolidate and make available to the public on request shareholder lists for all privatized enterprises.<br><br>At least 90 percent of issuers with more than 500 shareholders will have completed the transfer of registries to independent registrars. | The Commission will have started to impose sanctions for non-compliance. |
| Consolidate the mandate of the Securities Commission. | The Securities Commission has been established, staffed, and given a legal mandate to regulate and supervise all aspects of capital markets operations.<br><br>The SSMC has reached an agreement with the NBU confirming the SSMC as the primary regulator and supervisor of banks' operations with securities. | The Commission and the NBU will have adopted rules of organization of capital market activities within commercial banks. | Banks will have organized their capital market activities in organizationally and financially separate internal departments. or subsidiaries. |

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| | Through the period of the loan the Government will refrain from empowering other institutions to regulate securities markets, including derivatives in securities, commodities and currencies. | | |
| Strengthen the role of self-regulatory organizations (SROs). | An Association of Investment Businesses, an Association of Registrars and Depositories, and an OTC trading system, PFTS, have been granted temporary (six months) SRO licenses.<br><br>Membership in SROs is required for all professional participants of regulated markets.<br><br>The requirement that at least 25 percent of all licensed market participants should belong to an association before it can qualify as an SRO was replaced with the requirement that the association will have sufficient resources to carry out the statutory obligations of an SRO. | All trading systems will have been either licensed by the Commission or closed. | All broker/dealer firms and registrars will have become members of SROs of their choice or their license will have been revoked.<br><br>The responsibility for issuing rules of conduct and their implementation, and arbitrating out of court between investors and members will have been fully delegated to SROs. |
| Improve disclosure of information on publicly traded companies and on secondary trade of shares. | The SSMC has issued regulations to improve disclosure and market transparency.<br><br>A draft Securities Law includes a clause to require reporting by beneficiaries of block transactions. | All trading systems will have securities listing procedures approved by the Commission. | Apply EU standards to disclosure of information for all new public share issues. |

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| | A regulation requiring (i) reporting to the Commission of all transactions for blocks of shares greater than 10% of the total share capital of an enterprise and (ii) public announcement by the Commission of the details of the transaction has been approved by the Commission. | | |
| Develop the depository and clearance and settlement systems for corporate securities. | A dematerialized depository for government securities is in operation; a depository and settlement system for corporate securities is being set up.<br><br>One depository for corporate securities, MFS, has already been licensed and is operating.<br><br>The Law on the National Depository System and Electronic Circulation of Securities was approved by Parliament. | Issue regulations which meet IOSCO and EU standards for depositories, custodians and clearance and settlement.<br><br>All privatization IPOs will use dematerialized shares which will have been placed in a depository, and will be sold through regulated trading systems. | A depository system for corporate securities traded through regulated trading systems will be operational.<br><br>A clearance and settlement system for corporate securities traded through regulated trading systems will be fully operational.<br><br>A settlement payment system for regulated trading systems, with the participation of the NBU, will be operational. |
| Reform the taxation system to support the development of securities markets. | The Commission has completed an analysis of taxation of securities market services and revenues, and drafted a law on taxation of securities, to encourage the development of regulated markets for corporate securities.<br><br>The Commission has issued an interpretation to the tax authorities | The proposed changes in taxation will be submitted to Parliament.<br><br>Stock exchanges and regulated OTC markets will be treated | |

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| | for equal treatment of the stock exchanges and the regulated OTC markets. | equally for tax purposes. | |
| Clarify Government's role in the securities markets. | Government has already established its regulatory role for the securities markets and this is implemented through the independent SSMC.<br><br>Throughout the period of the loan the Government will refrain from creating unequal conditions for market participants and will not own controlling or blocking ownership vote in commercially viable capital market institutions. | | |
| **Enterprise Accounting Reform** | | | |
| Adopt and disseminate a National Accounting System (NAS) in compliance with International Accounting Standards (IAS). | MOF has created a Board (ASB) to adopt a NAS in compliance with IAS. The composition of the Board includes, among others, members nominated by the following entities: all significant professional accounting associations, educational associations, STA, SSMC, NBU, MOS, MOE, MINED and MOF.<br><br>The ASB has met and decided on its operational procedures and agenda. | MOF will, in coordination with the Board, develop a timetable for the development and adoption of a NAS which will be in compliance with IAS. | Satisfactory progress in implementation of NAS. |
| Adopt financial disclosure requirements, in compliance with IAS, for capital market participants | The Securities Commission has amended annual reporting formats for CMPs to follow IAS. | Instructions for annual report preparation by CMPs will be prepared by the Securities | |

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| (CMPs). | Pilot CMPs have been selected to adopt financial disclosure requirements in compliance with IAS. | Commission and disseminated to issuers. | |
| Adopt and disseminate a National System on Auditing (NSA) which is in compliance with International Standards on Auditing (ISA). | Most of the ISA standards from the 1994 International Federation of Accountants publication have been translated into Russian.<br><br>Seven audit standards, which are in compliance with ISA, have been developed and adopted in Ukraine.<br><br>The Chamber of Auditors, in coordination with the Securities Commission, and all significant accounting associations, has provided a timetable for the adoption of: a) a NSA which is in compliance with ISA; and b) the requirement of the use of a NSA by CMPs. | | Satisfactory progress in implementation of a NSA. |
| Reform educational curricula for accountants and auditors to incorporate IAS and ISA. | A Ukrainian/ British association of accounting and auditing teachers has been working on accounting curricula development and training of specialists in higher education institutions.<br><br>The Ministry of Education and a leading Ukrainian university has, in coordination with all significant | | An accounting curricula program will be prepared based on the pilot, incorporating IAS and ISA, to begin in at least one graduate level institution in Fall 1998. |

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| | accounting associations, jointly developed a pilot accounting curricula program incorporating IAS and ISA to be conducted at both the undergraduate and graduate levels. | | |
| Enhance the professional capacity of the accounting profession. | The Ukrainian Federation of Professional Accountants and Auditors (UFPAA) has conducted training and examinations for the first of a three level certification program (preliminary, intermediate and fully certified) which incorporates IAS concepts; training is currently being conducted for the second level certification. | The Chamber of Auditors, in conjunction with all significant accounting associations, will develop a program and timetable to provide training, testing, certification and other criteria to increase professional capacity on NAS and NSA which are in compliance with IAS and ISA. | Satisfactory implementation of training, testing, certification and other criteria for professional development; adoption of this criteria in the requirements to obtain and maintain an audit license. |
| **Bankruptcy Reform** | | | |
| Improve existing court procedures to facilitate restructuring of financially viable enterprises, or parts thereof, and the liquidation of non-viable enterprises; clarify mechanisms that would be available to permit post-petition financing and thereby preserve the underlying value of the business during the restructuring process. | A final version of Presidium Explanations was issued which includes, to the extent permitted under existing law, all relevant bankruptcy reform elements described in the proposed action plan and recommended by the donors, their consultants and other interested parties.<br><br>An inter-Agency Working Group on Bankruptcy Reform has been established by the Cabinet of Ministers. | Satisfactory progress in implementation. | Satisfactory progress in implementation. |

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| Clarify mechanisms in existing law for requirements for filing a bankruptcy petition, providing notice to all parties before the initial hearing, and commencing either a restructuring or liquidation case. | Consultants' and the Ukrainian Bankers' Association have prepared written comments on Draft Explanations re improving these mechanisms. | Satisfactory progress in implementation. | Satisfactory progress in implementation. |
| Clarify mechanisms in existing law for writing off and writing down debts (i.e., permitting creditors to accept less than 100% of their debt if they wish). | A law "On Write-Offs and Restructuring of Taxpayers' Liabilities as of March 31, 1997" was enacted on June 5,1997. | Satisfactory progress in implementation. | Satisfactory progress in implementation. |
| Clarify mechanisms under existing law to provide for a court-enforced moratorium on payments to creditors for pre-petition debts and a stay or cessation of all creditor proceedings against the debtor and its assets as soon as a petition is filed. | The high court explanations have clarified the necessary mechanisms. | Satisfactory progress in implementation. | Satisfactory progress in implementation. |
| Clarify and resolve the conflicting rules relating to the excessive special powers of collection provided to state budget creditors and the proper functioning of the bankruptcy laws. | Conflicting special powers of collection provided to state budget creditors, in particular those which may be in conflict with existing court procedures and/or those which may impede the smooth functioning of the bankruptcy laws were identified and action plan to remedy problems identified was prepared. | Prepare draft of revised enforcement procedures for state budget creditors. | Cabinet of Ministers (or President) will issue a decree adopting revised enforcement procedures for state budget creditors.<br><br>Satisfactory progress in implementation. |

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| Develop training programs, professional standards, payment mechanisms and a self-regulatory organization for bankruptcy trustees and liquidators | A "Professional Working Group" has been established comprised of representatives from the Highest Arbitration Court, Ministry of Justice, Ministry of Education, Kiev Economic University, Ukrainian Federation of Professional Accountants and Auditors, Ukrainian Bankers Association, Ministry of Economy, Agency for Prevention of Bankruptcy and Ukrainian Lawyers Association.<br><br>The Highest Arbitration Court, Ukrainian Bankers Association and State Property Fund have identified experienced Ukrainian liquidators and trustees, of the highest qualifications and integrity, to be included in pilot trustee training program and to establish an initial organizing group for the Trustee/Liquidator self-regulatory organization.<br><br>Draft professional criteria and requirements for licensing of bankruptcy trustees and liquidators were prepared, with input from SRO initial organizing group<br><br>Draft procedures clarifying | Cabinet of Ministers (or President) will issue a decree adopting professional criteria and requirements for licensing of bankruptcy trustees and liquidators.<br><br>Trustee/liquidator remuneration measures will be adopted, publicized and implemented.<br><br>A Trustees and Liquidators self regulatory organization will be established.<br><br>Inaugurate an education program for trustees/liquidators. | Satisfactory progress in implementation |

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| | compensation issues for trustees and liquidators under existing law were prepared, which, to the extent possible, establish remuneration measures based on a percentage of returns to creditors, rewarding success and penalizing long, drawn out proceedings. | | |
| Following the reform of the bankruptcy procedures described above, initiate proceedings, under the court-led bankruptcy law, to liquidate 2 post-privatized former state-owned debtor enterprises and to restructure 2 post-privatized former state-owned debtor enterprises (these proceedings may be initiated by either private or public sector creditors). | | Identify post-privatized enterprises to be liquidated or restructured and begin court-led proceedings. | Satisfactory progress in implementation.<br><br>Prepare a report detailing problems encountered within the bankruptcy system during the course of these proceedings, with suggestions for possible solutions to these problems. |
| **Deregulation** | | | |
| Develop a policy framework and strategy for deregulation of the Ukrainian economy. | An Expert Council on Deregulation was created under the Economic Reform Group headed by the Vice-Prime Minister.<br><br>The Expert Council has formally adopted a government strategy for deregulation.<br><br>Government has created a State Committee on Entrepreneurship, charged with deregulation and other measures to create a friendly | | |

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| | business environment. A draft strategy for deregulation has been prepared by the Expert Council on Deregulation and the Committee for Entrepreneurship. | | |
| Simplify business licensing processes and reduce the time for their completion. | Legislation has been approved by the Parliament and signed into Law to reduce the number of activities subject to licensing from 101 to 41, based on consistent criteria of protecting public health and safety, the environment and national security.<br><br>Analysis has been completed of business licensing problems and any necessary actions that are within Government's power to implement. | Prepare draft regulations necessary to resolve business licensing problems that are within Government's power to implement.<br><br>Complete the analysis of problems relating to obtaining permits other than licenses and prepare proposals to resolve them.<br><br>Propose institutional mechanisms to screen and limit any proposals that would extend licensing to new activities. | Implement regulations to resolve business licensing problems that are within Government's power to implement. |
| Simplify permissions and formal documentation for business registration with the aim of making it a quick, one stop process. | Government has completed an analysis of business registration problems and has prepared proposals to simplify registration and to make it more uniform. Under draft enabling legislation and a draft Presidential decree, registration would be handled by a single office under a simplified, accelerated procedure that should take no more than ten working days for processing. | | |

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| | Detailed implementation proposals to make registration a ten working day, one stop process have been prepared. | | |
| Eliminate unnecessary inspection procedures and standardize remaining ones under the principles of: one per year (except where there is an overriding technical need for higher frequency); adequate advance notice for routine inspections; no inspections without the approval of the management of the inspection agency; clear rules for due process in inspections including the rights of the inspected, clear rules for seizures and appeals. | Work has begun on the identification and analysis of existing inspection procedures, problems and abuses, and constraints imposed on businesses. | Complete analytical work on inspection procedures. | Specify principles and standard procedures to reduce problems and abuses and outline a plan for reforms at the central and local levels. |
| Institutionalize deregulation, making it the continuing work of government by launching a systematic review of new and existing regulation by a specialized unit with real power.<br><br>Increase transparency and accountability of government by creating a private business/government consultative mechanism. | An ombudsman for international investors has been appointed.<br><br>A Foreign Investment Advisory Council has been created<br><br>The newly created State Committee on Entrepreneurship has been consulting with the private sector to identify constraints with the intention of taking the role of reviewing all proposed regulations and other legislation for their impact on private business. A | Make the institutional arrangements fully functional.<br><br>Make the consultative process with the private sector fully functional with regular meetings and recommendations submitted to the Cabinet. | |

| | ACTIONS TAKEN PRIOR TO BOARD PRESENTATION | ACTIONS TO BE TAKEN BY SECOND TRANCHE | ACTIONS TO BE TAKEN BY THIRD TRANCHE |
|---|---|---|---|
| | consultative process involving the private sector has already been approved.<br><br>An inter-agency Expert Council on Deregulation has been created to promote a stable, continuing process of deregulation. In support of the work of the Expert Council criteria have been developed to review continuously and consistently all new and existing legislation and rules, with the aim of assessing their impact on private business development and the economy. | | |

## Post-Privatization Equity Markets in Ukraine

### Market Potential

Rapid and massive privatization has created a large potential for secondary trading in stock of mass-privatized companies and further flotation of new stock and corporate debt. The primary privatization offers have been mostly bought by managers, employees and financial intermediaries (investment funds and companies, and commercial banks). According to the privatization legislation, employees can sell their shares after the national currency was introduced on September 1, 1996. With the growing interest from foreign and domestic investors and increasing supply of shares of privatized companies from employees and domestic financial intermediaries, the development of the secondary equity market is likely to accelerate dramatically.

Around 7,000 privatized companies are formally available for public trading but it is not easy to find good investments among them. The Ukrainian economy is going through a dramatic adjustment, both at sectoral and enterprise levels. Collapse of the Soviet Union and price liberalization combined with the austerity program have resulted in severe internal and external disequilibria which, in turn, have changed the structure of industry. The share in the economy of the metal processing and electricity production industries has increased at the expense of engineering, light industry and food processing. This increase has been relative, as the metal and electricity production sectors shrank more slowly that the average 50 percent for the economy as a whole. At the industry/enterprise level, the most fundamental reasons for the low attractiveness of Ukrainian firms to investors are:

- overcapacity of many companies, such as steel and fertilizers producers, which were built to supply the whole Soviet Union. The only possible outlet for their products and source of financing for restructuring would be export. However, even in the FSU, Ukrainian companies have to compete with world-wide producers who have gained access to FSU markets and can also provide higher quality and lower priced products.

- obsolete technologies and outdated equipment are the legacies of the Soviet Union. Most of Ukrainian industry was built during the 1930s and rebuilt during the 1940s and early 1950s. The limitations of outdated equipment in light industry have been magnified by generally poor quality and product design during the Soviet central planning period.

- the obscure financial position of companies as a result of inter-enterprise arrears, heavy use of barter transactions, and inadequate accounting standards. Poor information about companies is also the result of the vested interest of managers who want to maintain the control of ownership and, therefore, suppress secondary trade in shares of "their" companies, by keeping information for themselves.

### Portfolio Investors

Under these circumstances, investors look for bargain basement equity prices. For investors, the expected dividends are not a main consideration as the main components of the calculation--risk assessment and cash flow projections--are not reliable. Investment decisions are based on the broad fundamental analysis of the growth potential of particular firms and/or branches of the economy.

One group of important investors are Privatization Investment Funds (PIF's). PIFs have used discounted privatization certificates during the primary privatization auctions to buy shares of companies which are believed to have good long-term prospects. Funds buy shares on their own account (to build portfolios for their own shareholders), or act as the agents for other investors, mostly foreign. Acquisitions, in this case, are pre-arranged deals between PIFs and foreign investors. A PIF acts as a *de facto* broker buying shares from individuals, mostly employees, packaging them and offering them to foreign investors. It is a niche created by regulatory and institutional imperfections of Ukrainian markets. Foreign investors, or western brokers acting on their behalf, have less information about current shareholders and they do not want to bother about retail re-registration of shares and payment settlement.

The second important group of investors are insiders--managers and employees. Protection of jobs and retaining control are essential factors for insiders. Usually, they use leveraged buy-out financing to take-over their own companies.

Foreign portfolio investors are a growing part of the equity market. Their first, and still prevailing, interest have been in government debt instruments. It is estimated that some $2 billion worth of foreign capital was invested in high-yielding T-bills in 1997. There is also, however, growing investment in equity by specialized funds or western institutional investors (pension funds, etc.). For example, in mid-July 1997, the Societe Generale raised $80 million for a Ukraine country fund which will focus on private equity and is hoped to be fully invested within 12 months.

Investors are taking a long-term view -- believing in a once-in-a-lifetime opportunity to acquire Ukrainian companies at low prices. The distinction between strategic and portfolio investment is not always clear. Low liquidity of secondary markets often forces investors to follow a "buy-and-keep" investment strategy. Trading of large blocks of shares takes place when an investor emerges. Public secondary trade in shares, in the traditional Western sense, is very limited.

**Market Regulation and Supervision.**

The Ukrainian capital market is relatively well-regulated, compared with other FSU republics. Unlike in Russia, where securities regulation and supervision are struggling to catch up with rapidly growing trade, Ukrainian market infrastructure is being established ahead of secondary stock trading. In July, 1996, the Parliament adopted a Law on the State Regulation of Securities Markets. The Law strengthened the position of the State Securities and Stock Exchange Commission (SSMC)--previously established by a Presidential Decree--as an independent regulatory body. It also transferred to the Commission all regulatory authority in the area of licensing, issuing, and trading in securities, previously scattered among various governmental bodies. The Chairman of the Commission and the Commissioners were appointed according to the new Law and started their statutory activities. The Commission issued a number of its own regulations which, together with the new Law on Regulation and an old Law on Securities and Stock Exchanges, created a comprehensive although temporary base for regulation of capital markets activities.

The Commission started to build its professional capacity in the areas of reviewing and approving prospectuses, licensing and inspecting market participants, imposing sanctions for violation of securities legislation and regulations. In particular, the Commission entered into a "twinning arrangement" with the Polish Securities Commission which has resulted in the transfer of know-how and hands-on experience in regulation of an emerging capital market. Staff of the Commission have also participated in training activities offered by the US SEC. In March 1997 the SSMC practically launched its enforcement program by investigating an investment company, as a result of an investor's complaint, and subsequently suspending their operating license.

Regulation and supervision of commercial banks in their capacity of securities dealers is an area of potential regulatory conflict between the SSMC and the NBU. The model of universal banking adopted in Ukraine comprises, in addition to basic banking services, brokerage services and insurance activities. Progressive interconnection between banking, insurance and securities activities requires close coordination of work of regulatory agencies. Integration of supervisory activities based on a long-term coordination plan is needed. It should lead to joint on-site examination of universal banks by the NBU and SSMC.

**Stock Ownership Registration**

There has been good progress, compared with other FSU republics, in registration of share ownership of mass-privatized companies. About 65 percent of privatized companies consolidated the lists of their original shareholders and transferred them to registrars. Some 330 registrars are operational, of which about 130 are operated by banks or financial groups and can be considered as truly independent and having a stable financial and organizational base. The rest, some 200 registrars, have been organized and financed by issuers; these are "pocket registrars" with managers of companies at least trying to influence their statutory functions. Problems which will have to be addressed soon are consolidation of registration functions and costs of services. The number of registrars is apparently to large and financially not sustainable. Operating registrars try to survive by charging very high fees; reportedly, re-registration fees can be as high as 8 percent of the transaction volume.

There has been visible progress in building depository capacity. In particular, a depository called MFS, established by the major banks and traders has a real chance of becoming an all-Ukrainian depository for shares. The MFS has been supported by TA from USAID. A SRO of registrars, custodians and depositories (PARD) was organized and presently has 102 members and is becoming a partner to the SSMC in regulating its members.

**Market Intermediation**

In theory, the market is intermediated by more than 600 licensed broker/dealer firms but in practice no more than 10 percent of them are active. Commercial banks are active and important market participants, most notably Bank Ukraina, the Savings Bank (both state-owned) and the privately owned Privatbank and Gradobank. They offer brokerage services, custodian services and also buy shares on their own account. The weak financial position of the banks limits their opportunities for further expansion into the securities market.

**Secondary Trading**

Secondary trade is fragmented. Three market places operate in Kiev and at least one regional universal exchange trades in shares (Donetsk). The OTC trading system (PFTS) is the most promising one. It was established by the Ukrainian Securities Traders Association in June 1996. The system is similar to Russia's PORTAL and is broadly modeled on the US NASDAQ. The PFTS connects 65 broker/dealers in major Ukrainian cities who post on an electronic board their bids and offers. Transactions are fixed over the phone and settled individually between the parties. Over 70 stocks are listed, of which some 10 are actively traded on a regular basis. PFTS also trades in compensation (privatization) certificates and T-Bills.

Regulated markets, however, still handle a minority of overall trade taking place in Ukraine. Reportedly, about 80 percent of transactions are concluded off the market. Information about prices and volumes traded is scarce and unreliable. A business journal, IntelNews, publishes its own stock index which, however, has a limited and vague stock base. Presently, there is no tax incentive for concentration of trade on regulated markets. Public disclosure of trade in large blocks of shares is not required. The SSMC plans to build a sufficient monitoring system to effectively enforce larger transparency of the market.

**Clearance and Settlement**

There is still much work to be done to create well functioning, transparent and robust secondary securities markets. One area of need is to establish necessary clearing and settlement infrastructure. Presently, transactions are settled individually on cash-versus-delivery basis. Re-registration (transfer) of shares and payment arrangements are left to contracting parties. This apparently has hampered the trade of small blocks of shares between small investors and between regions, and added to market fragmentation and lack of transparency. Establishment of a consolidated depository system will hopefully solve the problems on the side of settlement of securities (transfer of ownership). The payment side of settlement will require involvement of the NBU. The plans in this area will be coordinated by the end of 1997. Building the necessary market infrastructure requires financing, not always available from private sources. Clearing and settlement is one area where public money is often used in emerging markets to build necessary infrastructure. The National Depository System may be another area where Government financing is necessary. The SSMC is preparing a study regarding necessary investments in this area to be financed from the budget and foreign aid.

**Corporate Securities versus Public Debt: Crowding-out**

A large budget deficit and its financing through the public debt led to the fast growth of the T-bills primary market. Growing popularity of government securities has helped curb the inflation rate but has been crowding-out investment in stock by local and foreign investors. In 1996 and in early 1997, the yield offered on three-month T-bills was 40 percent. The need for deficit financing will not go away soon. The government is also raising capital in the international markets. In December 1997, it issued US$400 million in bonds with a minimum guaranteed yield of 22% in dollars; and, in February 1998, the government sold a 750 million DM placement with a 16% yield. Apparently, corporate stock cannot offer anything close to it, particularly after risk adjustment.

The Government also has a unique international exposure related to its overdue U$1.4 billion debt to the (formally) private Russian company Gazprom. The debt was replaced with the equivalent dollar-denominated state bonds, with 12 years maturity, two years grace period and 8.5 percent interest (in dollar terms). It is possible that part of the debt may be swapped for equity of privatized companies. If handled properly, this could stimulate trade in corporate equity.

# UKRAINE: SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

**Timetable of Key Processing Events**

| | |
|---|---|
| Time taken to prepare | 12 months |
| Prepared by | Government with IBRD assistance |
| Project Identification | February 1997 |
| Appraisal | November 1997 |
| Negotiations | February 1998 |
| Planned Date of Effectiveness | March 1998 |
| Expected Program Completion | December 1998 |

# Status of Bank Group Operations in Ukraine
## IBRD Loans and IDA Credits in the Operations Portfolio

| Project ID | Loan or Credit No. | Fiscal Year | Borrower | Purpose | Original Amount in US$ Millions | | | | Difference Between expected and actual disbursements a/ | | Last ARPP Supervision Rating b/ | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | IBRD | IDA | Cancellations | Undisbursed | Orig | Frm Rev'd | Dev Obj | Imp Prog |
| Number of Closed Loans/credits: 2 | | | | | | | | | | | | |
| Active Loans | | | | | | | | | | | | |
| UA-PE-9106 | IBRD 36140 | 1993 | MINISTRY OF FINANCE, UKRA | INSTITUTION BUILDING | 27.00 | 0.00 | 0.00 | 11.48 | 11.48 | 11.48 | S | S |
| UA-PE-9117 | IBRD 38910 | 1995 | GOVT. OF UKRAINE | AGRIC. SEED DEVELOPM | 32.00 | 0.00 | 0.00 | 31.04 | 28.63 | 1.05 | S | S |
| UA-PE-38820 | IBRD 38650 | 1995 | GOVT. OF UKRAINE | HYDROPOWER REHAB. | 114.00 | 0.00 | 0.00 | 99.90 | 38.67 | 0.00 | S | S |
| UA-PE-35814 | IBRD 40570 | 1996 | UKRAINE | ENTER. DEV. ADJUST. | 310.00 | 0.00 | 0.00 | 9.40 | 4.65 | 0.00 | S | S |
| UA-PE-44110 | IBRD 40160 | 1996 | GOVERNMENT OF UKRAINE | COAL PILOT | 15.81 | 0.00 | 0.00 | 10.01 | 5.37 | 0.00 | S | S |
| UA-PE-40564 | IBRD 41180 | 1997 | GOVERNMENT OF UKRAINE | COAL SECAL | 300.00 | 0.00 | 0.00 | 150.00 | 150.00 | 0.00 | HU | HU |
| UA-PE-44851 | IBRD 41070 | 1997 | STATE EXPORT/IMPORT BANK | EXPORT DEVELOPMENT | 70.00 | 0.00 | 0.00 | 65.71 | -5.50 | -5.50 | S | S |
| UA-PE-9113 | IBRD 41030 | 1997 | UKRAINE | AGRICULTURE SECAL | 300.00 | 0.00 | 0.00 | 150.00 | 150.00 | 0.00 | S | U |
| UA-PE-44444 | IBRD 40980 | 1997 | UKRAINE | ELECTRICITY MARKET | 317.40 | 0.00 | 0.00 | 240.88 | 247.78 | 0.00 | HU | U |
| UA-PE-45940 | IBRD 40970 | 1997 | UKRAINE | SOCIAL PROTECT. SUPP | 2.60 | 0.00 | 0.00 | 2.60 | 2.27 | 0.00 | S | S |
| Total | | | | | 1,488.41 | 0.00 | 0.00 | 770.89 | 653.03 | 7.03 | | |

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| | Active Loans | Closed Loans | Total |
|---|---|---|---|
| Total Disbursed (IBRD and IDA): | 715.84 | 500.00 | 1,215.84 |
| of which has been repaid: | 0.00 | 0.00 | 0.00 |
| Total now held by IBRD and IDA: | 1,488.41 | 500.00 | 1,988.41 |
| Amount sold : | 0.00 | 0.00 | 0.00 |
| Of which repaid : | 0.00 | 0.00 | 0.00 |
| Total Undisbursed : | 770.89 | 0.00 | 770.89 |

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Note:
Disbursement data is updated at the end of the first week of the month.

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ANNEX 5

**Ukraine**
**STATEMENT OF IFC's**
**Committed and Disbursed Portfolio**
As of 31-Dec-97
(In US Dollar Millions)

| | | Committed | | | | Disbursed | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | IFC | | | | IFC | | | |
| **FY Approval** | **Company** | **Loan** | **Equity** | **Quasi** | **Partic** | **Loan** | **Equity** | **Quasi** | **Partic** |
| 1994/96 | Ukraine VC Fund | 0.00 | 3.50 | 0.00 | 0.00 | 0.00 | 2.10 | 0.00 | 0.00 |
| | Total Portfolio: | 0.00 | 3.50 | 0.00 | 0.00 | 0.00 | 2.10 | 0.00 | 0.00 |

Approvals Pending Commitment

| | | Loan | Equity | Quasi | Partic |
|---|---|---|---|---|---|
| 1998 | CREDITANSTALT-UK | 5.00 | 2.36 | 0.00 | 0.00 |
| 1996 | FUIB | 10.00 | 6.50 | 0.00 | 0.00 |
| | Total Pending Commitment: | 15.00 | 8.86 | 0.00 | 0.00 |

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## Ukraine - Selected Indicators of Bank Portfolio Performance and Management

| Indicator | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|
| *Portfolio Assessment* | | | | |
| Number of Projects under implementation[a] | 4 | 7 | 11 | 10 |
| Average implementation period (years)[b] | .72 | 1.04 | 1.38 | 1.97 |
| Percent of problem projects[a, c] | | | | |
| by number | 25.00 | 42.86 | 54.55 | 30.00 |
| by amount | 4.01 | 17.03 | 50.91 | 61.61 |
| Percent of projects at risk[a, d] | | | | |
| by number | 25.00 | 50.00 | 72.73 | 60.00 |
| by amount | 4.01 | 33.54 | 72.96 | 70.51 |
| Disbursement ratio (%)[e] | 7.97 | .61 | 32.86 | 8.59 |
| *Portfolio Management* | | | | |
| CPPR during the year (yes/no) | | | | |
| Supervision resources (total US$ thousands) | 307.79 | 345.12 | 1,361.78 | 467.68 |
| Average Supervision (US$/project) | 76.95 | 49.30 | 123.80 | 42.52 |

| Memorandum item | Since FY80 | Last five FYs |
|---|---|---|
| Projects evaluated by OED | | |
| by number | 1 | 1 |
| by coimmitment amount* (US$ millions) | 500 | 500 |
| Percent rated U or HU | | |
| by number | 0 | 0 |
| by commitment amount* | 0 | 0 |

* the commitments are nominal amounts

a. As shown in the Annual Report on Portfolio Performance (except for current FY)
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: investment projects only.

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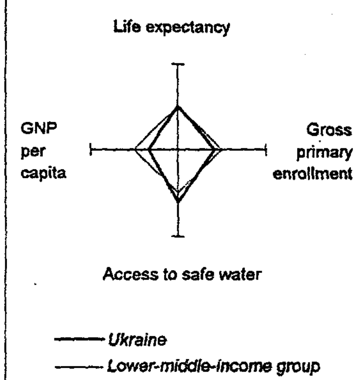
# Ukraine at a glance

8/28/97

| POVERTY and SOCIAL | Ukraine | Europe & Central Asia | Lower-middle-income |
|---|---|---|---|
| Population mid-1996 *(millions)* | 51.4 | 479 | 1,125 |
| GNP per capita 1996 *(US$)* | 1,180 | 2,180 | 1,750 |
| GNP 1996 *(billions US$)* | 60.7 | 1,043 | 1,967 |
| **Average annual growth, 1990-96** | | | |
| Population *(%)* | -0.2 | 0.3 | 1.4 |
| Labor force *(%)* | -0.2 | 0.5 | 1.8 |
| **Most recent estimate** *(latest year available since 1989)* | | | |
| Poverty: headcount index *(% of population)* | 32 | .. | .. |
| Urban population *(% of total population)* | 70 | 65 | 56 |
| Life expectancy at birth *(years)* | 69 | 68 | 67 |
| Infant mortality *(per 1,000 live births)* | 15 | 26 | 41 |
| Child malnutrition *(% of children under 5)* | .. | .. | .. |
| Access to safe water *(% of population)* | 97 | .. | 78 |
| Illiteracy *(% of population age 15+)* | 2 | .. | .. |
| Gross primary enrollment *(% of school-age population)* | 87 | 97 | 104 |
| Male | 87 | 97 | 105 |
| Female | 87 | 97 | 101 |

Development diamond*

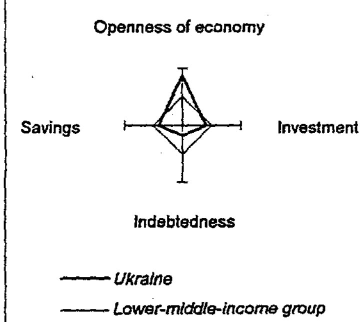



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

| | 1975 | 1985 | 1995 | 1996 |
|---|---|---|---|---|
| GDP *(billions US$)* | .. | .. | 47.5 | 46.6 |
| Gross domestic investment/GDP | .. | .. | 26.7 | 22.7 |
| Exports of goods and services/GDP | .. | .. | 47.1 | 45.5 |
| Gross domestic savings/GDP | .. | .. | 23.5 | 20.5 |
| Gross national savings/GDP | .. | .. | 22.9 | 20.4 |
| Current account balance/GDP | .. | .. | -3.2 | -2.6 |
| Interest payments/GDP | .. | .. | 1.4 | 1.2 |
| Total debt/GDP | .. | .. | 17.3 | 19.6 |
| Total debt service/exports | .. | .. | 6.9 | 6.3 |
| Present value of debt/GDP | .. | .. | .. | .. |
| Present value of debt/exports | .. | .. | 47.9 | .. |

| | 1975-85 | 1986-96 | 1995 | 1996 | 1997-05 |
|---|---|---|---|---|---|
| *(average annual growth)* | | | | | |
| GDP | .. | *-9.0* | -12.2 | -10.0 | 5.4 |
| GNP per capita | .. | .. | -11.5 | -9.6 | 5.4 |
| Exports of goods and services | .. | .. | 2.7 | 19.1 | 7.2 |

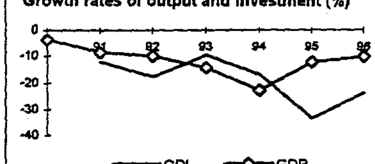
Economic ratios*




STRUCTURE of the ECONOMY

| | 1975 | 1985 | 1995 | 1996 |
|---|---|---|---|---|
| *(% of GDP)* | | | | |
| Agriculture | .. | .. | 15.0 | 13.0 |
| Industry | .. | .. | 50.3 | 46.2 |
| Manufacturing | .. | .. | .. | .. |
| Services | .. | .. | 34.7 | 40.8 |
| Private consumption | .. | .. | 55.1 | 57.8 |
| General government consumption | .. | .. | 21.1 | 21.7 |
| Imports of goods and services | .. | .. | 50.2 | 47.9 |

Growth rates of output and investment (%)




| | 1975-85 | 1986-96 | 1995 | 1996 |
|---|---|---|---|---|
| *(average annual growth)* | | | | |
| Agriculture | .. | .. | -4.6 | -10.3 |
| Industry | .. | .. | -15.7 | -10.2 |
| Manufacturing | .. | .. | .. | .. |
| Services | .. | .. | -6.4 | -8.5 |
| Private consumption | .. | .. | -0.1 | -5.6 |
| General government consumption | .. | .. | -3.5 | -8.2 |
| Gross domestic investment | .. | .. | -33.7 | -23.5 |
| Imports of goods and services | .. | .. | 1.5 | 17.4 |
| Gross Domestic Product | .. | *-9.5* | -12.1 | -9.9 |

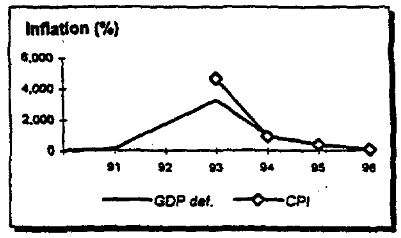
Growth rates of exports and imports (%)


Note: 1996 data are preliminary estimates. Figures in italics are for years other than those specified.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

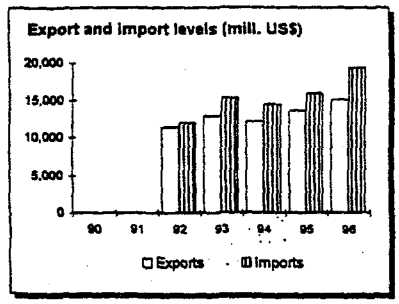
**PRICES and GOVERNMENT FINANCE**

| | 1975 | 1986 | 1995 | 1996 |
|---|---|---|---|---|
| *Domestic prices* | | | | |
| *(% change)* | | | | |
| Consumer prices | .. | .. | 377.0 | 80.0 |
| Implicit GDP deflator | -0.5 | -1.3 | 415.8 | 64.1 |
| *Government finance* | | | | |
| *(% of GDP)* | | | | |
| Current revenue | .. | .. | 37.8 | 37.2 |
| Current budget balance | .. | .. | -5.0 | -3.1 |
| Overall surplus/deficit | .. | .. | -4.9 | -3.2 |



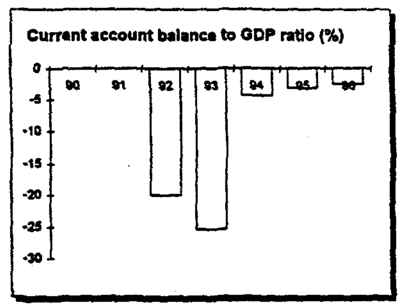

**TRADE**

| | 1975 | 1986 | 1995 | 1996 |
|---|---|---|---|---|
| *(millions US$)* | | | | |
| Total exports (fob) | .. | .. | 13,647 | 15,118 |
| Commodity 1 - *ferrous metals* | .. | .. | 4,484 | 4,847 |
| Commodity 2 - *ores, slags, ashes* | .. | .. | 560 | 605 |
| Manufactures | .. | .. | .. | .. |
| Total imports (cif) | .. | .. | 15,945 | 19,376 |
| Food | .. | .. | 745 | 811 |
| Fuel and energy | .. | .. | 6,946 | 8,107 |
| Capital goods | .. | .. | 3,281 | 4,891 |
| Export price index *(1995=100)* | .. | .. | 100 | 102 |
| Import price index *(1995=100)* | .. | .. | 100 | 99 |
| Terms of trade *(1995=100)* | .. | .. | 100 | 103 |



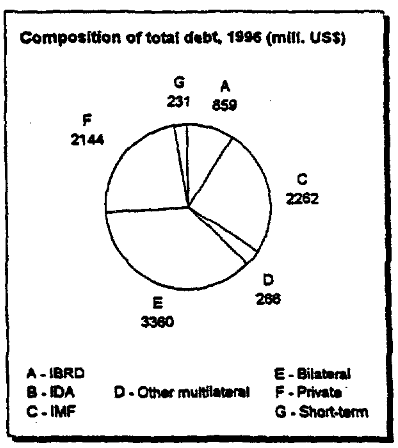

**BALANCE of PAYMENTS**

| | 1975 | 1986 | 1995 | 1996 |
|---|---|---|---|---|
| *(millions US$)* | | | | |
| Exports of goods and services | .. | .. | 16,436 | 19,935 |
| Imports of goods and services | .. | .. | 17,643 | 21,067 |
| Resource balance | .. | .. | -1,207 | -1,132 |
| Net income | .. | .. | -508 | -579 |
| Net current transfers | .. | .. | 200 | 512 |
| Current account balance, before official capital transfers | .. | .. | -1,515 | -1,199 |
| Financing items (net) | .. | .. | 476 | 1,295 |
| Changes in net reserves | .. | .. | 1,039 | -97 |
| *Memo:* | | | | |
| Reserves including gold *(mill. US$)* | .. | .. | 1,069 | 2,087 |
| Conversion rate *(local/US$)* | .. | .. | 1.11 | 1.83 |




**EXTERNAL DEBT and RESOURCE FLOWS**

| | 1975 | 1986 | 1995 | 1996 |
|---|---|---|---|---|
| *(millions US$)* | | | | |
| Total debt outstanding and disbursed | .. | .. | 8,219 | 9,122 |
| IBRD | .. | .. | 491 | 859 |
| IDA | .. | .. | 0 | 0 |
| Total debt service | .. | .. | 1,137 | 1,247 |
| IBRD | .. | .. | 8 | 32 |
| IDA | .. | .. | 0 | 0 |
| Composition of net resource flows | | | | |
| Official grants | .. | .. | 0 | 0 |
| Official creditors | .. | .. | 401 | 426 |
| Private creditors | .. | .. | -220 | -384 |
| Foreign direct investment | .. | .. | 266 | 436 |
| Portfolio equity | .. | .. | 517 | 350 |
| World Bank program | | | | |
| Commitments | .. | .. | 146 | 1,260 |
| Disbursements | .. | .. | 401 | 406 |
| Principal repayments | .. | .. | 0 | 0 |
| Net flows | .. | .. | 401 | 406 |
| Interest payments | .. | .. | 8 | 32 |
| Net transfers | .. | .. | 393 | 374 |




Development Economics 8/28/97

Note: Estimates for economies of the former Soviet Union are subject to more than the usual range of uncertainty.

# Ukraine - Key Economic Indicators

| Indicator | Actual 1993 | 1994 | 1995 | 1996 | Estimate 1997 | 1998 | Projected 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| **National accounts (as % GDP at current market prices)** | | | | | | | | |
| Gross domestic product | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Agriculture[a] | 20.0 | 13.2 | 12.1 | 10.5 | .. | .. | .. | .. |
| Industry[a] | 34.1 | 39.1 | 34.2 | 31.2 | .. | .. | .. | .. |
| Services[a] | 38.3 | 30.4 | 34.6 | 39.1 | .. | .. | .. | .. |
| Total Consumption | 64.2 | 68.1 | 76.5 | 79.7 | 83.8 | 82.4 | 82.0 | 81.7 |
| Gross domestic fixed investment | 24.3 | 23.5 | 23.3 | 20.8 | 19.3 | 19.1 | 18.7 | 18.5 |
| Government investment | .. | .. | .. | .. | .. | .. | .. | .. |
| Private investment (includes increase in stocks) | .. | .. | .. | .. | .. | .. | .. | .. |
| Exports (GNFS)[b] | 25.9 | 35.4 | 47.1 | 45.5 | 40.4 | 40.0 | 39.1 | 38.6 |
| Imports (GNFS) | 26.2 | 38.6 | 50.2 | 47.9 | 45.3 | 43.3 | 41.5 | 40.6 |
| Gross domestic savings | 35.8 | 31.9 | 23.5 | 20.3 | 16.2 | 17.6 | 18.0 | 18.3 |
| Gross national savings[c] | .. | 31.7 | 22.7 | 20.2 | .. | .. | .. | .. |
| *Memorandum items* | | | | | | | | |
| Gross domestic product (US$ million at current prices) | 32,731 | 36,756 | 37,008 | 44,007 | 48,207 | 51,427 | 55,190 | 58,733 |
| Gross national product per capita (US$, Atlas method) | 2,380 | 1,910 | 1,630 | 1,180 | .. | .. | .. | .. |
| Real annual growth rates (%, calculated from 1995 prices) | | | | | | | | |
| Gross domestic product at market prices | -14.2% | -23.0% | -12.2% | -10.0% | -3.0% | -2.0% | 0.0% | 1.0% |
| Gross Domestic Income | .. | .. | .. | -8.8% | -5.0% | -0.7% | 1.0% | 1.7% |
| Real annual per capita growth rates (%, calculated from 1995 prices) | | | | | | | | |
| Gross domestic product at market prices | -14.2% | -22.6% | -11.6% | -9.7% | -2.7% | -1.7% | 0.3% | 1.3% |
| Total consumption | .. | .. | .. | .. | .. | .. | .. | .. |
| Private consumption | .. | .. | .. | .. | .. | .. | .. | .. |

(continued)

## Ukraine - Key Economic Indicators (Continued)

| Indicator | Actual 1993 | 1994 | 1995 | 1996 | Estimate 1997 | 1998 | Projected 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| **Balance of Payments (US$m)** | | | | | | | | |
| Exports (GNFS)[b] | 15,850 | 14,713 | 16,436 | 20,346 | 19,480 | 20,569 | 21,598 | 22,678 |
| Merchandise FOB | 12,796 | 12,111 | 13,647 | 15,547 | 14,952 | 15,951 | 16,749 | 17,586 |
| Imports (GNFS)[b] | 16,755 | 16,044 | 17,643 | 21,468 | 21,817 | 22,253 | 22,920 | 23,837 |
| Merchandise FOB | 15,315 | 14,471 | 15,945 | 19,843 | 20,169 | 20,572 | 21,189 | 22,037 |
| Resource balance | -905 | -1,331 | -1,207 | -1,122 | -2,337 | -1,684 | -1,323 | -1,160 |
| Net current transfers (including official current transfers) | 120 | 200 | 200 | .. | 770 | 300 | 225 | 169 |
| Current account balance (after official capital grants) | -854 | -1,395 | -1,515 | .. | -2,163 | -2,021 | -1,785 | -1,747 |
| Net private foreign direct investment | 200 | 91 | 266 | 526 | 437 | 550 | 589 | 630 |
| Long-term loans (net) | 709 | -1,065 | -347 | -482 | -176 | -901 | 1,553 | 1,108 |
| Official | 307 | 98 | 385 | 241 | -93 | -619 | -525 | -208 |
| Private | 402 | -1,163 | -732 | -723 | -83 | -282 | 2,078 | 1,316 |
| Other capital (net, including errors and omissions) | -92 | 2,510 | 867 | .. | 2,311 | 2,327 | 408 | 509 |
| Change in reserves[d] | 37 | -141 | 729 | -83 | -409 | 44 | -765 | -500 |
| *Memorandum items* | | | | | | | | |
| Resource balance (% of GDP at current market prices) | -2.8% | -3.6% | -3.3% | -2.5% | -4.8% | -3.3% | -2.4% | -2.0% |
| Real annual growth rates ( 1995 prices) | | | | | | | | |
| Merchandise exports (FOB) | 2.7% | -7.3% | 9.8% | .. | .. | .. | .. | .. |
| Primary | .. | .. | 9.9% | .. | .. | .. | .. | .. |
| Manufactures | .. | .. | 9.8% | .. | .. | .. | .. | .. |
| Merchandise imports (CIF) | 25.6% | -7.4% | 7.4% | .. | .. | .. | .. | .. |
| **Public finance (as % of GDP at current market prices)[e]** | | | | | | | | |
| Current revenues | .. | .. | 37.6 | 36.9 | 36.9 | 33.9 | 31.8 | 30.7 |
| Current expenditures | .. | .. | 39.3 | 39.3 | 41.1 | 37.9 | 32.7 | 31.4 |

*(Continued)*

## Ukraine - Key Economic Indicators
## (Continued)

| Indicator | Actual 1993 | 1994 | 1995 | 1996 | Estimate 1997 | 1998 | Projected 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Current account surplus (+) or deficit (-) | .. | .. | -1.7 | -2.4 | -4.3 | -4.1 | -0.9 | -0.7 |
| Capital expenditure | .. | .. | 3.4 | 1.1 | 1.1 | 1.1 | 1.3 | 1.6 |
| Foreign financing | .. | .. | 2.7 | 2.1 | 0.0 | 0.0 | .. | .. |
| **Monetary indicators** | | | | | | | | |
| M2/GDP (at current market prices) | .. | .. | 26.2 | 34.2 | 44.2 | 50.1 | 56.5 | .. |
| Growth of M2 (%) | .. | .. | .. | 92.9 | 44.3 | 27.1 | 24.0 | .. |
| Private sector credit growth / total credit growth (%) | .. | .. | .. | .. | .. | .. | .. | .. |
| **Price indices( 1995 =100)** | | | | | | | | |
| Merchandise export price index | 123.5 | 126.0 | 129.3 | .. | .. | .. | .. | .. |
| Merchandise import price index | 123.5 | 126.0 | 129.3 | .. | .. | .. | .. | .. |
| Merchandise terms of trade index | 100.0 | 100.0 | 100.0 | .. | .. | .. | .. | .. |
| Real exchange rate (US$/LCU)[f] | 243.7 | 33.3 | 4.5 | .. | .. | .. | .. | .. |
| Real interest rates | | | | | | | | |
| Consumer price index (% growth rate) | 5371% | 891.1% | 376.8% | -94.9% | 30.0% | 12.0% | 10.0% | 10.0% |
| GDP deflator (% growth rate) | 3334% | 954.4% | 415.8% | 64.1% | 15.3% | 14.3% | 10.0% | 8.0% |

a. If GDP components are estimated at factor cost, a footnote indicating this fact should be added.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Should indicate the level of the government to which the data refer.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

# UKRAINE
# SECOND ENTERPRISE DEVELOPMENT ADJUSTMENT LOAN

## External Financing
## (US$ millions at current prices)

| | *Estimated* | *Projection* | | |
|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 |
| **Sources** | 2,596 | 3,454 | 3,502 | 3,549 |
| Disbursement | 1,278 | 1,309 | 2,913 | 2,919 |
| IMF | 235 | 354 | 0 | 0 |
| Other medium- and long term | 739 | 912 | 2,513 | 2,419 |
| of which IBRD | 306 | 824 | 594 | 584 |
| Net short-term | 304 | 43 | 400 | 500 |
| Direct foreign investment | 434 | 550 | 589 | 630 |
| Debt relief | 884 | 1,595 | 0 | 0 |
| **Uses** | 2,596 | 3,454 | 3,502 | 3,549 |
| Non-interest current account deficit | 1,082 | 895 | 878 | 528 |
| Debt service due | 1,346 | 2,467 | 2,262 | 2,245 |
| of which IBRD | 87 | 135 | 176 | 239 |
| Repayments (including IMF) | 794 | 1,813 | 1,526 | 1,390 |
| Interest payments | 551 | 654 | 735 | 855 |
| Increase in gross reserves | 176 | 0 | 236 | 835 |
| Other capital flows | -7 | 92 | 126 | -60 |