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BLACK SEA TRADE AND DEVELOPMENT BANK

UKRAINE

Country Strategy

2011-2014

THESSALONIKI
JUNE, 2011

UKRAINE COUNTRY STRATEGY
TABLE OF CONTENTS

TABLES:

Table 1: **Basic Macroeconomic Indicators at a Glance**

Table 2: **Active BSTDB Portfolio as at end December 2010**

TEXT:

I. **Recent Economic Developments and Outlook**

a. Real Sector

b. Public Sector and Fiscal Policy

c. Monetary and Financial Sector

d. External Sector

e. Forecast for 2011-12

II. **Overview of Current BSTDB Portfolio**

III. **Review of Country Strategy 2007-2010**

IV. **Priorities for 2011-2014**

ANNEXES:

Annex I: Post Evaluation of 2007-2010 Country Strategy Ukraine

Table 1: Basic Macroeconomic Indicators at a Glance for UKRAINE

Key Long Term Foreign Currency Sovereign Risk Rating at 31 May, 2011:

Moody's: B2 | S&P: B+ | Fitch: B

		2007	2008	2009	**Est. 2010**	**Proj. 2011**	**Proj. 2012**
1	Population (Million)	46.6	46.4	46.1	**46.0**	**45.8**	**45.3**
2	Avg Exch. Rate (Hryvna/ US$)	5.05	5.27	7.79	**7.94**	**7.92**	**7.83**
3	Inflation (CPI Avg.)	12.8%	25.2%	15.9%	**9.4%**	**10.4%**	**9.3%**
4	Average monthly wages (US$)	267.5	342.9	244.6	**282.1**		
5	GDP (Hryvna million)	720,731.0	948,056.0	913,345.0	**1,094,607.0**	**1,234,800.0**	**1,361,300.0**
6	GDP US$ million	142,719.0	179,991.7	117,227.2	**137,935.6**	**155,928.8**	**173,945.8**
7	GDP per capita (US$)	3,059.6	3,881.4	2,540.5	**3,001.0**	**3,406.2**	**3,839.0**
8	Real GDP growth, %	7.9%	2.3%	-14.8%	**4.2%**	**4.5%**	**4.7%**
9	Official Unemployment (end of period) %	6.4%	6.4%	8.8%	**8.1%**	**7.5%**	**7.1%**
10	Industrial Production Growth, %	7.6%	-5.2%	-21.9%	**11.2%**	**7.5%**	**6.0%**
11	Agricultural Production Growth %	-6.5%	17.1%	-1.8%	**-1.0%**		
12	Domestic Credit Growth %	77.0%	76.9%	3.9%	**6.3%**	**14.1%**	**15.4%**
13	Domestic Credit/ GDP	61.1%	82.1%	88.6%	**78.6%**	**79.5%**	**83.2%**
14	Foreign Direct Investment - $US million	9,891.0	10,913.0	4,816.0	**6,495.0**	**6,000.0**	**7,000.0**
15	FDI/ GDP	6.9%	6.1%	4.1%	**4.7%**	**3.8%**	**4.0%**
16	Consolidated Budget Balance/ GDP, %	-1.1%	-3.2%	-6.2%	**-5.2%**	**-4.0%**	**-3.0%**
17	Total External Debt- US$ million	79,955.0	101,659.0	103,396.0	**117,343.0**	**107,300.0**	**115,200.0**
18	Total External Debt/ GDP	56.0%	56.5%	88.2%	**85.1%**	**68.8%**	**66.2%**
19	Public External Debt/GDP	9.7%	15.0%	21.0%	**25.2%**	**21.8%**	
20	Private External Debt/ GDP	46.3%	41.5%	67.2%	**59.9%**	**47.0%**	
21	Exports- $US million (Goods)	49,840.0	67,717.0	40,394.0	**51,430.5**	**58,337.4**	**58,754.4**
22	Imports- $US million (Goods)	60,412.0	83,808.0	44,701.0	**60,740.0**	**68,973.0**	**72,242.0**
23	Trade Balance $US mn (Goods)	-10,572.0	-16,091.0	-4,307.0	**-9,309.4**	**-10,635.6**	**-13,487.6**
24	Trade Balance/ GDP	-7.4%	-8.9%	-3.7%	**-6.7%**	**-6.8%**	**-7.8%**
25	Current Account Balance $US mn	-5,272.0	-12,763.0	-1,732.0	**-2,884.0**	**-4,403.2**	**-6,740.2**
26	Current Acct. Bal./ GDP	-3.7%	-7.1%	-1.5%	**-2.1%**	**-2.8%**	**-3.9%**
27	Forex Reserves (end period- exc gold) US$ m	31,786.0	30,800.6	25,556.9	**33,327.4**	**38,170.0**	**41,870.0**

Sources: National Bank of Ukraine; State Statistics Committee of Ukraine, IFS –IMF March 2011; IMF Ukraine: First Review Under the Stand---By Arrangement, Report No. 11/52 February 2011; EIU Country Report- Ukraine April 2011.

I. Recent Economic Developments and Outlook

a. Real Sector

In the aftermath of the Russian financial crisis, Ukraine experienced an eight year stretch of high GDP growth averaging 7.5% per annum between 2000-2007. Although there was some year on year fluctuation, outturns were positive, and cumulative real growth during this period reached 78%. Ukraine's growth was fuelled by a number of factors, including favorable external circumstances such as growing demand in neighboring Russia, Ukraine's main trading partner. Ukraine also benefited from the global economic boom which resulted in rising prices for steel, metals and other commodities. Having emerged from a lengthy economic slowdown in the 1990s during which much factory capacity had been idled or underutilized, Ukrainian industry was well placed to reactivate production quickly and without much additional investment to meet promptly the surge in demand, which resulted in rapid export growth to east Asia, especially China.

At the same time, the growing interest of European Union based firms in Eastern Europe resulted in increasing inflows of foreign direct investment, as well as bank lending. The rising inflows resulted in increased domestic demand- including a domestic property boom- which further fueled growth and towards the latter part of the of the eight year high growth period became the main source of domestic growth. However, as consumption overtook investment and source of growth shifted from tradable to non-tradable sectors, the economy started to display symptoms of overheating, including rising inflation and a deteriorating current account balance, which shifted from a surplus of nearly 11% of GDP in 2004 to a deficit of over 7% of GDP in 2008. Put differently, the composition of growth changed significantly over the course of Ukraine's boom. Roughly speaking, between 2000 and 2004, exports were the major contributors to growth, whereas between 2005 and 2008 growth was mostly consumption-led.

When the Global financial crisis of late 2008 struck, Ukraine was in a particularly vulnerable situation. In addition to having an overheating economy experiencing declining competitiveness, Ukraine's terms of trade suddenly worsened and export demand dropped, while Ukrainian banks and firms had become dependent on continued inflows of financing from abroad after having indulged in high foreign borrowing for a number of years. The collapse in international trade resulted in a sharp drop in exports, and the sudden cessation of external capital flows to Ukrainian firms and banks created a severe domestic financial crisis. The result for the economy was a sudden reversal of the high growth of previous years. Real GDP contracted by approximately 8% in the last quarter of 2008[1], reducing annual growth for the full year to 2.3%. The contraction gathered pace in early 2009, bottoming out in the second quarter of the year. While the situation began to improve in the latter part of 2009, the decline in real GDP for the full year reached -14.8%, among the most severe globally, and a reversal of over 17% from the previous year.

The recovery, which began in the second half of 2009, continued into 2010 aided by a recovery of private consumption and investment. Exports, in particular steel, also rose after the collapse of 2009. On the supply side, industry, which accounts for around 30% of GDP formation, grew by 11.2% in 2010 after having declined nearly 22% in 2009. Services, which account for nearly 60% of GDP formation, grew by a more modest 2.2% in 2010, after having declined nearly 11% in

[1] *Ukraine: First Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement—Staff Report*, IMF Country Report No. 09/173, May 2009.

2009. As a result, growth for 2010 reached 4.2%, a figure which would have been higher but for the extended droughts which resulted in a decline of -1.0% in agricultural production, which roughly accounts for 10% of GDP.

The extended period of growth had a positive impact on living standards and key social indicators. Nominal per capita income grew from US$ 630 in 2000 to US$ 3,000 in 2010 (peaking at nearly US$ 3,900 in 2008), a nearly five-fold increase. In purchasing power parity terms the increase is more modest, from US$ 4,040 in 2000, to US$ 6,680 in 2010 (peaking at US$ 7,370 in 2008) [2]. For the same time period, average monthly wages, in dollar terms, rose nearly 6.7 times. The growth had a significant impact on poverty reduction, with poverty rates dropping sharply from 47% of the population in 2002 to 12.3% in 2007, although the economic downturn is expected to have resulted in an increase in poverty to around 16% for 2009.

a. *Public Sector and Fiscal Policy*

An important legacy of the Russian financial crisis was a commitment in Ukraine to improved fiscal performance. In the subsequent period of growth between 2000-2007, the government deficit averaged -0.7% per annum, and never reached -3% of GDP. Reforms were undertaken that resulted in both improved expenditure control and better tax collection. The government eliminated long lingering arrears in wages and pensions, successfully broadened the tax base, and introduced important reforms such as a unified 13% income tax rate. Government spending also rose during this period, but revenues increased in tandem on the strength of overall economic growth.

The economic downturn in late 2008 and into 2009 resulted in a deterioration of the fiscal balance. Government revenues declined due to lower tax receipts resulting from the decline in economic activity, and as a share of GDP slipped from around 44% to 42%. Government expenditures were largely restrained in nominal terms, as the government did not attempt a fiscal stimulus. It contained capital spending and wage and non-wage spending and it cut subsidies, while social spending increased due to rising unemployment payments and other social transfers which kicked in automatically. As a result of the decline, expenditures increased as a share of GDP from around 47% to over 49%. Consequently, the overall budget deficit increased from around -3.2% of GDP in 2008 to -6.2% in 2009.

Unable to increase spending domestically or to borrow on international capital markets, Ukraine turned to the IMF and by end October 2008 reached agreement on a US$ 16.5 billion 24 month Stand-By Arrangement (SBA). The SBA sought to meet Ukraine's balance of payments needs and to support the government's program to restore financial stability by addressing financial sector liquidity and solvency problems, smoothing the adjustment to the external shock experienced, and mitigating some of the effects of the sharp decline in economic output. This SBA disbursed partially as its reform program eventually slipped. In view of changed circumstances it was replaced in July 2010 by a 29 month US$ 15.2 billion updated SBA which laid out the following key objectives: "consolidate public finances, restore banking system soundness, and develop a more robust monetary policy framework"[3].

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[2] EIU Viewswire five year forecast tables for Ukraine.

[3] *IMF Executive Board Approves US$15.15 Billion Stand-By Arrangement for Ukraine*, IMF Press Release No. 10/305 July28, 2010.

Under the SBA, the government presented a revised program of fiscal consolidation which for 2010 contained a budget deficit target of 5.5% of GDP, excluding support to the state owned energy firm Naftogaz and the recapitalization of banks. This was largely met, with the budget deficit for 2010 reaching -5.2% of GDP, with Naftogaz, the recapitalization of banks, and the clearance of accumulated VAT refund arrears respectively adding an additional 1.4%, 1.8%, and 1.5% of GDP. Of these, the bank recapitalization and VAT arrears were one off events, while the payments to Naftogaz are recurring and reflect compensation to Naftogaz for charging utility companies tariffs below cost recovery levels. As such, reducing payments to Naftogaz to zero constitutes an objective of the SBA. Another factor affecting the fiscal adjustment is the need to increase capital spending for the Euro 2012 football tournament. It is estimated that overall public spending for the tournament will reach approximately 6.5% of GDP, including loan guarantees.

b. Monetary and Financial Sector

Although the hryvnia has officially operated under a flexible exchange rate regime since 2000, in practice the National Bank of Ukraine (NBU) has followed a monetary policy which informally pegged the exchange rate to the dollar, often intervening with unsterilized foreign currency purchases in order to prevent appreciation of the hryvnia against the dollar, caused by rising capital inflows. While the hryvnia/ dollar exchange rate remained largely stable between 2000-2008 (with a modest appreciation of the hryvnia), the consequence was a de-facto pegged exchange rate which, as the dollar slid and dollar interest rates remained low, translated into an expansionary monetary policy which facilitated the rapid accumulation of external debt by private banks and firms. With the onset of the financial crisis in late 2008, the dollar strengthened globally since it was viewed as a 'safe haven'. In Ukraine, there was substantial downward pressure on the hryvnia, and in the last quarter of 2008 it fell sharply by 59% against the dollar. Subsequently, the hryvnia re-stabilized, falling only slightly in 2009 and 2010, although against the strengthening euro the devaluation has been more pronounced.

NBU's exchange rate interventions sought to achieve a dual objective of controlling inflation on the one hand while maintaining external sector competitiveness on the other hand. In practice, this proved difficult to achieve and inflationary pressures have fluctuated considerably. In the aftermath of the Russian financial crisis, inflation receded rapidly from over 20% in 1999 and 2000, to a low of 0.8% in 2002. As monetary policy loosened and capital inflows surged, inflationary pressures began to grow steadily and between 2004-2007 annual inflation ranged between 9-14%. In 2008, with rising fuel, food, and commodity prices, plus the overheating of the economy, inflation jumped to over 25% for the year. It decreased to 15.9% in 2009, helped by the decline in demand that caused the sharp economic contraction, but still remained quite high by regional standards, in part due to the effect on prices from the fourth quarter depreciation. In 2010, it decreased further to 9.4% although in the latter part of the year inflationary pressures re-emerged.

This has resulted in NBU alternately lower its refinancing rates, when inflationary risks are deemed lower, such as in 2009 and early 2010, and then raising them when those risks rise, as happened in the latter part of 2010 and into 2011. Recent rate rises have been supplemented by other measures to tighten liquidity conditions such as stepping up placements of CDs, repo operations, and sales of government securities. The NBU has also encouraged early repayment by stronger banks of emergency liquidity support granted during the crisis, and restored a 20% reserve requirement on short-term external capital inflows that had been lifted in 2008.

Encouraged by the IMF, the NBU is planning to place greater emphasis in coming years on controlling inflation, including a move towards inflation-targeting. However, this will require NBU relinquishing control over the exchange rate and accepting larger fluctuations than it has historically. Recent laws strengthening NBU independence indicate a commitment on the part of Ukraine to move towards independent setting of monetary policy and adoption of inflation targeting by NBU. However, before such a policy can become effective to the degree it works in more developed countries, the domestic financial sector needs to develop and deepen further so that the setting of key interest rates may serve as a useful policy tool, effectively transmitting desired signals to the economy.

Banking Sector & Capital Markets

The banking sector in Ukraine is regulated by the NBU, which issues operating licenses for the conduct of banking operations. As at end 2010[4], there were 176 banks which had a license from the NBU to perform banking transactions. Of these, five were government controlled and 171 were privately controlled. The ten largest banks accounted for around 53% of total assets, while the share for the top 25 banks was around 76%. There were 18 banks in distress or in receivership excluded from the coverage of the sector of deposit-taking corporations. There were 53 foreign owned banks, of which 20 were 100% foreign owned. Foreign owned banks accounted for around 40% of statutory capital. The shareholders' equity of licensed banks amounted to UAH 141.7 billion, or 15.0% of the banks' liabilities. The banks' liabilities totaled UAH 803.8 billion.

The main components of liabilities were:

- deposits from individuals – UAH 270.7 billion, or 33.7% of liabilities;
- time deposits from other banks and loans obtained from other banks – UAH 172.8 billion, or 21.5%;
- deposits from legal entities – UAH 144.0 billion or 17.9%.

Banks had the following structure of household deposits with respect to maturity. Time deposits amounted to UAH 206.6 billion, or 76.3% of the total household deposits, whereas demand deposits totaled UAH 64.1billion, or 23.7%. The banks' assets totaled UAH 945.5 billion, total assets – UAH 1,090.1billion.

Between 2000 and 2008, Ukraine's banking sector grew rapidly, with domestic credit increasing as a share of GDP from 24% to 82%. The credit growth was particularly rapid between 2005 and 2008, when bank asset growth was fueled by a sharp rise in external borrowing. As a result, Ukrainian banks became increasingly dependent upon continued inflows of capital from abroad, since the deposit base grew more modestly and covered a declining share of overall lending. Banks aggressively promoted consumer borrowing, fueling a real estate bubble and contributing to the overheating of the economy. Regulation and supervision were unable to keep up with the pace of growth and to ensure that credit quality was maintained. When the global financial crisis hit, shutting down international credit markets, Ukrainian banks were left vulnerable by their dependence on continued external inflows. In combination with the end 2008 devaluation of the hryvnia and the collapse in international trade, banks experienced a surge in non-performing loans (NPLs) and sizeable withdrawals from the already weak deposit base- an erosion of nearly 25%.

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[4] From www.bank.gov.ua , and *IMF Ukraine: First Review Under the Stand---By Arrangement*, Report No. 11/52 February 2011.

Facing imminent collapse of the financial system in the face of this crisis, the government had no choice but to intervene forcefully with an extensive and expensive program of support to restore confidence. Key parameters of the program involved recapitalizing banks or bringing them to resolution, strengthening state-owned banks, and enacting key financial sector legislation. Thus, banks considered systemically important underwent stress tests and put in place recapitalization plans. A number of banks received capital from the state, a process which included the nationalization (acquisition) of three private banks and injections of capital into two existing state-owned banks. Several small and weak banks were liquidated

In addition to raising capital levels and resolving failing banks, plans were put into place for the strengthening of regulation and oversight of the financial system with measures (i) to strengthen consolidated supervision, (ii) to require full and regular public disclosure of ultimate controllers of banks, in order to enhance transparency and confidence in the sector, and (iii) to facilitate loan workouts by adopting an updated legal framework for corporate insolvency and related legislation.

The support program succeeded in stabilizing the financial system and averting collapse, but problems remain. With banks under pressure to raise capital, there has been de-leveraging and a marked slowdown in new bank lending. Some banks stopped lending altogether while those that continued have tightened the terms of credit and prefer to lend mainly to large established enterprises. As a result, many smaller firms are unable to access financing and this hurts Ukraine's economic growth potential.

Moreover, NPLs remain a problem. They rose rapidly from 3.2% of total loans at the end of 2007 to 4.6% at end 2008, and then rocketed to 15.2% by the end of 2009. Despite the stabilization of the financial sector, asset quality is still deteriorating as NPLs reached 17.0% at end September 2010. This has hindered the return to bank profitability, acted as a brake on new lending, and remained a strain on the system.

The non-bank financial sector remains underdeveloped, as markets for insurance, leasing and asset management products are small. The pension system, which could contribute to financial deepening and improved resource mobilization, does not yet play a role of note in financial market development. Ukraine has two stock exchanges, the PFTS Stock Exchange and the Ukrainian Exchange. PFTS, which began operating in 1996, has approximately 220 companies listed with a total market capitalization around $140 billion. The Ukrainian Exchange was founded in 2008 and is a trading venue for local securities in Ukraine. Both are relatively small and do not yet play a significant role in resource mobilization for companies active and investing in Ukraine. Regulatory powers are vested in the Securities and Stock Market State Commission (SSMSC).

c. External Sector

Debt

After adopting the so-called 'zero option' in December 1994, under which Russia assumed all Soviet Union era external debts and Ukraine relinquished all claims to former Soviet Union assets, Ukraine's debt rose during the remainder of the 1990s, peaking at 60% of GDP in 1999 in the aftermath of the Russian financial crisis. Of this amount, nearly two thirds was externally owed debt (39% of GDP). A comprehensive debt restructuring with external creditors ensued between 2000 and 2002, as a result of which Ukraine's public debt was cut and became manageable. As the economy grew in the period up to the global financial crisis of 2008 and fiscal discipline was largely maintained, public debt levels shrank steadily. Total public debt declined to 12.3% of GDP at end

2007, with publicly owed or guaranteed external debt at 9.7% of GDP. Public debt rose to 20% of GDP (15% of GDP externally owed) in 2008 as imbalances in the economy grew. Ukraine was then hit by the crisis, and debt jumped to 34.6% of GDP at end 2009 (21% of GDP externally owed) as the economy contracted, government finances deteriorated, hryvnia depreciation raised the value of external debt and more disbursements were made under the IMF agreed SBA. Public debt growth continued but at a slower pace in 2010, and after rising to 39.3% of GDP by the end of the year (of which 25.2% of GDP externally owed) it is expected to rise slightly above 40% of GDP over the next couple of years, but otherwise remain stable before beginning a declining trajectory; the intention is for public debt to fall below 35% of GDP by 2015. Despite the increase, overall levels remain fairly modest and manageable. This view is reflected by the fact that in September 2010 and in February 2011, the Ministry of Finance successfully undertook two issues of ten-year Eurobonds, worth US$1.5bn each. The issues were oversubscribed, enabling the government to increase the volume and to achieve a yield slightly below the targeted level of eight percent. All public sector external debt is long term much of it is owed to the IMF and other official creditors (such as development institutions).

In contrast to the steady decline of public external debt during the high growth era, Ukrainian banks and corporations began accumulating increasing amounts of external debt from 2000 onward, a trend which accelerated rapidly after 2004 and up to the crisis of 2008. Ukraine's gross external debt rose to around 56% of GDP in 2007 and 2008, and then rocketed to around 88% of GDP in 2009 as a result of the hryvnia's sharp devaluation. Tellingly, the share of external debt owed by the private sector increased steadily from 39% in 1999 to a peak of nearly 83% in 2007, before declining slightly after the onset of the crisis (since Ukrainian firms were effectively shut out of global credit markets and many were unable to rollover credits). As at end 2010, around 70% of external debt is concentrated in the private sector, although it is projected to decline as a percent of GDP in coming years as the buildup of bank and corporate loans from previous years stabilizes. Around three quarters of private external debt is long term.

Ukraine's credit rating reflects the country's economic cycles. After receiving a series of upgrades on its foreign and local currency sovereign debt during the 2000s up to 2007, a series of downgrades followed during the crisis period of 2008 and 2009 before stabilizing and, during the course of 2010, receiving upgrades from Standard and Poor's.

Trade and the Current Account

Export led growth was an important factor behind Ukraine's economic boom in the early part of the 2000-2007 period, although its impact waned over the latter part as the economy began to overheat, and competitiveness eroded. As a result, Ukraine went from running trade and current account surpluses between 1999-2004 to running trade and current account deficits in 2006-2007, peaking in 2008 with a trade deficit equal to -8.9% of GDP, and a current account deficit which reached -7.1% of GDP. The economic contraction of late 2008 and 2009 caused a painful adjustment; exports declined 40% in 2009 relative to the peak year of 2008, while imports fell by nearly 47%. As a result, the trade gap declined to -3.7% of GDP and the current account deficit fell to -1.5% of GDP.

Export oriented industries helped the economy pick up in the first half of 2010, in particularly the recovery in global demand for steel products, but then slowed over the course of the year, with import growth (36%) outpacing export growth (27%). As a result, the trade deficit widened to -6.3% of GDP in 2010, while the current account deficit increased moderately to -2.1%

of GDP. Looking at the composition of exports in 2010[5], metals- especially steel- accounted for 33.7% of total by value, followed by minerals (13.1%), machinery and equipment (11.0%), plant products (7.7%), chemicals (6.8%) and transport equipment (6.3%). On the import side, minerals (including fuel) were the single largest import item at 34.8%, and were followed by machinery and equipment (13.4%), chemicals (10.6%) metals (6.8%), transport equipment (6.0%) and plastics and rubber (6.0%).

Russia has been and remains Ukraine's largest single trade partner for both exports and imports, by a considerable margin. It accounted for 31.8% of Ukraine's total international trade turnover, a sum larger than the cumulative trade turnover of Ukraine's next five largest trade partners: Germany and China, which accounted for 5.4% of Ukraine's trade respectively, Poland (4.1%), Turkey (3.9%) and Italy (3.4%). Among BSEC Members, Azerbaijan (1.39%) and Romania (1.24%) are the next two largest trade partners for Ukraine, with others accounting for less than one percent of Ukraine's international trade.

Trade between Ukraine and other BSEC members increased by 311% between 2000 and 2010, a pace higher than that of the overall external trade growth of 266% for Ukraine during this period. The growth was balanced, with exports growing 307% and imports growing 314%. With the exception of 2007 and 2008, when the balance turned positive on the strength of a surge in exports to other BSEC states, Ukraine has generally run trade deficits in its commercial relations with other BSEC states, primarily due to the high volume of energy imports from Russia.

Foreign Direct Investment

Ukraine experienced a surge in foreign direct investment (FDI) from 2003 on, albeit with considerable year to year fluctuation. Nevertheless, FDI flows, which had generally languished between 1-2% of GDP suddenly increased, with a peak occurring in 2005, on the strength of the re-privatization of the Kryvorizhstal steel plant for US$ 4.8 billion, which remains the single biggest privatization undertaken in Ukraine. Between 2006-2008, FDI remained high at between 5-7% of GDP, and while it subsequently declined due to the crisis- dropping over 50% from nearly US$10.9 billion in 2008 to US$ 4.8 billion in 2009, it stayed above 4% of GDP, and recovered further to US$ 6.5 Billion (4.7% of GDP) in 2010, a figure slightly more than double the Black Sea regional average for FDI of 2.3%. Most FDI was used for the acquisition of existing companies, while over time a growing share was invested in nontradable sectors (such as real estate). By way of contrast, FDI for greenfield investments in exporting sectors was far less common. Manufacturing sectors relatively successful in attracting FDI included food processing, basic and fabricated metal products and machine building. The ten principal sources of foreign investment are Cyprus, Germany, the Netherlands, Russia, Austria, France, the United Kingdom, Sweden, the British Virgin Islands, and the United States.

Although Ukraine contains numerous investment attractions, including a sizeable internal market, quality labor force, and proximity to the EU and other key markets, in the World Bank's *Doing Business 2011* report it ranked 145th out of 183 countries surveyed. Ukraine fares well in areas such as obtaining credit and enforcement of contracts, where it is ranked in the top quartile. Its scores for starting a business and protecting investors are in the third quartile. By way of contrast, it is in the fourth quartile for items such as international trade practices, closing a business, registering property, dealing with construction permits, and difficulty and cost of paying taxes. The report indicates some improvement over the five year period 2006-11, suggesting that recent slippage is due

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[5] From Economist Intelligence Unit, Country Report Ukraine, April 2011.

more to improvements in other countries, and not absolute slippage in Ukraine. Another indicator of country risk and business environment in which Ukraine is rated is *Euromoney* magazine's country risk index, in which Ukraine's score has risen (improved) substantially over the years, coming in 50.7 (out of a perfect score of 100) in September 2010, which ranks slightly below the average of BSEC region of 52.6 and further behind the EU average of 75.0.

d. Forecast for 2011-12

According to the *Universal of National Unity*[6] issued in August 2006, which contains a series of proclamations and an Action Plan aiming to guarantee national unity, the national economic development related goals of Ukraine include political reform activities such as improving the rule of law and governance, and the protection of property rights as well as:

- Improving the common wealth of Ukraine and fighting poverty;
- Forming a middle class through the transformation of revenue policy, development of businesses and creation of employment;
- Increasing access to, and quality of, education and health provision to promote human development, as well as the access to and quality of communal services;
- Achieving GDP growth rates of at least five percent annually, and stimulating the creation of at least one million new jobs annually;
- Carrying out key structural reforms in the economy, including reform of the tax system by decreasing tax pressure on the economy, enlarging the taxation base, and introducing a property tax and a and common social fee from the remuneration fund;
- Ensuring the energy safety of Ukraine, including effective use of natural resources and energy carriers and the introduction of energy saving technologies;
- Improving the efficiency of agriculture and increasing attention on rural inhabitants;
- Enhancing international economic cooperation, including accession to organizations such as the World Trade Organization, and the European integration of Ukraine with the prospect of accession to the European Union.

Ukraine has also adopted key Millennium Development Goals including: Poverty reduction (Goal 1), Quality life-long education (Goal 2), Sustainable environmental development (Goal 3), Improved maternal health and reduced child mortality (Goal 4), Reduction and slowing down in the spread of HIV/AIDS and TB (Goal 5), and Gender equality (Goal 6).

For 2011, real annual GDP growth is expected to pick up a bit further to approximately 4.5%, and for the period 2012-2014 real GDP growth rates are expected to remain around 4.5% or so. As with the rest of the BSEC Region, these numbers represent a slowing down relative to the very high figures reached during the 2000-2007 boom period. Nevertheless, they still exceed projections for the EU over the same period, and thus would result in convergence at a slower pace to EU living standards. A lower but steady rate of growth may prove more sustainable, and less prone to substantial year on year fluctuations which have been a feature of Ukrainian economic performance in the past. The figures are subject to some uncertainty, as Ukraine's performance

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[6] Available at: http://www.kmu.gov.ua/

depends upon developments in its main economic partner, Russia, and to a growing degree to developments in the EU, from where most investment and other forms of financing originate. As the financial crisis of 2008 demonstrated, Ukraine is sufficiently linked into the global economy that exogenous shocks can impact the domestic economy significantly. Shifts in global terms of trade may also impact economic performance either adversely or positively, as Ukraine's relative dependence on steel exports leaves it vulnerable to changes in world steel prices. Implementation of market oriented reforms may boost growth. The government has announced an ambitious program that includes new state procurement and gas sector reform laws, and a new tax code, all of which have been adopted. The government has also announced a privatization program for remaining state enterprises and in March 2011, reached agreement on the privatization of the state telecommunications company Ukrtelecom, the largest privatization in Ukraine since 2005.

Domestic demand is expected to pick up due to investments undertaken in 2011 and 2012 in preparation for the Euro 2012 football championships, which Ukraine is co-hosting with Poland. While this will help to sustain growth, it may create challenges for meeting fiscal consolidation targets in coming years. However, fiscal policy is expected to be conservative generally, as the government seeks to meet targets set under the agreed SBA with the IMF to reduce budget deficits. Monetary policy will likely be tight in order to support the fiscal retrenchment, to maintain market confidence and to counteract inflationary pressures. Average annual inflation is expected to be around 9-10% in 2011 and 2012 and then to decline gradually, with the SBA setting a target of around 5% in later years.

II. Overview of Current BSTDB Portfolio

As of 31 December, 2010, the active BSTDB portfolio in Ukraine consisted of 13 operations approved by the Board of Directors (BoD), involving an investment of € 196.6 million (US$ 260.6m). All these operations were signed for € 183.5 million (US$ 243.2m) and the outstanding disbursements were at € 111.7 million (US$ 148.0m). Ukraine ranks third across the board in the BSTDB portfolio, with 17.23% of BoD approved operations, 18.2% of signed operations, and 16.8% of amounts outstanding in the total portfolio. Relative to the Bank's active portfolio at the end of 2006, Board approvals increased by 59.7%, signings by 81.0%, and amounts outstanding by 39.0%.

Table 2: Active BSTDB Portfolio in Ukraine as at end December 2010

All Figures in Euros Million	BoD Approval Date	Approved Amount	Signed Amount	Amount Oustanding
Transbalkan Gas Pipeline, Phase 2	13-Sep-01	4.5	4.5	0.9
Chornomornaftogaz	17-Apr-04	15.1	13.6	1.9
Galnaftogaz	5-Jun-04	17.4	17.4	3.5
First Ukrainian International Bank	5-Jun-04-Dec-06	13.6	13.6	8.0
Vernal Group Fleet Renewal	28-Jul-06	14.0	10.0	7.4
Kreditprombank	27-Apr-07	7.5	7.5	-
Alfa Nafta Petroleum	27-Apr-07	27.2	27.2	19.0
Galnaftogaz II	27-Apr-07	10.6	10.6	8.4
Chornomornaftogaz II	27-Apr-07	15.8	15.8	11.9
Ukrainian Railways	6-Jul-07	27.2	19.6	11.4

Industrial Union of Donbass	9-Aug-07	27.5	27.5	27.5
Pivdennyi SME	4-Apr-08	15.1	15.1	11.7
Emerging Europe Accession Fund	25-Sep-09	1.2	1.2	0.0
Total		**196.6**	**183.5**	**111.7**

III. Review of Country Strategy 2007-2010

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2007-2010 Country Strategy, Ukraine. Its goal is to provide accountability to the Board of Directors and Board of Governors as well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated targets with actual results as of end of 2010, and provides a country-oriented analytical picture. A mid-term evaluation of the Country Strategy was conducted in early 2009 and reported to the Board of Directors and Board of Governors in June 2009, as part of the Annual Evaluation Overview, issued by the Evaluation Office.

Performance of Country Strategy 2007-2010, Ukraine

The 2007-2010 Country Strategy was approved by the Board of Directors in early 2007, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier strategies, conducted by the Evaluation Office in late 2006. It was aligned with the objectives of the Bank's Business Plan 2007-2010 and was therefore evaluated in that context.

Overall, the implementation of the Country Strategy was consistent with the Business Plan implementation. The performance of the strategy is rated as Satisfactory. Overall the targets were met: broad sector coverage, although the cross-border infrastructure/cooperation could have been better represented. No operation was approved after 2009. For a more comprehensive overview, see Annex I.

IV. BSTDB Operational Priorities for 2011 - 2014

The Bank's role and priorities are defined (i) in accordance with the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2011-2014* and (ii) country needs and objectives, as well as (iii) available resources, strategies and policies of BSTDB. In this respect, BSTDB will seek viable opportunities and will continue closely monitoring the developments in the Ukrainian economy in order to support bankable projects that promote sustainable development and are in compliance with environmental standards. In addition the Bank shall seek co-financing opportunities with international financial institutions (IFIs), public sector institutions and private partners.

BSTDB will focus in the next four years on providing support for the implementation of the government program and priorities, while responding to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities promoting export of goods and services, and development of infrastructure, including energy efficiency. In addition, through selected intermediaries, the Bank would attempt to expand its financing programs in favor of SMEs.

Based on the 2011- 2014 BSTDB Business Plan, the Bank would expect to approve between two to three new operations per annum during this period, for approximately € 25-38 million per year. Over the four year period, this implies around 11 approved operations for approximately € 126 million. With the Bank determined to raise the level of commitments (signed operations) to approved operations to over 85%, the Bank expects signings for 2011-2014 to be on the order of nine to ten operations for € 111 million (a range of € 22-33 million per annum).

These indicative targets are based on the Base Case Scenario of the MTSBP, and given appropriate circumstances and sufficient operational opportunities the Bank would make efforts to exceed this level. In case of higher regional economic growth rates, increased demand for Bank funding, and an improved situation in financial markets, a phased increase in the average number and size of operations would allow the Bank to move towards achieving the targets envisaged under the High Case Scenario. Moreover, at the Mid-Term Review, depending upon performance and prospects, the above targets may be revised upwards[7].

Areas for BSTDB Financing:

Financial Sector Strategy

By developing a network of financial intermediaries in Ukraine, BSTDB intends to support Ukraine's emerging private financial sector. BSTDB will consider increasing the number of financial intermediaries to deliver Bank products with an emphasis on SME lending, and to increase the exposure and tenor to existing financial intermediaries with whom the Bank has cooperated successfully, within their capacity.

The Bank will also consider equity participations in select national and regional private equity funds to promote development of the capital market, and will also seek to develop quasi-equity products, such as subordinated loans. Other areas which will receive consideration include microfinance and municipal lending. Bank involvement will be determined by assessment of the potential of such involvement, and the extent to which involvement with such institutions will play a catalytic role and provide clear demonstration effects.

The Bank hopes to find suitable partners to support the development of leasing, as well. Medium-term credit lines to leasing companies will enable them to offer their customers finance for capital expenditures on imports from other countries in the region.

Manufacturing and Enterprise Sector

Ukraine is characterized by a complex legal environment, which has an impact on activities of foreign investors and lenders. Structuring of financings in Ukraine requires engagement of outside legal counsel at an early stage of project appraisal and also, as a rule, involves a comparatively more extensive due diligence. In addition, the country's regulations envisage compliance with restrictions on pricing and application of financial instruments. These circumstances make the project appraisal and approval process more expensive and time consuming. Given the above, and the availability of a developed manufacturing sector, the Bank will focus on identification of large corporate clients and investment projects.

The primary objective in the manufacturing sector will be support of local companies in their efforts to improve efficiency of operations and modernize their technological base. BSTDB will be

[7] Under no circumstances would targets be revised downwards unless the lower case scenario of the 2011-2014 BSTDB Business Plan were to be followed.

particularly keen to participate in transactions involving direct foreign investments by corporates from the Bank's countries of operations, as well as in investments implemented by Ukrainian companies in the Black Sea region. Important criteria for prioritization will be the degree to which potential operations (i) support production and export of high technology products of Ukrainian origin, and (ii) provide prospects for import substitution, something that will apply for all manufacturing sectors but will be especially important for areas such as mechanical engineering, chemicals, and mining.

The Bank will support the improvement of Ukraine's transport infrastructure, which is the key to enhancing the country's competitiveness and its integration into European transport networks and the world economy.

Given the BSTDB experience in Ukraine during turbulent 2008 – 2010, the Bank will make put particular efforts to ensure the bankability of prospective operations, which ideally would also contain regional cooperation criteria.

BSTDB transport and manufacturing strategy in terms of banking instruments:

- Project Finance limited recourse transactions;
- Continuing emphasis on financing in the form of Equity and Quasi Equity instruments;
- Co-financing with other international financial institutions and foreign commercial banks;
- Work with medium- and large-scale Ukrainian companies.

Areas of particular focus in transport and manufacturing strategy:

- Metallurgy, chemical industry and food processing industry;
- Development and operation of airports (and landside developments), sea terminals;
- Real estate development, including retail outlets, warehouse facilities and logistic centers.

Energy and Infrastructure (E&I)

Since energy and infrastructure projects contain important developmental elements as well as strong regional cooperation enhancement prospects, the Bank will be keen to participate in corporate and project financing operations in the energy, power, telecommunications and other infrastructure related sectors seeking to upgrade existing, or build new, infrastructure in Ukraine.

The energy sector is a significant area for seeking investment opportunities. Ukraine's economy is highly energy intensive and wasteful in its use of energy resources, thus rendering a priority the undertaking of projects to improve the efficiency of energy infrastructure. Ukraine is also an important energy transit conduit, and it contains significant refining capacity, which has made it an exporter of finished energy goods even though it is a net importer of energy commodities. The Bank will therefore seek to continue its support to projects contributing to rehabilitation of the existing energy transport and storage infrastructure, that are designed to expand existing export capacities. It will also support projects designed to improve regional energy transport and handling infrastructure. Furthermore, the Bank will explore opportunities for projects in oil and gas downstream, such as the expansion of retail networks and the upgrading of oil refinery and petrochemical facilities by improving their product quality or the environmental acceptability of refined products. In the power sector, the Bank will seek opportunities envisaging upgrading, modernization and/or expansion of energy infrastructure that facilitate power generation, transmission, distribution and sale. This may include, among other things, green-field start-ups or the

renovation of existing power capacities in Ukraine. The Bank will also seek to provide financing for renewable energy projects such as solar, wind and hydropower.

Municipal infrastructure represents another area in which the Bank can assist municipalities in activities such as water supply and waste management. The Bank will also consider projects aiming to improve energy efficiency or to increase energy saving.

In terms of financing instruments, BSTDB will focus on medium/long-term loans (senior or subordinated) and equity/quasi-equity to either local or foreign companies, which may utilize the loan proceeds in one or several BSEC countries. The Bank may apply the financing instruments for the purpose of financing capital expenditures, corporate and development needs, working capital requirements or re-financing of existing borrowings.

The Bank will work in cooperation with other IFIs and commercial banks in joint energy and infrastructure sector projects as an important source of institutional knowledge transfer.

<table>
<tr><td colspan="5">ANNEX I: Post Evaluation of 2007-2010 Country Strategy Ukraine (approved 04.02.2007)</td></tr>
<tr><td colspan="3">2007- 2010 TARGETS</td><td colspan="2">RESULTS (end of 2010)</td></tr>
<tr><td>General</td><td>Sectors</td><td>Target operations: Number approved/ number signed; USD approved/ USD signed (million)</td><td>Actual operations: Number approved/ number signed; USD approved/ USD signed (million)</td><td>Evaluation Summary</td></tr>
<tr><td>Work with Ukrainian firms (or banks), which wish to expand the range of their investment, trade, and financing activities to other BSEC Member Countries.

Search more intensively for involvement in projects which tend to have greater cooperation benefits.</td><td>1. Project and corporate finance
▪ Modernization/ restructuring
▪ Shipbuilding
▪ Textiles and small scale manufacturing
▪ Reputable firms and large chains entering the Ukrainian market (e.g. in retailing and tourism)
▪ Construction-related businesses

2. Infrastructure
▪ Transport, energy, etc.
▪ Port expansion/modernization
▪ Roads and airports
▪ Municipal infrastructure
▪ Energy efficiency and transportation/export
▪ Oil & gas and downstream
▪ Power generation / transmission

3. Financial sector
▪ Trade finance and SME/microfinance
▪ Emerging private financial sector
▪ Mortgage financing and retail banking, extend longer term financing (e.g. over 3 years)
▪ Equity/quasi participations in FIs and funds.

4. Cooperation with other IFIs
▪ Coordinate activities and share experiences
▪ TA on regional cooperation, knowledge generation, new products.</td><td>14/12
170/142</td><td>10/9
195/185</td><td>1. Volume: on target
Approved number: 71%
Approved volume: 115%
Signed number: 75%
Signed volume: 130%

2.Sector coverage:
▪ Kreditprombank (Tr. Finance)
▪ Alfa Nafta Petroleum (Energy)
▪ Galnaftogaz II (Energy)
▪ Chornomornaftogaz II (Oil/Gas)
▪ Pivdennyi (Tr. Finance)
▪ Ukrainian Railways (Transportation, Public)
▪ Donbass (Manufacturing)
▪ Pivdennyi SME (SME, repaid)
▪ Emerging Europe Accession Fund (Equity/SME)
▪ Procredit Bank SME (prepaid)

3. Performance: Satisfactory. Generally, targets were met. Broad sector coverage, although the cross-border infrastructure/ cooperation could have been better represented. No operation was approved after 2009.</td></tr>
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