April 26, 2006

INDEPENDENT EVALUATION GROUP
UKRAINE COUNTRY ASSISTANCE EVALUATION (CAE)
APPROACH PAPER

Country Background

1. Ukraine re-established its independence in 1991, after more than 70 years of Soviet rule. The nation of almost 50 million people is strategically located at a crossroads between east and west, and has a great endowment of human and natural resources. It was widely considered to have excellent prospects, instead, during the 1990s, it endured one of the world's worst depressions. This was partially due to difficult initial conditions of economic transition and the burden of an inherited energy-intensive and defense-oriented industrial infrastructure that was largely isolated from international markets. The output contraction lasted for nearly 10 years, between 1991 and 1999, and gross domestic product (GDP) declined by about 60 percent.

2. Among all transition countries and even among those of the former Soviet Union, Ukraine's economic decline was one of the deepest and longest. The relatively successful transition countries—such as the Czech Republic, Estonia, Hungary, Poland—quickly imposed hard budget constraints on large public enterprises and privatized them. Ukraine, by contrast, propped up these enterprises with direct subsidies, direct credits, and tax concessions. In addition, the lack of structural reforms led to continued economic decline and to high budget deficits, propelling the vicious circular relationship between them. If Ukraine had more quickly implemented fundamental structural reforms in enterprise ownership, market relations, the legal and juridical structure, and the role of government, the economy may not have contracted as much as it did.[1] The impact of declines in GDP on the people of Ukraine was acute. The incidence of poverty increased considerably, to 27 percent of the population in 1999. A fifth of the population was working part-time or was on administrative leave; formal unemployment rose to 11 percent of the economically active population.[2]

3. Ukraine's economic performance has improved since the late 1990s. The economy has enjoyed six consecutive years of growth between 2000 and 2005, during which GDP expanded more than 50 percent. Growth derived from a highly favorable external environment, a revival of the country's traditional industrial base, and improved macroeconomic policies and management. The devaluation of 1998-99, together with the revival of growth in Russia, increased demand for some of the traditional, metal-based industries of Ukraine, which had ample spare capacity following the large declines in production of the 1990s. A number of important changes in economic policy and reforms strengthened incentives and the expectations of the population. These include a responsible and effective macroeconomic policy, measures to enhance payment systems and financial discipline, major reform in agriculture, key changes in tax policy, and reductions in subsidies to loss-making firms. These measures, together with related institutional reforms have contributed to improved macroeconomic performance. In 2004,

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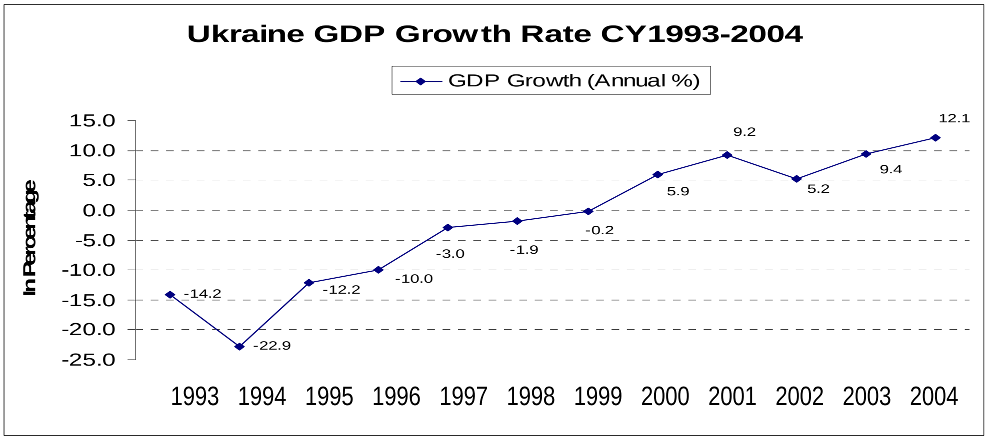
1. Ukraine-Restoring Growth with Equity: A Participatory Country Economic Memorandum (1999).

2. Ukraine-Country Assistance Strategy, August 16, 2000, Report No. 20723-UA.

Ukraine achieved the highest growth rate (12 percent) in Europe and the current account surplus reached a record 10.4 percent of GDP. Ukraine's credit rating has been steadily upgraded, providing improved access to international financial markets. Unemployment has declined in recent years from more than 11 percent in 2000 to 9.1 percent in 2003. Despite improved macroeconomic performance over the past five years, the return of inflation has emerged as a significant concern, reaching 12.3 percent at the end of 2004.



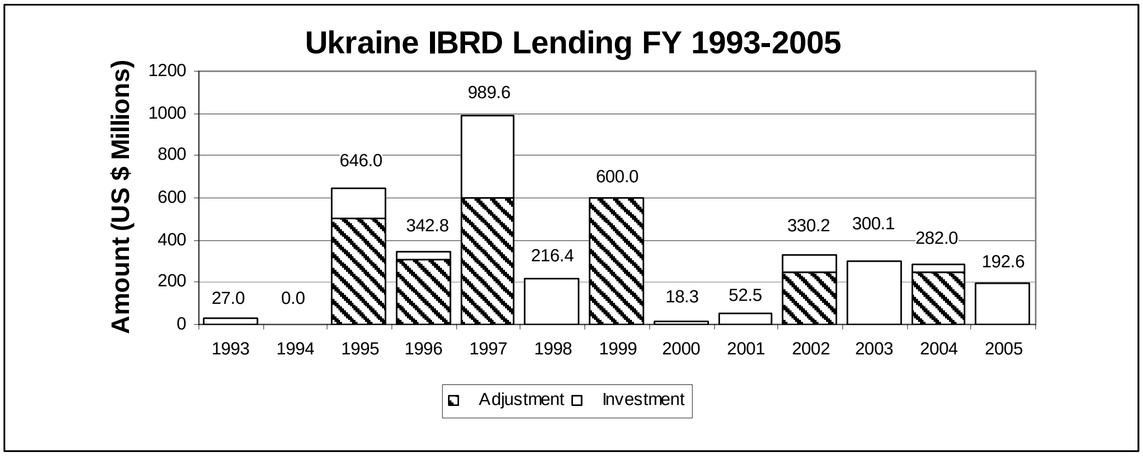
4. High growth reduced poverty, which declined from more than 30 percent in 2000-2001 to 19 percent in 2003. The reduction of poverty has been faster in Ukraine than in some neighboring countries. In 1999, Ukraine had a poverty incidence higher than Bulgaria, Lithuania, Poland, and Russia. By 2003, Ukraine's poverty incidence was the lowest among these countries. Despite overall poverty reduction there are increasing disparities. Poverty reduction has been slower in rural areas and small towns compared to large cities, and poverty is becoming an increasingly rural phenomenon. While most of the regions have poverty levels around the national average, regions in Eastern Ukraine have lower than the average. These are more urban centers where industrial facilities are located. The Western and Black Sea Coast regions, where more agricultural and rural activities are located, have higher poverty rates than the average.

5. Ukraine's political landscape was dramatically changed by the presidential election of 2004 and the related events which became known as the "Orange Revolution." The former Prime Minister, Viktor Yushchenko, emerged as the winner and was inaugurated as President on January 23, 2005. The new administration announced that accession to membership in the European Union was Ukraine's top priority. An ambitious program was announced to deliver sustained growth, improve the efficacy of the state institutions, fight corruption, advance social inclusion, and deepen Ukraine's evolution into a modern democratic society.

The World Bank Program

6. Since FY93 the Bank has financed 32 operations totaling US$4.4 billion, including nine adjustment loans amounting to US$2.8 billion (or 64 percent of commitments) and 23 investment operations accounting for one-third of commitments. However, disbursements of investment projects in Ukraine account for only 14 percent of total disbursements in the period FY1993-2005.

7. The Bank's investment lending portfolio in Ukraine has had a difficult history and continues to face major challenges. Many projects experienced difficulties and were halted at various stages of preparation by the Bank or dropped by the government during negotiations or after Board approval. Projects take a long time to prepare and a long time to implement. Ukraine's average disbursement ratio was only one-third of the Bank-wide average of 18.4 percent, and significantly below the ECA region average during the 1990s. This trend has continued. In 2004, the disbursement ratio for investment projects was only 4 percent, the lowest in the ECA region, where the average rate was 18 percent.



8. Given the prevailing business climate and challenges, the International Finance Corporation's (IFC) operations in Ukraine over FY1994-2005 featured only a few investment operations.[3] The IFC focused mainly on Technical Assistance and Advisory Services (TAAS) operations to improve the enabling environment and build capacity, thereby helping to address constraints to private sector development. Therefore, IFC investment operation commitment volumes and numbers were low through FY03 but grew significantly in FY04-05, in parallel with improvements to Ukraine's business climate, reaching a total of US$259 million over the review period, with 84 percent of that committed in FY04-05.

9. The World Bank Group's assistance to Ukraine between 1992 and 1998 was previously evaluated in the 2000 Country Assistance Evaluation (CAE).[4] The CAE found that the country assistance strategy was relevant in terms of proposing a "graduated approach." It noted that some progress had been made in privatization, trade, and price liberalization, but progress in other areas had been limited. The CAE concluded that the Bank has often overestimated the government's implementation capacity and the speed with which the economy would respond to changes in the incentive structure and policy environment. The following lessons emerged from the evaluation: (i) reforms might not realize their intended supply response because of vested interests; (ii) the essence of the reform agenda in Ukraine is to re-orient the role of government and public administration in the economy; (iii) the Bank needed to promote public education about reform to build social consensus; (iv) the Bank should broaden the range of partners and stakeholders

3. Ukraine also joined IFC in 1993.

4. Ukraine CAE, OED, November 8, 2000, Report No. 21358.

involved in its activities; and (v) in the case of limited consensus for reform, lending should be targeted either toward the poorest groups or small demonstration projects.

10. This CAE will cover the seven years from January 1, 1999 to December 31, 2005. During that period, the Bank's assistance to Ukraine has been guided by two CASs (2000 and 2003) and most recently a CAS Progress Report in May 2005. The first CAS, covering FY01-03, aimed to address the institution building challenges faced by Ukraine both from the demand side (civil society) and supply side (government). The demand side component of the CAS contained a number of initiatives to strengthen civil society's demand for improved accountability and transparency of government at all levels. The next CAS, covering FY04-07, was developed around the government's program of *European Choice*, which commits the country to move in the direction of European market institutions.[5] The overarching objectives of the CASs were to achieve: (i) sustainable economic growth and integration into the world economy; (ii) restructuring of public sector, improved transparency, and accountability; (iii) poverty reduction, comprehensive human development and reduction of regional imbalances; and (iv) environmental sustainability.

General Approach to the Evaluation

11. The CAE will evaluate the relevance of Bank objectives in the context of the development constraints facing Ukraine at the time the CASs were prepared, and the realism of Bank assistance objectives in view of the political environment for development and the capacity of the government. In evaluating the Ukraine program, the study will also draw on evidence and findings in recent and ongoing IEG evaluations of the Economies in Transition, HIV/AIDS Review, Trade Study, Natural Disasters, the Bank's Support to Middle-Income Countries as well as specific Project Performance Assessments and ICR Reviews on the Ukraine portfolio. It will also draw on work by the Quality Assurance Group, and other relevant Bank documents.

12. The CAE will examine the degree to which the CAS objectives have been achieved and what role the Bank's support has played in this achievement. In each of the four areas named in para.10 the CAE will use a set of indicators, with end 1998 as the baseline, to evaluate the achievements by the end of 2005. These indicators will be drawn mainly, but not exclusively from the Bank's strategy document. The CAE will assess the relative contribution to attainment of objectives of the Bank's interventions, taking into account the contributions of other donors and the government, as well as exogenous factors, which have been exceptionally important for Ukraine.

13. IFC-IEG will undertake a parallel evaluation of the IFC's activities in Ukraine. Since most of IFC's recent investment projects are concentrated in FY04-05 (see para. 8), many may not have reached operating maturity in time to meet the CAE submission date in FY07. It is therefore expected that in the absence of prior evaluation of IFC operations in Ukraine, IFC-IEG's evaluation will cover the entire period of Ukraine's membership (FY1994-2005) and focus on advisory operations, drawing on existing and ongoing evaluations and

5. The EU-Ukraine Action Plan, signed by the government and European Commission in February 2005, provides a structured framework to advance the European integration agenda.

additional findings, in order to assess IFC's effectiveness in responding to changes in Ukraine's business climate.

Issues Focus of the Evaluation

14. The CAE will focus on four strategic objectives:

(i) Sustainable economic growth and integration into the world economy

- To maintain the momentum of growth in the medium term, the Bank program highlights four priorities: (i) consolidate macroeconomic stability and establish the conditions to achieve economic growth and long-term fiscal sustainability; (ii) improve the business environment and deepened the financial sector; (iii) develop a financially viable energy sector operating on commercial principles and improve infrastructure; and (iv) improve the institutional basis for a knowledge-based economy.

- What have been the sources of Ukraine's high growth and macroeconomic stability and what extent has the Bank program contributed? Have reforms in the financial sector been carried out? What has been the impact of high energy intensity in Ukraine and how has the Bank supported a reduction in energy intensity?

- Have the cost of doing business and administrative barriers to investment been lowered? To what extent has the business climate improved in response to reducing the oligopolistic nature of the economy and how has the Bank's program contributed to changes?

- What have been the institutional and legal requirements for WTO membership? What aspects of the Bank's program have contributed to meeting WTO requirements? What progress has been made in adopting EU legal and institutional requirements? What has been the Bank's role?

(ii) Restructuring of public sector, improved transparency, and accountability

- The Bank and the government maintained an extensive governance agenda covering taxation, public expenditure management, intergovernmental transfers, oversight and accountability, management of state-owned enterprises, public administration, and civil service reform. The Bank program also supported a wide spectrum of civil society activities ranging from advocacy to public education and oversight of local and regional governments. The aim was to enhance the role of civil society in monitoring, and assuring good governance and public sector accountability.

- Was the Bank's assistance strategy to improve public sector financial and expenditure management relevant, and what have been the outcomes? Are recent improvements in the public sector, including the steps in anti-corruption activities, sufficient to justify additional development policy lending? What is the impact of the pioneering "the People's Voice Project" in facilitating civil society growth?

(iii) Poverty reduction, comprehensive human development, and reduction of regional imbalances

- *Poverty reduction.* The fall in poverty incidence resulted from high economic growth and rapid increases in salaries and pensions. Poverty reduction responded more slowly in rural areas, and among vulnerable groups and regions.

- *Comprehensive and harmonized human development.* An important element of the government's *European Choice* program is the development of a healthy and highly educated citizenry, within a framework of assured rights and freedoms.

- What progress has been made in improving access to quality services in the education and health sectors? What progress has been made in achieving the Millennium Development Goals (MDGs)? What were the chief reasons for the Bank's limited early involvement in education and health sectors and what was the impact on Ukraine's program?

- *Reduction of regional imbalances.* Ukraine lacks a comprehensive vision of regional development. Limited progress has been made in regional policy due to combination of political, economic, and fiscal factors. What has been the Bank contribution to regional development? Have measures introduced during the review period to broaden the benefits of growth to the entire population?

(iv) Environmental sustainability

- CASs have paid particular attention to monitoring the implementation of environment legislation in Ukraine. Has progress been made in improving environmental policies and regulations? What are areas of progress, and areas where progress has not been made, and where there has been a decline?

15. The performance of Bank products and services (lending, analytical and advisory services, and aid coordination) intended to contribute to the achievement of CAS objectives will be examined. The Bank's lending program in Ukraine over the period under review relied heavily on adjustment lending, and the performance of the investment lending portfolio has been consistently below the region (see paras. 6 and 7). The CAE will examine whether the Bank selected the right mix of instruments to implement its strategy, and will also examine the performance of investment lending.

CAE Outputs and Timetable

16. The CAE will be issued to CODE during FY07, well before the next CAS. The task team will be led by Ismail Arslan (IEGCR) under the direction of Kyle Peters (Senior Manager, IEGCR). Consultations with the government will take place before issuing the report. Peer reviewers are John Johnson (IEGCR) and James Parks (LCSPR).