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PROJECT PERFORMANCE ASSESSMENT REPORT

UKRAINE

**FINANCIAL SECTOR ADJUSTMENT LOAN
(LOAN NO. 4391-UA)**

**PROGRAMMATIC ADJUSTMENT LOAN I
(LOAN NO. 4639-UA)**

**SECOND PROGRAMMATIC ADJUSTMENT LOAN
(LOAN NO. 4722-UA)**

January 9, 2008

*Country Evaluation and Regional Relations
Independent Evaluation Group (World Bank)*

Currency Equivalents (annual averages)

Currency Unit = Ukraine Hryvnia

1998	US\$1.00	\$2.45
1999	US\$1.00	\$4.13
2000	US\$1.00	\$5.44
2001	US\$1.00	\$5.37
2002	US\$1.00	\$5.33
2003	US\$1.00	\$5.33
2004	US\$1.00	\$5.32
2005	US\$1.00	\$5.12

Abbreviations and Acronyms

CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
DPL	Development Policy Loan
EDAL	Enterprise Development Adjustment Loan
EFF	Extended Fund Facility
FSAL	Financial Sector Adjustment Loan
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IAS	International Accounting Standards
ICR	Implementation Completion Report
IEG	Independent Evaluation Group
IMF	International Monetary Fund
NBU	National Bank of Ukraine
PAG	Privatization Advisory Group
PAL	Programmatic Adjustment Loan
PPAR	Project Performance Assessment Report
PSR	Project Supervision Report
SECAL	Sector Adjustment Loan
WTO	World Trade Organization

Fiscal Year

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To prepare a Project Performance Assessment Report (PPAR), IEGWB staff examine project files and other documents, interview operational staff, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

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Bank Performance: The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. *Possible ratings for Bank Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. *Possible ratings for Borrower Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Contents

Principal Ratings	v
Key Staff Responsible	vi
Preface	vii
Summary	ix
1. Country Context and Bank Assistance Program	1
<i>Introduction</i>	<i>1</i>
<i>Ukraine's Economic Performance, 1996-2006</i>	<i>1</i>
<i>Bank Assistance Strategy</i>	<i>2</i>
2. The Financial Sector Adjustment Loan	5
<i>Introduction</i>	<i>5</i>
<i>Sector Context and Analytical Underpinnings</i>	<i>5</i>
<i>Preparation, Objectives, and Design</i>	<i>6</i>
<i>Implementation</i>	<i>10</i>
<i>Outcomes and Assessment</i>	<i>12</i>
<i>Lessons</i>	<i>18</i>
3. The PAL Program	21
<i>Introduction</i>	<i>21</i>
<i>Objectives</i>	<i>21</i>
<i>PAL I. Preparation, Design, and Implementation</i>	<i>22</i>
<i>PAL I Achievements and Transition to PAL II</i>	<i>26</i>
<i>PAL II. Preparation, Design, and Implementation</i>	<i>26</i>
<i>Outcomes and Assessment of the Program</i>	<i>32</i>
<i>Lessons</i>	<i>40</i>
<i>Overall Lessons (including FSAL)</i>	<i>41</i>
Annex	
Annex A. Basic Data Sheet.....	43
Boxes	
Box 1: FSAL Components and Tranche Release Conditions.....	9
Box 2: State- and Former State-Owned Banks in Ukraine.....	10
Box 3: PAL I Benchmarks.....	23
Box 4: PAL II Benchmarks.....	29
Tables	
Table 1: Ukraine: Selected Macroeconomic Indicators, 1999-2005.....	2
Table 2: Supervision Schedule and Ratings.....	11
Table 3: Selected Banking Sector Indicators.....	13

Principal Ratings

	<i>ICR</i> ^{1/}	<i>ES</i> ^{1/}	<i>PPAR</i>
<i>Financial Sector Adjustment Loan</i>			
Outcome	Satisfactory	Satisfactory	Satisfactory
Sustainability ^{2/}	Highly Likely	Highly Likely	--
Risk to Development Outcome ^{3/}	--	--	Negligible to Low
Institutional Development Impact ^{4/}	Substantial	Substantial	--
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory
<i>Programmatic Adjustment Loan (PAL I)</i>			
Outcome	Satisfactory	Satisfactory	Satisfactory
Sustainability ^{2/}	Likely	Likely	--
Risk to Development Outcome ^{3/}	--	--	Negligible to Low
Institutional Development Impact ^{4/}	Substantial	Substantial	--
Bank Performance	Highly Satisfactory	Highly Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory
<i>Second Programmatic Adjustment Loan (PAL II)</i>			
Outcome	Satisfactory	Satisfactory	Satisfactory
Sustainability ^{2/}	Highly Likely	Highly Likely	--
Risk to Development Outcome ^{3/}	--	--	Negligible to Low
Institutional Development Impact ^{4/}	Substantial	Substantial	--
Bank Performance	Highly Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Moderately Satisfactory

^{1/} The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate IEGWB product that seeks to independently verify the findings of the ICR.

^{2/} This rating was discontinued as of July 1, 2006.

^{3/} This rating was introduced as of July 1, 2006.

^{4/} This rating was discontinued as of July 1, 2006. To the extent that the project has institutional objectives, performance is reflected in the Outcome rating.

Key Staff Responsible

<i>Project</i>	<i>Task Manager/Leader</i>	<i>Division Chief/ Sector Director</i>	<i>Country Director</i>
<i>Financial Sector Structural Adjustment Loan</i>			
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<i>Programmatic Adjustment Loan (PAL I)</i>			
Appraisal	Dusan Vujovic	Pradeep Mitra	Luca Barbone
Completion	Mark S. Davis	Cheryl W. Gray	Luca Barbone
<i>Second Programmatic Adjustment Loan (PAL II)</i>			
Appraisal	Dusan Vujovic	Pradeep Mitra	Luca Barbone
Completion	Mark S. Davis	Cheryl W. Gray	Paul G. Bermingham

Preface

This is the Project Performance Assessment Report (PPAR) on three adjustment loans to Ukraine from 1998 to 2005. These loans are the: Financial Sector Adjustment Loan (FSAL, Loan No. 4391), Programmatic Adjustment Loan I (PAL I, Loan No. 4639), and Programmatic Adjustment Loan II (PAL II, Loan No. 4722).

This PPAR is based on all relevant Bank and Fund documents and on interviews with Bank and Fund staff. A mission visited Ukraine in June 2006 to discuss performance with officials who implemented the projects, representatives of civil society, and members of the Bank resident mission.

Following standard Independent Evaluation Group (IEG) procedures, copies of the draft PPAR was sent to government officials and agencies for their review and comments. No comments were received from the Government.

This report was prepared by Manuel Penalver-Quesada (Consultant), with Ismail Arslan (IEGCR) as Task Manager. Agnes Santos and Roderick de Asis provided administrative support.

Summary

Introduction

1. This PPAR assesses three adjustment loans to Ukraine, prepared and implemented between 1996 and 2005. This long period covers the last years of economic decline experienced by Ukraine throughout the decade of the 1990s, (with GDP falling each year, to a level of about 40 percent of its starting point, by the end of the decade), as well as a period of strong recovery, starting in 2000 and continuing until 2006.

2. The Bank assistance strategy during this decade also changed substantially. In particular, the Bank approach to adjustment lending in Ukraine changed from one based on a variety of sector adjustment loans (SECALs) in the 1996 country assistance strategy (CAS), to one based on a series of multi-sector Programmatic Adjustment Loans (PALs) in the 2000 CAS. The three operations assessed in this report include one of the last two sector operations under the 1996 CAS (the Financial Sector Adjustment Loan) and the first two programmatic operations (PAL I and PAL II) under the 2000 CAS.

3. The SECALs had a rocky implementation, in line with the political and economic events of the period. The 2000 CAS, in its assessment of the previous CAS period concluded that *“the design of the adjustment assistance, based on a number of separate sector adjustment operations, proved to be a major shortcoming”* and proposed a more comprehensive program of Programmatic Adjustment Loans, with three annual, single-tranche PALs during the CAS period. PAL I and PAL II, were the first two adjustment operations emerging from the program outlined in the 2000 CAS.

4. This PPAR confirms that the outcome of the three operations assessed was *Satisfactory*, although there were shortcomings in some areas that are discussed below. In two cases (restructuring of Savings Bank in FSAL and energy privatization in PAL II) the shortcomings reflected an underestimation of the political difficulty of the reforms on the part of the Bank, led to delays in tranche releases, and required waivers. At the same time, the country’s economic progress was greater than anticipated at the beginning of the period in terms of economic growth and macro performance, improvements in the banking sector, and overall financial sector performance.

The Financial Sector Adjustment Loan (FSAL)

5. Preparation of FSAL took place during a period of initial improvements in overall macro policy following the hyperinflation of 1993-94. The reforms supported by FSAL covered three main areas: (i) legal framework of the banking activity (new Law on National Bank of Ukraine (NBU) and new Law on Banks and Banking Activity), (ii) informational and regulatory basis for banking (accounting principles, banking supervision and intervention of problem banks), and (iii) structure of the sector (future role of Savings Bank, role of deposit insurance, liquidation of marginal banks).

6. Given the sector conditions at the time, presented in an earlier (1995) financial sector review and in the FSAL documents, the objectives were adequate although the

third objective, related to the performance of private banks (including the former state banks), and the reform of one of the two remaining state banks (Savings Bank) was modest (and yet not fully achieved).

7. Country events had a negative impact on FSAL before Board approval: following completion of negotiations in February 1998, the macroeconomic program (and IMF Stand By arrangement) went off-track, causing a delay in FSAL approval. In August of 1998, the financial crisis in Russia, added to Ukraine's rapidly growing debt made it impossible for the country to roll over the T-bills (many owned by foreign investors) and forced a financial crisis that required a *de facto* external debt restructuring. The crisis, however, also helped the government to take corrective actions, and to reach agreement with the IMF on an Extended Fund Facility (EFF), in September 1998. The FSAL was approved shortly thereafter and became part of the financial rescue package to address the crisis.

8. Implementation of FSAL was affected by changes in the overall policy environment (the macro program went off-track in several occasions) and uneven progress in the financial sector reforms. Second tranche conditions were met with delays, and the tranche was released in September 1999, nine months later than scheduled. The delays led to two extensions of the closing date, as well as restructuring (and partial cancellation) of the third tranche. The decision to grant more time to the government to meet the third tranche conditions appears justified: in December 2000 the macro program was back on track, and the Banking Law was finally passed.

9. **Assessment.** The legislative and regulatory objectives of FSAL were achieved. In addition, by the time of FSAL closing, the country's economic performance had already turned the corner: the year 2000 saw GDP growth for the first time after a decade of decline, and the sector reforms and the economic recovery led to improvements in the financial sector. The specific objectives of FSAL regarding the performance of specific banks were also largely achieved (in some cases exceeded). Two large banks, however, fell short of the objectives established in their commitments to the NBU under FSAL: one was Bank Ukraine (a former state bank) and the other was Savings Bank (a state-owned bank). Improvements in the latter were a condition for third tranche release: as this was not met, the tranche was reduced and the condition was transferred to the PAL program. The resolution of Bank Ukraine was the subject of intensive discussions in the transition from FSAL to PAL I, and the bank was eventually liquidated (formally under PAL I). Institutional development impact was substantial, because of the impact of the FSAL on the regulatory and supervisory capacity of the NBU and the improvements in the large banks mentioned above. Credit for this institutional development impact is shared with the parallel technical assistance provided by several donors, particularly the European Union (EU) TACIS program and USAID. For all of the above, including high relevance, achievement of outcomes in each component, and institutional development impact, *the outcome of FSAL is rated satisfactory.*

10. In retrospect, the performance of Ukraine's banking sector between the time of FSAL approval and 2005 has gone well beyond the expectations of FSAL, and of a subsequent Bank financial sector review (in 2001). For example, the latter noted that, with the right policies, Ukraine could reach a deposit to GDP ratio of 16 percent in 2005:

the actual figure, in mid-2005 was close to 28 percent, and the 16 percent ratio was already exceeded by end-2002. Thus, what in 2001 was diagnosed as a problem of insufficient credit creation by the financial sector, in the 2005 FSAP Follow-Up Report and more recent assessments during 2006 has become a concern about asset quality as a result of the rapid credit expansion. In addition, the increasing number of acquisitions of Ukrainian banks by foreign banks, and the high prices paid for these acquisitions attest to the market perception of the strength of the sector. Therefore, *risk to development outcome is rated negligible to low*. Both Bank and Borrower performance are rated *satisfactory*.

11. The FSAP of 2003, and the FSAP Follow-up Report of 2005 noted that vulnerabilities continued to exist, particularly due to the rapid credit increase, the still limited supervisory capacity of NBU, and the continuing existence of a large number of small banks with unclear (and unknown) links to other economic groups. More recently, the Bank has also noted concerns regarding the high share of foreign currency lending by commercial banks. The remaining concerns point the way to possible additional assistance to the sector by the Bank.

12. Major lessons from FSAL are the importance of a sound legislative and regulatory framework in the financial system, and the greater role of the country's overall economic performance, as well as market forces, than of formal technical assistance, in achieving improvements in specific financial institutions. In particular, (i) establishing a sound legislative and regulatory framework for the financial sector is a necessary, but not sufficient, condition for financial sector development, (ii) strengthening the supervisory and enforcement capacity of the supervisory agency is essential to achieve the benefits of a sound legal and regulatory frame, (iii) technical assistance to strengthen poor performing institutions has poor results without a strong demand-pull, mainly from market forces, and (iv) restructuring and improving the performance of state-owned financial institutions is a slow and risky proposition in a poor governance environment.

The Programmatic Adjustment Loan (PAL) Program

13. The PAL program was proposed in the 2000 CAS as “the flagship operation for the Base Case scenario.” The program, introduced as an explicit change from the previous CAS approach based on sector adjustment operations, was seen as a sequence of single-tranche operations, based on achieved benchmarks, about one year apart.

14. The focus of the PAL program was on the same five thematic areas as the CAS, and included:

- Financial discipline in public and private sectors;
- Improvements in the regulatory framework for business;
- Transparent definition and protection of property rights;
- Public sector accountability and effectiveness; and
- Mitigation of the social costs of transition and improvements in the delivery of social services

15. **PAL I:** Preparation of PAL I started shortly after the 2000 CAS. Originally designed as a single-tranche operation, and scheduled for Board discussion in late FY01, it fell captive to political events: the government change in 2001 led to delays and to a change in the design, from a single tranche to a two-tranche operation (a first tranche of \$150 million and a second one for \$100 million). It was approved in September 2001.

16. The objectives and components of PAL I, and of the full PAL program, were presented along the lines of the five thematic areas above, with specific benchmarks already met for the first tranche of PAL I, conditions for release of the second tranche, and indicative benchmarks for PALs II and III. PAL I had a total of 16 benchmarks, reflecting the very broad coverage of the operation. There were few benchmarks for the second tranche, reflecting the fact that many of the reforms were already adopted during 2000 and early 2001, and the intention to reach disbursement of the second tranche shortly after the first tranche.

17. The Government requested an early second tranche disbursement but the Bank raised concerns regarding the further privatization of Oblenergos. A Presidential Decree annulling the earlier instruction was issued on December 3, and on December 6, 2001, the Bank approved disbursement of the second tranche. This initial concern with further privatization of Oblenergos was an early sign of later problems that persisted throughout PAL II and led to a waiver in the second tranche of PAL II, in mid-2005.

18. PAL I achieved its objectives and was particularly successful in the areas of financial discipline (arrears, collections) and of budget and treasury reforms. Progress in all other areas was also substantial although some of the early concerns (such as the one above) suggested the areas where difficulties would continue during PAL II.

19. At the time of PAL I closing (December 2002), Ukraine had experienced two consecutive years of high growth, and its external sector had improved substantially (foreign reserves doubled, the external debt was falling rapidly). The improved economic performance also had a dampening effect on the willingness to adopt politically difficult reforms. In this setting, the transition from PAL I to PAL II was slower, and more difficult than had been expected in the 2000 CAS.

20. **PAL II:** Preparation of PAL II took longer than anticipated. It lasted nearly two years, from February 2002 to December 2003, covered two governments, and took place in the context of continuing rapid growth and improvements in the external sector. In spite of the good economic performance, a major source of the delays in PAL II preparation was the fact that Ukraine's EFF program with the IMF was off-track during most of 2002. At the time of PAL II approval Ukraine had not been able to conclude a new (precautionary) Stand By agreement with the Fund. Although PAL II had been originally conceived as a single tranche operation, the above delays, and the absence of an IMF program led again to a two-tranche design.

21. The PAL II objectives and components were a continuation of those of PAL I. They were grouped under the same five areas of fiscal and financial discipline, regulatory framework, property rights, public sector efficiency and accountability, and management

of social and environmental risks. The benchmarks for first and second tranche were compared with achievements under PAL I, and expected outputs of PAL III.

22. Second tranche conditions were few, but some of these conditions proved difficult to achieve, leading to delays in tranche release and requiring waivers. The deteriorating political environment of late 2004, including the elections in October and December, and the contested outcome of the elections added to the difficulties in meeting the tranche conditions, and the closing date was extended to June 30, 2005.

23. After the new government was formed (in February 2005), the expected fiscal deficit for the year was close to 7 percent of GDP. The government introduced a revised budget to reduce the consolidated deficit to 2.2 percent of GDP, addressed inflationary pressures, and adopted several other macroeconomic stabilization measures. In June, the second tranche of PAL II was released with one waiver (on the adoption of a law on debt resolution in the energy sector) and a partial waiver (on the privatization of Oblenergos).

24. **Assessment and outcomes:** The PAL program was slower in preparation and implementation than it had been expected in the 2000 CAS. Instead of three PALs in the three years of the CAS there were only two PALs covering a five-year period (PAL III was converted into a different operation, Development Policy Loan (DPL) I in early FY06). The speed of the reform program was slower than initially anticipated, but progress took place in practically all areas, and the economic performance exceeded the expectations at the time of the 2000 CAS. The specific benchmarks of PAL I and PAL II, were all achieved with the exception of the energy debt restructuring law and the privatization of the Oblenergos.

25. In some areas, formal achievement of the benchmarks fell short of achieving the intended outcomes. In land titling, institutional problems with the creation of a land-titling agency (formally part of a parallel investment operation) meant that the benchmark (passing of the law) was not enough. Also, increasing transparency of the privatization process was not fully achieved in spite of the formal compliance with the procedures established and monitored by the Privatization Advisory Group (PAG).

26. Overall, however, these shortcomings should not detract from the achievements under the program. The achievements were substantial in the areas of fiscal and financial discipline, particularly regarding the energy sector and in spite of the remaining problems in the sector, in improving the financial performance of the government and of its treasury operations, of the financial sector, through the liquidation of Bank of Ukraine, restructuring of Savings Bank (which also took longer than originally expected) and improvements in the regulatory framework, and in the elimination of tax exemptions, privileges, etc. as well as a good beginning in the reform of the pensions system. The improvements seem more moderate in areas such as property rights and business environment, at least partially because of governance issues, and in the reform of public administration. The institutional development impact of PAL I and PAL II was also substantial. The program had a major role in supporting the change from a culture of arrears, poor collections and offsets, as barter, to one based on timely monetary transactions. Institutional development was also achieved in public sector agencies

(Treasury, pension system), and continued in the banking sector. Based on all of the above *the outcomes of PAL I and of PAL II are rated satisfactory.*

27. The assessment of the PAL program also confirms that the risk to the development outcomes of PAL I and PAL II is *negligible to low*, although recent issues have appeared regarding public procurement. *Bank performance is rated satisfactory for PAL I and PAL II, and borrower performance is rated satisfactory for PAL I and moderately satisfactory for PAL II.* The latter rating differs from the assessment in the review of the ICR, where it was rated satisfactory.

28. **Lessons:** Three major categories of lessons emerge from this assessment of the PAL program:

29. *Links and complementarity between the PAL (now DPL) program and investment lending need reinforcing.* The 2000 CAS presented the PAL program as the centerpiece of Bank assistance, with investment operations complementing this assistance in specific sectors. While this was a well thought through approach, in practice, the PAL program attempted to cover too many issues and areas, while the investment projects became too isolated and outside of the main dialogue. Paradoxically, this may have contributed to worsen the implementation of some investment projects. Looking forward, the core adjustment program should concentrate on main policy issues, while investment and other sector operations should focus on the related institution building objectives. In other sectors, the reform program in health and education, and in the environmental area, could have been more adequately pursued through other instruments, both lending and non-lending. An additional advantage of this approach would have been to simplify the very broad-based PAL operations.

30. *Politically difficult issues are noticeable during the early stages of program implementation and when crucial to the success of the program should be addressed early.* Several of the shortcomings noted above (privatization of Oblenergos, law—and implementation—regarding land titling, transparency in privatization) were potential deal breakers in 2004/05 but had already emerged at the beginning of the PAL program. When these “sticky issues” are crucial to the success of the program, they need early attention rather than postponement. Regarding the transparency of privatization objective, an over-ambitious objective that leads to accepting a dubious outcome risks conferring Bank legitimacy to a poor governance situation. As in the lesson above, over-reaching may result in a worse outcome.

31. *Tranching was not fully consistent with the PAL program approach and brought no obvious advantages.* The PAL program was conceived as a series of single tranche operation based on a medium-term program and achieved results. The tranching of PAL I and II was an ad hoc Bank response to uncertainty, which could have been equally or better addressed through adjustments in the timing and/or amount of each PAL. The new series of DPL operations should benefit from using the original approach of the PAL program.

Overall Lessons

32. In addition to the FSAL and PAL program lessons discussed above, the assessment of the three adjustment operations in Ukraine between 1998 and 2005 suggests some common lessons of experience.

33. *Both sector-specific and broad-based multi-sector adjustment operations can be successful, when adequately linked to the country's reform program and to the Bank's assistance strategy.* The FSAL was successful because it targeted a crucial sector in the country, and allowed the removal of a major binding constraint, while the PAL program was specifically designed to support the major components of the government program. When constraints on growth are multi-sectoral, cross-sector operations, albeit with selective thematic focus, may be the preferred way to go.

34. *Sector-specific adjustment operations require an adequate overall policy environment to achieve their intended results.* The FSAL was more successful than the earlier SECALs approved during the 1996 CAS period because, shortly after its approval, a broader policy reform effort started (following the September 1998 economic and financial crisis in Ukraine, and the coming to office of a reform-minded government in 1999).

Vinod Thomas
Director-General
Evaluation

1. Country Context and Bank Assistance Program

Introduction

1.1 This PPAR assesses three adjustment loans to Ukraine, prepared and implemented during a period of a decade, from 1996 to 2005. This period would cover a wide range of events in any transition economy: in the case of Ukraine, the changes in economic performance, external shocks, and political events of the period are even greater than average.

1.2 Bank assistance strategy during this decade also changed substantially, from that presented in the 1996 CAS (and adjusted in a CAS Update in 1998 and a progress report in 1999), to the 2000 CAS covering the period until 2003.¹ In particular, Bank approach to adjustment lending in Ukraine changed, from one based on a variety of sector adjustment operations in the 1996 CAS, to one based on a series of multi-sector Programmatic Adjustment Loans (PALs) in the 2000 CAS. This change reflected the Bank's perception that, starting in late 1999, the Government of Ukraine had embarked on a broader and more consistent economic reform program.

1.3 The three operations assessed in this report include one of the last two sector operations under the 1996 CAS (the Financial Sector Adjustment Loan) and the first two programmatic operations (PAL I and PAL II) proposed in the 2000 CAS.

Ukraine's Economic Performance, 1996-2006

1.4 Ukraine's economy suffered a severe decline throughout the decade of the 1990s, with GDP falling each year, to a level of about 40 percent of its starting point, by the end of the decade. This was followed by an equally strong recovery, including economic growth, and improving fiscal and external sector performance, starting in 2000 and continuing until 2005. Growth continued in 2005 and in 2006 but at a slower pace, while fiscal performance weakened and inflation rose again.

1.5 Following independence in August 1991, the dislocations related to the dismantling of the Soviet Union, as well as poor domestic policies, led to large GDP declines as well as hyperinflation in 1993 and 1994. Some measure of stabilization started in 1995, and continued in 1996 when the first Bank CAS was prepared, but output continued to decline until 1999.

1.6 In mid-1998 the Russia crisis provided an additional negative external shock which, combined with a mounting public sector debt, led to a financial and external debt crisis in August-September of 1998. The crisis was of a shorter nature than anticipated: not only Russia's recovery soon provided renewed demand for Ukraine's exports, but the crisis provided a needed impetus for economic reforms that had been faltering in earlier

¹ When a new CAS was prepared and reviewed by the Board (Country Assistance Strategy for Ukraine, Report No. 26448-UA of September 29, 2003).

years². As discussed later in the report, this impetus extended to the reforms supported by the FSAL.³

1.7 Starting in 2000, the economic recovery was remarkably strong. GDP grew by nearly 6 percent in 2000 and more than 9 percent in 2003. Thereafter GDP growth remained strong, exports also grew rapidly, generating large current account surpluses, reserves increased, and the external debt fell from more than 66 percent of GDP in 1999 to a low 20 percent in 2005⁴ (see table 1 below). GDP growth in 2005, was lower than in the previous years (at 2.7 percent) and inflation increased, but growth recovered again in 2006 (to an estimated 7.1 percent) and inflation moderated. This period of strong economic growth is the background against which completion of the FSAL (third tranche release), preparation of the PAL program, and implementation of PAL I, and PAL II took place.

Table 1. Ukraine: Selected Macroeconomic Indicators, 1999-2005*

	1999	2000	2001	2002	2003	2004	2005
Real GDP Growth (percent)	-0.2	5.9	9.2	5.2	9.6	12.1	2.7
Fiscal Balance (percent of GDP)	-2.4	-1.3	-1.6	0.5	-0.9	-4.4	3.0
Current Account Balance (% of GDP)	5.2	4.7	3.7	7.5	5.8	11.0	3.1
Public Debt and Arrears (% of GDP)	66.7	47.0	38.6	35.7	30.0	25.1	19.1
Inflation (CPI a.o.p.)	22.7	28.2	12.0	0.8	5.2	9.0	13.5
GDP (US\$ billion)	31.6	31.3	38.0	42.4	50.1	64.9	81.7
Foreign Exchange reserves (US\$ billion)	1.1	1.5	3.1	4.4	6.9	9.5	19.4

Source: PAL II ICR, Report No. 35811

Note: Preliminary data for 2006 includes GDP growth of 7.1 percent, current account balance of -1.5 percent of GDP and inflation of 9.1 percent.

Bank Assistance Strategy

1.8 The 1996 CAS was prepared at a time when the improvements following the 1994 election (of President Kuchma), and the success of the limited stabilization program, created hopes for a broader reform program. The expectation at the time was that the stabilization had created the basis for structural reforms in several areas, and the Bank planned to support them through several sector adjustment loans (SECALs). At about the time of the 1996 CAS, the Bank approved the first Enterprise Development Adjustment Loan (EDAL I), and this was followed by SECALs in the Agriculture and Coal sectors in FY97, and the FSAL and EDAL II in FY99 (they had been originally scheduled for FY98).

² An Ex-Post Assessment by the IMF has noted that “The 1998 financial crisis proved, with hindsight, a turning point” (IMF. 2005. “Staff Report for the 2005 Article IV Consultation.” In Ukraine: 2005 Article IV Consultation and Ex Post Assessment of Longer-Term Program Engagement—Staff Reports; Staff Supplement; and Public Information Notice on the Executive Board Discussion. IMF Country Report No. 05/415. Washington, D.C.: IMF.)

³ Although originally scheduled for Board discussion in March 1998, the FSAL was only approved in September 1998, after the crisis led to the adoption of a package of reforms. The macroeconomic program which was off track during early 1998 was put back on-track at that time and the IMF approved an EFF to Ukraine.

⁴ World Bank. 2005. Implementation Completion Report for PAL II. Table 1 (page 11).

1.9 Although the outcome of four of the five SECALs has been rated satisfactory at completion,⁵ all the SECALs had a rocky implementation, in line with the political and economic events of the period, and the overall assessment of the structural reforms accomplished during this period is less than positive: for example, the 2000 CAS, in its assessment of the previous CAS period concluded that *“the design of the adjustment assistance, based on a number of separate sector adjustment operations, proved to be a major shortcoming. Stand alone operations were not well suited to address cross-sectoral institutional and governance issues. This led to a situation in which reforms were reversed or stalled in some areas while Bank resources were disbursed in others. Because the design of the operations focused mostly on inputs rather than effective results on the ground, adjustment loans focused on the Government producing satisfactory laws and regulations, but did not wait for proper implementation.”*⁶

1.10 The first Country Assistance Evaluation (CAE) for Ukraine⁷ assessed the Bank’s assistance during the period 1992-98 and noted the limited achievements during the period, although it was too early to assess the impact of most of the SECALs (the CAE mission took place in September 1998, at the time of approval of FSAL and EDAL II). For the overall period of 1992-98 the CAE concluded that *“Development outcomes over the past six years have clearly been unsatisfactory. Living standards for most of the population have declined dramatically, and absolute poverty has increased rapidly since independence.”*⁸ It noted that (i) progress had been mixed in establishing a legal framework suitable for a market economy, (ii) the Bank’s assistance efforts in the energy sector had had limited success, (iii) in the agricultural sector the Bank and the government did not reach consensus on the basic spirit of the reform program, (iv) there had been progress on small-scale privatization, and (v) in the financial sector the strategy of focusing on strengthening the central bank and developing the regulatory infrastructure for a sound banking sector was relevant.

1.11 The more recent International Monetary Fund (IMF) ex-post assessment of this period⁹ is also negative. It notes that (i) the lack of policy resolve during mid-1995 delayed stabilization, and pushed the first Stand-by Agreement (SBA) off track, (ii) the second SBA (in 1996) helped achieve financial stability but the fiscal deficit was reduced mainly by running arrears, (iii) the initial EFF discussions failed, and a third SBA was approved (in August 1997) but fiscal adjustment continued to lag and the program went off track, and (iv) even when the EFF was finally agreed (in September 1998), stabilization policies under the EFF were broadly appropriate, but the program was derailed by lagging structural reforms.¹⁰

⁵ The Agriculture SECAL was rated moderately satisfactory.

⁶ World Bank. 2000. *Country Assistance Strategy for Ukraine*. Report No. 20723-UA, paragraph 48.

⁷ IEG. 2000. *Ukraine Country Assistance Evaluation*. Report No. 21358. Washington, D.C.: The World Bank.

⁸ *Ibid.* page 19.

⁹ IMF. 2005. “Staff Report for the 2005 Article IV Consultation.” (See footnote 2 above).

¹⁰ *Ibid.* page 11.

1.12 The 2000 CAS was prepared at a high point of optimism in the Bank's assessment of Ukraine performance and prospects: the economic recovery had started, and the combination of the Presidential elections of late 1999 (which broke the stalemate between President and Parliament), with a newly installed reformist government (under PM Yushchenko) had good promise for a more successful program of economic reform and governance improvements. Given its poor assessment of the previous approach to adjustment lending (above), the 2000 CAS proposed a more comprehensive program of Programmatic Adjustment Loans, with three annual, single-tranche PALs during the CAS period. The PAL I and PAL II operations assessed in this report were the first two operations emerging from the program outlined in the 2000 CAS.

2. The Financial Sector Adjustment Loan

Introduction

2.1 The Ukraine FSAL, approved in September 1998, was the last of the five sector adjustment operations, approved during the period covered by the 1996 CAS.¹¹ The five operations turned out to account for a much larger share of the total program than had originally been anticipated, and at the time of the subsequent CAS (2000) they accounted for more than two-thirds of total loan commitments, and a much higher share of disbursements.

2.2 Although prepared and approved during the 1996 CAS period, the FSAL's straddled the 2000 CAS period because of its long implementation (the third tranche was disbursed, and the loan closed, in February 2001, after two extensions of the closing date). Thus, although prepared and approved in earlier, more difficult times, it closed well after the economic recovery had started (and with it, the improvements in the financial sector performance). It is against this background, and the overall assessment of the assistance strategy of the period, that the FSAL design, implementation and achievements need to be assessed.

Sector Context and Analytical Underpinnings

2.3 Ukraine's financial sector at the time of preparation of the FSAL was worrisome. The Bank's financial sector report of 1995,¹² prepared shortly after the near hyperinflation of 1994, and with the economy still in a sustained decline, summarized the situation as follows: "*The unfavorable circumstances of the five past years have already combined to diminish the size and significance of the sector, and the crisis in the banking sector which emerged early in 1995 now threatens a further downsizing of its importance*".¹³ The report noted the financial sector decline since the early 1990s, with net domestic assets of the banking sector falling from 42 percent of GDP in 1992 to 14 percent in 1994, and total deposits (including foreign) falling from 45 percent to 11 percent of GDP.

2.4 The Bank's report discussed in detail the weaknesses of the sector and outlined a strategy for addressing these weaknesses that provided the analytical underpinnings for the subsequent FSAL. The main areas covered by the analysis and recommendations, taken up later in the FSAL, were the need to improve the legal and regulatory framework of the banking sector, to improve the supervisory and regulatory authority and skills of the National Bank of Ukraine (NBU), and to address the specific problems of the three main groups of banks at the time: the remaining state banks (Savings Bank and Exim

¹¹ The FSAL was approved together with the Second Enterprise Development Loan (EDAL II). The three previous adjustment operations were EDAL I in FY96, and the Agriculture Sector Adjustment Loan and Coal Sector Adjustment Loan in FY97.

¹² "*Ukraine. Risks and Transition: A Review of the Financial Sector*", Report No. 14526UA, June 30, 1995 (in two volumes).

¹³ *Ibid*, Executive Summary paragraph 2.

Bank), the former state banks (Prominvest, Ukrsofs Bank and Bank Ukraina) which had been “corporatized” in 1991, and the new private banks. The report also covered the development of capital markets, the insurance sector, and the regulation and supervision of non-bank financial institutions.

2.5 The evolution of Ukraine’s financial sector in the decade following the Bank’s 1995 report has been documented in several subsequent studies, including another comprehensive financial sector report by the Bank in 2001,¹⁴ a joint IMF-Bank Financial Sector Assessment Program (FSAP) in 2003,¹⁵ an IMF update of the FSAP in 2005,¹⁶ and a recent Bank report on the non-banking financial sector.¹⁷ These reports, while noticing the continuing vulnerabilities of the sector throughout the period and until today, also record the very rapid growth of the sector, its gradual strengthening and increasing profitability, as well as the recent trend of acquisitions of Ukrainian banks by foreign institutions. Most strikingly, they also show the change in the concerns, from one of declining size and insufficient supply of credit (e.g. in the World Bank reports of 1995 and 2001), to one of very rapid credit increase and the attendant risks of asset quality and vulnerability to an economic slowdown (in the FSAP Follow-Up report of 2005). The concerns about asset quality and vulnerabilities because of rapid credit expansion (and a high share of domestic lending in foreign currencies) continued during 2006. A summary overview of this transformation is presented below, in the discussion of the FSAL outcomes.

Preparation, Objectives, and Design

2.6 Preparation of the FSAL took place during a two-year period, from mid-1996 to early 1998.¹⁸ During this period there were initial improvements in overall macroeconomic policy following the hyperinflation of 1993 and 1994 (a currency reform introduced the new currency—the Hrivna (UAH)—in September 1996, and inflation in 1997 was down to 16 percent) while, in the financial sector, the NBU acquired full authority to license banks and carried out a re-licensing process for existing banks. At the same time, however, the economic decline continued and the fiscal situation was still one of substantial deficits increasingly financed, particularly after 1997, by a growing volume of Treasury bills. The T-bills had high yields (which kept increasing with every auction after the East Asia crisis in mid-1997) and a large percentage was sold abroad.

¹⁴ World Bank. 2001. *Ukraine. The Financial Sector and the Economy: The New Policy Agenda*. Washington, D.C.: The World Bank.

¹⁵ IMF and World Bank. 2003. “Financial Sector Assessment Program—Review, Lessons, and Issues, Going Forward” In IMF Country Report No. 03/172.

¹⁶ IMF. 2005. “Developments in Ukraine’s Financial Sector—FSAP Follow-up Report.” In IMF Country Report No. 05/416.

¹⁷ Fursova, Olena, Zeynep Kantur, Michel Noel, Angela Prigozhina, and Sue Rutledge. 2006. “The Development of Non-Bank Financial Institutions in Ukraine: Policy Reform Strategy and Action Plan.” World Bank Working Paper No. 81. Washington, D.C.: The World Bank.

¹⁸ Appraisal took place in November 1997 and negotiations were completed in February 1998.

2.7 Country events had a negative impact on FSAL even before Board approval, which had been scheduled for March 1998, following the successful completion of negotiations in February. Outstanding Board presentation conditions were met by March 15, 1998, but by that time Parliamentary elections (also in March) created an impasse: the anti-reform parties won 171 out of 450 seats, while the pro-reform parties won only 151. The balance was held by a group of other parties and independents, and this created a deadlock on policy decision-making. Shortly thereafter (late March) the macroeconomic program (and IMF Stand By arrangement) went off-track, causing a delay in FSAL approval.¹⁹

2.8 In addition, in August of 1998, the financial crisis in Russia, added to Ukraine's rapidly growing debt made it impossible for the country to roll over the T-bills (many owned by foreign investors) and forced a financial crisis that required a *de facto* external debt restructuring. The crisis, however, also helped the government to take corrective actions, and to reach agreement with the IMF on an EFF, in September 1998. The FSAL was approved shortly thereafter and became part of the financial rescue package to address the crisis.

2.9 The FSAL was approved by the Board on September 15, 1998, and declared effective on September 18, 1998. The initial project supervision report (PSR) noted that formal compliance with Board conditions had been met earlier in the year, that no backsliding had taken place and that there had been progress in several areas.²⁰

Objectives

2.10 The main objective of FSAL was to underpin the macroeconomic reform program in Ukraine through a comprehensive set of policy measures intended to strengthen the financial sector, with a special emphasis on the banking system, while EDALs I and II supported complementary reforms in capital markets. The reforms supported by FSAL covered three main areas: (i) legal framework of the banking activity (new Law on NBU and new Law on Banks and Banking Activity), (ii) informational and regulatory basis for banking (accounting principles, banking supervision and intervention of problem banks), and (iii) structure of the sector (future role of Savings Bank, role of deposit insurance, liquidation of marginal banks).

2.11 As the 2000 CAS noted later, FSAL, like the other adjustment loans of the period in Ukraine, focused on inputs and adoption of laws and regulations, without specifying effective results on the ground. Thus, the FSAL report does not include a set of expected outcomes nor measurable outcome indicators against which to measure the success of the

¹⁹ Shortly after the postponement of FSAL and EDAL II, the Board reviewed the country strategy progress report and noted in its concluding remarks that the Directors recognized the fragile nature of Ukraine's present macroeconomic condition, especially the unsatisfactory situation of its fiscal accounts and endorsed the provision of significant Bank technical support for the preparation of the IMF's Extended Fund Facility. The Board expressed the hope that agreement on this program could be achieved with less delay, thus providing the macro environment for the submission to the Board of the two new adjustment loans that were delayed from March and the release of further tranches of earlier adjustment loans.

²⁰ November 10, 1998.

operation. The policy matrix includes a list of issues and objectives as well as specific actions prior to approval and as conditions of tranche release. The Government's memorandum of financial sector development policy also discusses the proposed actions at length, while stating the objectives in somewhat general terms (for example, providing a stronger legal framework to regulate and support banks, ensuring that the information provided by the banks is compatible with generally accepted international standards, and producing a stronger and more competitive banking sector) but does not include outcome indicators either.

2.12 The implementation completion report (ICR) cast the FSAL objectives also in a general way, as (i) support the balance of payments and budget financing needs of the period 1998-99, (ii) strengthen the financial sector, (iii) to mitigate the direct budgetary cost of the reform program in the financial sector, and (iv) to provide a framework of reform to guide technical assistance support to the sector by other donors. The somewhat vague characterizations of objectives and expected outcomes, as well as the greater focus on inputs, noted by the 2000 CAS, are consistent with the "vintage" of the operation although, as noted above, the earlier (1995) financial sector report had analyzed in detail the structure and issues of the sector and had provided a detailed sector strategy.

Components

2.13 The main components of the FSAL can be grouped under the three areas of legal framework, regulatory reforms, and structure of the sector, plus its links to macroeconomic policy framework. The items included in the policy matrix, including second and third tranche conditions are summarized in box 1 below.

2.14 The project objectives and components were not changed during project implementation, except for the restructuring preceding the third tranche release, which is discussed below, in the implementation section. An FSAL report noted that the fiscal costs of the reform, linked to the introduction of tax deductibility of loan loss provisions, repayment of guaranteed/directed loans by the former state banks, and restructuring costs for the Savings Bank, would be considerable, but did not provide any estimate of such costs. The FSAL did not provide any technical assistance but indicated that ongoing assistance by other donors as well as by the Bank was already present, and a report includes an annex listing the technical assistance from other donors.²¹

2.15 The objectives and components of the FSAL were consistent with the assessment of the sector and with the strategy proposed in the 1995 financial sector report. They were adequate considering the country and sector conditions at the time, although they were weak in dealing with the problems of the remaining state banks (particularly Savings Bank) and of the former state banks that had been "corporatized" but not yet truly privatized and were still subject to frequent government interference (see also box 2 below). Eventually, the delays in the restructuring of Savings Bank were part of the reduction of the third tranche and continued to be addressed under the PAL program, while of the three former state banks, one (Bank Ukraina) was closed (also under the PAL, although the

²¹ Additional Bank technical assistance for the sector was to be provided by a (then) proposed Financial Services Project. This project, however, did not materialize.

Box 1. FSAL Components and Tranche Release Conditions

Stable Macroeconomic Environment

Establish and maintain an appropriate macroeconomic framework:

- *First tranche* (met prior to Board approval): maintain a macro framework consistent with the program, based on indicators agreed by the Government and the Bank/IMF, and progress achieved in carrying out the program.
- *Second tranche*: same as above
- *Third tranche*: same as above

Maintain liberal interest rate policy:

- *First tranche*: maintain interest rates largely free and generally positive
- *Second tranche*: same as above
- *Third tranche*: same as above

Legal Framework for Banking Activity

New law on National Bank of Ukraine (NBU)

- *Second tranche*: Approval of NBU Law

New law on Banks and Banking Activity (including provisions for NBU intervention in banks)

- *Second tranche*: submission of draft law to Parliament
- *Third tranche*: approval of the law

Informational and Regulatory Systems

Introduction of International Accounting Standards (IAS) by NBU (achieved prior to negotiations)

Commercial banks to report to NBU in IAS-consistent format

- *First tranche only*: small subset of IAS reporting forms mandated by NBU

Introduction of IAS accounting in commercial banks

- *First tranche only*: Conversion mandated by NBU

Improved arrangements for loan loss provisioning and tax treatment (legislation passed prior to negotiations)

- *Second tranche*: NBU to require banks to fully provision all “loss” loans
- *Third tranche*: NBU to require banks to fully provision all classified loans

Reorganize and strengthen bank supervision in NBU (following department reorganization)

- *First tranche only*: NBU Board to approve strategy for bank supervision

Improve off-sight surveillance of banks

- *First tranche only*: approve improvements in prudential regulations

Improve on-site examination of banks

- *First tranche*: NBU to prepare detailed two-year program of bank examinations
- *Second tranche*: on-site inspections for 60 percent of total bank assets completed

Banking Sector Structure

Strengthen arrangements for licensing new, and re-licensing existing banks

- *First tranche*: develop the policy for referral of banks failing statutory capital requirements to Bank Resolution Unit and develop criteria for solution or liquidation
- *Second tranche*: remove licenses to all banks not meeting minimum capital requirements, and liquidation started

Establish enforcement capacity and procedures to address problem banks

- *First tranche*: Enforcement Resolutions signed for an additional 21 banks
- *Second tranche*: initiate liquidation procedures for no less than three banks
- *Third tranche*: liquidation procedures initiated for at least half of all insolvent banks

Assess capacity and define role of Savings Bank

- *First tranche*: Supervisory Board to approve outline of strategic plan
- *Second tranche*: four specific sub-components of plan implemented
- *Third tranche*: three additional sub-components of plan implemented

Establish intervention mechanisms to prevent systemic spill-over from illiquidity problems in larger banks

- *First tranche only*: NBU approval of contingency planning and emergency procedures, establishing Working Group, seeking short term external advice

Specific interventions in former State Banks

- *First tranche*: Presidential Decree or Council of Ministers (CoM) resolution on schedule of Government, debt repayments, and scheme for privatizing remaining state shares
- *Second tranche*: NBU to review performance of Work-Out units, Government to complete debt repayment and reduce stock of guaranteed/directed loans
- *Third tranche*: Government to further reduce guaranteed/directed loans to UAH 100 million

Establish a sound system of Deposit Insurance

- *First tranche*: complete technical work for viable deposit insurance scheme
- *Second tranche*: submit revised Deposit Insurance law to Parliament
- *Third tranche*: Parliament adoption of Law on Deposit Insurance and implementation of scheme.

decision was reached on December 15, 2000 prior to the third tranche release) and the other two (Prominvest and Ukrsots Bank) were fully privatized and are now operating profitably.

Box 2. State- and Former State-Owned Banks in Ukraine

Before independence in 1991, Ukraine's banking sector was comprised of five Ukrainian departments of the USSR Gosbank. Although specialized by function, these five "banks" were little more than channels either for allocation of credit resources determined by central planners or, in the case of the Savings Bank, for the collection of household savings deposits, also for centralized reallocation. In 1991, they became independent banks, but with few of the commercial skills of modern commercial banks.

Throughout the 1990s, and despite the rapid growth of the newly created private banks, the five specialized banks continued to dominate Ukraine's banking sector. These banks were Prominvest Bank (the industrial bank), Bank Ukraina (the agricultural bank), Ukrsots Bank (the social sector bank) the State Export-Import Bank-EXIM (the foreign trade bank) and Oschadny Bank (the Savings Bank). By the time of FSAL preparation, the last two of these banks were still wholly owned by the government while Prominvest, Bank Ukraina and Ukrsots Bank were notionally private ("corporatized") with ownership vested in state owned enterprises and/or their employees, and governance fragmented and ineffective. Also throughout the 1990s, all the banks received large amounts of technical assistance from different sources, in an attempt to introduce modern banking practices.

For the former state banks, the FSAL approach was to require NBU to apply the new and strengthened legislation as well as supervisory and enforcement capacity to ensure liquidity and solvency (while insisting, at the same time in the government paying its debts to the banks and reducing the level of guaranteed/directed lending), or to move to liquidation. During the FSAL two of the three former state banks (Prominvest and Ukrsots), were fully (truly) privatized, as strategic investors acquired controlling interests in the banks, and managed to improve operations, capitalization rates, as well as liquidity and solvency. The third, however (Bank Ukraina) was unable to meet the conditions set out by NBU and, during the last months of FSAL, agreement was reached that liquidation procedures would be started. The decision to start liquidation procedures for Bank Ukraina became part of the "first tranche" conditions of PAL D).

For the two remaining state-owned banks (EXIM and Oschadny), the Bank agreed to support restructuring plans to make these two banks more efficient, and to help them meet all requirements set out by NBU. In the case of EXIM, this was pursued through project lending, with an operation (credit line) providing financial resources and technical assistance to EXIM. For the Savings Bank, the approach was to include its restructuring plan among the main conditions of FSAL, with specific components for the second tranche (registration as joint stock company with 100 percent state ownership, strengthening of credit function, restructuring of loan portfolio and detailed plan for the creation of a treasury function), and for the third tranche (initiate rationalization of branch network, operationalize treasury function, and finalize IT, product development and market strategy, and HR policy).

Restructuring of Savings Bank was not achieved during the FSAL (the third tranche was reduced because of this), and it became a major objective of the PAL program, requiring considerable time and effort. By 2003, with the economy and the financial sector already growing rapidly, the FSAP noted that the two state banks accounted for 12 percent of the sector and that "the risks to the Savings Bank represent the largest single challenge to the system" because, adjusting for provisions, the bank had a substantial shortfall relative to NBU's 8 percent capital adequacy requirement, reinforced by recurrent losses until 2001, and high operating costs due to its extensive branch network and large number of staff.

Under the PAL program, the Savings Bank entered into a formal Memorandum of Understanding with NBU, which limited its lending activities, reduced its administrative costs, and allowed it to reach the capitalization levels required by NBU regulations, primarily out of its own revenues (plus a government capital injection of UAH 400 million. By late 2005, the bank was profitable and well managed, and in early 2006 it has moved into a next stage in which lending activities may start to increase again, while remaining under close oversight of NBU.

The limitations on lending by the Savings Bank during the early 2000s, combined with the explosive growth of the sector, has reduced substantially the Savings Bank share in the sector (its deposits are about 8 percent of the sector, mostly invested in treasury bills). Thus, its potential for systemic risk to the sector is limited, although its new lending power could change this somewhat, while the risk of renewed government involvement and deterioration in governance of the bank remains. Most importantly, a strategic decision regarding the future of the Savings Bank is still missing, nearly a decade after it was seen as an important step during the preparation of FSAL.

Implementation

2.16 Implementation of the FSAL was rocky from the start. After approval, implementation continued to be subject to the impact of the overall policy environment, with uneven progress leading to two extensions of the original closing date (from the original one of December 1999 to June 2000, and again to February 2001), and a restructuring (and partial cancellation) of the third tranche. An overview of the

implementation difficulties can be gauged from the evolution of supervision ratings in the archived PSRs (table 2 below).

Table 2. Supervision Schedule and Ratings

<i>Report #</i>	<i>Date</i>	<i>DO</i>	<i>IP</i>	<i>Comments in PSR</i>
1	11/10/98	S	S	Initial PSR
2	12/21/98	S	S	Second tranche release by year end (original schedule) unlikely. March 1999 is a more realistic date.
3	06/25/99	S	S	Progress on 2 nd tranche conditions good, but problems in: banking legislation, deposit insurance and bank liquidations. 2 nd tranche expected early FY00.
4	12/22/99	U	U	2 nd tranche disbursed in 9/99. Progress since then disappointing. Main issues: deposit insurance law, Savings Bank, loan loss provisions. Government still anxious to complete reforms and receive 3 rd tranche by mid-2000.
5	12/30/99	S	S	Ratings upgraded eight days later. Mentions appointment of PM Yushchenko. Recommends extension of closing date to June 2000.
6	06/23/00	U	U	Progress on 3 rd tranche conditionality disappointing. Government confirms willingness to implement conditions but unlikely by 6/30 closing date.
7	06/29/00	S	S	Ratings upgraded six days later. Progress now described as "mixed." Proposes extension of closing date, mission in Fall, restructuring and partial cancellation. Link with PAL proposed.
8	11/28/00	U	U	Closing date was extended to 12/00. Progress since then disappointing. Main problem: interference with Savings Bank lending.
9	01/25/01	S	S	Last PSR. EFF restored 12/29. Banking law also passed in December. Restructuring and partial cancellation.

2.17 The sequence of PSRs shows that, after the initial delays in Board approval, from March to September, 1998 (due to the macroeconomic program going off-track) there was no backtracking on Board conditions and some progress on other reforms. Second tranche conditions, however, already experienced some additional delays, and the tranche was released in September 1999, nine months later than originally scheduled. From mid-1999 to late 2000, it appears that progress was very limited, and the development objective (DO) and implementation progress (IP) ratings were nearly constantly "Unsatisfactory (U)". The ratings were upgraded twice, in December 1999, and in June 2000,²² in each case along with a proposal to extend the closing date.

2.18 In retrospect, the decision to grant some more time to the government to meet the third tranche conditions appears justified: in December 2000 the macro program was back on track (the EFF, interrupted earlier, was restored), and the Banking Law was finally passed. The handling of PSR ratings, however, should have been more transparent: instead of introducing upgradings shortly after the unsatisfactory ratings to justify the closing date extension it would have been preferable to maintain, at least, a U rating for IP while arguing that achievement of the DO could be supported by the extension.²³

²² In each case only a few days after unsatisfactory ratings were recorded.

²³ None of the PSR for the FSAL includes management comments. This makes it more difficult to reconstruct the process that led to the reversal in ratings within a few days.

2.19 The uneven (and slow) progress in meeting the conditions of the loan (mainly regarding the legislative and regulatory framework, the supervisory work of NBU, the introduction of new accounting standards, and dealing with the remaining and former state banks) took place at a time when other (more positive) changes were taking place in the general economic conditions and the financial sector as a whole.

2.20 Although the 2001 financial sector report found that the banking sector as a whole experienced losses in 2000 (after recording profits in earlier years), it also noted that the losses were largely driven by the losses of twelve banks “particularly the largest, which were being forced to push to make previously unrecognized provisions”).²⁴ Thus, the accounting losses of 2000 were largely the result of accounting for the losses experienced, but not recorded, in previous years. At the same time, the economy had started to grow (following a fast recovery of the Russian economy) after ten years of falling GDP and, based only on the activities of the year the financial sector was more profitable than the “catching up” in provisioning made it appear. Moreover, the former state banks were also changing hands at the time: a controlling stake in Ukrspots Bank was sold to an Ukrainian investor in 1999.

2.21 Following a third and final extension of the closing date, from December 2000 to February 2001, the Government and the Bank agreed that of the six specific conditions for third tranche release (other than the macroeconomic framework condition—see box 1 above) three were fully met (approval of the new law on Banks and Banking Activity, liquidation of at least 50 percent of insolvent banks and reduction of government guaranteed/directed loans to no more than HUA 100 million), but of the other three one would be only partially met (full provisioning for classified loans) and two would not be met (progress in restructuring of Savings bank, and approval of the Law on Deposit Insurance). As a result, the project was restructured, and the third tranche reduced (to \$60 million). The two unmet conditions were incorporated into the PAL program that was being prepared at the time.

Outcomes and Assessment

Overview

2.22 At the time of the closing of FSAL, the assessment of the outcomes in the sector, as reflected in the 2001 Financial Sector Report was extremely cautious. Inevitably, the experience of the previous decade, with its major shrinking of the sector, which went beyond the extent of the GDP decline, was a major source of this caution. The report noted that there had been considerable progress, since the time of the previous report six years earlier, in the legal, regulatory, and supervisory framework for banking, but it added that “*Regrettably this progress has not translated into a major improvement in the financial health and general performance of the sector. Nor, more importantly, has it led*

²⁴ Financial sector report 2001, paragraph 5.3.

to the significant increase in the size of the sector and its capacity to deliver credit and other products in the amounts that Ukraine large productive sector needs.”²⁵

2.23 This cautious assessment was justified at the time as the report found that bank credit and deposits had stagnated until 1999 (the last year for which data was available during the preparation of the report),²⁶ with deposits hovering around 10 percent of a declining GDP. The report also tempered the assessment by noting some progress in the restructuring of some former state banks (Ukrsofs Bank and Prominvest) which had reached their recapitalization targets (but noting the still serious problems faced by Bank Ukraina and Savings Bank). The final published version also noted that, in 2000, deposits had increased by about 2 percentage points of GDP.

2.24 In retrospect, it appears that the financial sector was at a turning point at the time of the 2001 report, partly as a result of the earlier policy and institutional improvements but mostly as a result of the big economic turnaround that started in 2000. For example, the 2001 report, in a section called “A Perspective on Achievable Progress Through 2005” notes that, with the right policies, Ukraine could reach a deposit to GDP ratio of 16 percent in 2005: the actual figure, in mid-2005 was close to 28 percent, and the 16 percent ratio had been exceeded already by end-2002. Thus the performance of Ukraine’s banking sector, in terms of growth, between the time of FSAL approval and 2005 has gone well beyond the expectations at the time of FSAL approval, and of the financial sector review at the time of FSAL closing. An overview of the sector performance following FSAL is summarized in table 3 below.

Table 3. Selected Banking Sector Indicators

	2000	2001	2002	2003	2004	June 2005
Deposit GDP Ratio	11.4	12.8	16.9	23.4	24.1	27.9
Credit/GDP Ratio	12.4	14.5	19.4	26.6	27.1	30.7
Credit Growth (year over year)	61.3	40.5	47.3	60.8	31.2	33.9
Non performing loans (NPL)*/total loans	29.6	24.6	21.9	28.3	30.0	23.1
NPL**/Total Loans	n.a.	n.a.	n.a.	8.5	8.9	6.6
Liquid assets/Total assets	20.8	15.3	13.5	15.3	16.7	15.1
Customer deposits/Loans	59.1	87.6	87.6	87.1	89.2	91.2
Return on assets	-0.1	1.2	1.2	1.0	1.1	1.2
Return on equity	-0.5	7.5	8.0	7.6	8.4	9.2
Banks not meeting capital adequacy	7	3	1	1	2	0
Banks not meeting prudential regulations	27	21	16	9	14	9

Notes : * Including substandard, doubtful and loss

** Excluding timely served substandard loans

Source: IMF, FSAP Follow-up Report, 2005

2.25 Paradoxically, what in 1995 and 2001 was diagnosed as a problem of insufficient credit creation by the financial sector, in the 2005 FSAP Follow-Up Report by the IMF (and in a more recent macroeconomic assessment by the Bank) has become a concern about asset quality as a result of the rapid credit expansion. At the same time, the increasing number of acquisitions of Ukrainian banks by foreign banks, and the high prices paid for these acquisitions suggests a positive market perception of the strengths of the sector. It is difficult to assess to what extent to this progress was the result of the

²⁵ Financial sector report 2001, paragraph 1.3.

²⁶ An early version of the report was discussed at a seminar in Kyiv in August of 2000.

reforms introduced by FSAL, or the result of the overall economic recovery, but there is little doubt that the contributions of the FSAL, particularly in terms of improving the legislative framework and the supervisory and enforcement capacity of the NBU, as well as in resolving the issues with the larger banks (see box 2) were positive and sustainable.

2.26 At the same time, the FSAP of 2003, the (IMF) FSAP Follow Up Report of 2005, and the Bank's recent report on Non-Bank Financial Institutions (of June 2006) note that vulnerabilities continue to exist, and that "At the moment, the largest vulnerability of the banking sector stems from the downside macroeconomic risks and their potential impact on the repayment ability of borrowers, particularly given the rapidly expanding credit portfolio, notably in the real estate sector."²⁷ Other issues mentioned include, for some banks, concerns about capitalization and profitability, risk management, related-party lending, widening maturity mismatches and still high non-performing loans ratio. A more recent concern refers to the high share of domestic lending in foreign currency by commercial banks (including in the housing market). For the sector as a whole, improving the supervisory and structural framework of the banking sector (amendments to the Banking Act to require identification of bank owners, further strengthen banking supervision), and achieving greater transparency in the insurance sector (with companies tied to banks, and some activities related to tax avoidance) are some of the major challenges. Thus, the agenda for further reforms in the financial sector is still considerable and points the way to possible additional assistance to the sector by the Bank (see also the discussion of PAL II below).

Relevance

2.27 The above discussion, and the poor condition of the sector at the outset of FSAL, means that its relevance was high. The objectives and all its components were very relevant, as the legislative, regulatory, and supervisory reforms, as well as the strengthening of the state banks, were necessary conditions for the recovery of the sector. The only concerns applied to what was not included: a tougher approach earlier on to the main problem banks (particularly Bank Ukraina and Savings Bank). Yet, as noted above, although the decision to liquidate Bank Ukraina was not a formal condition of FSAL, and was listed as a benchmark for PAL I, it was achieved prior to third tranche release. At the same time, the delays in implementation of the Savings Bank restructuring, discussed in box 2 above, suggests that an even more ambitious agenda (for example, liquidation or privatization of Savings Bank) would have been overloading the system at the time.

Quality at Entry

2.28 The assessment of quality at entry is closely related to the above. As discussed, all the objectives and components were relevant, the analytical underpinnings of the reforms were sound and based on previous analytical work, and the policy and institutional reforms were accompanied by technical assistance support provided by other donors. Therefore, quality at entry is rated *satisfactory*.

²⁷ FSAP Follow-Up Report, paragraph 134.

Outcome by Objective and Component

2.29 The outcome of each of the major objectives/components is summarized below:

- ***Macroeconomic environment:*** (i) maintain an appropriate macroeconomic framework and (ii) maintain a liberal interest rate policy. As noted earlier, the FSAL was approved shortly after the agreement between the government and the IMF on an EFF agreement, and FSAL implementation overlapped with that of the EFF, including periods in which the EFF program went off track. In terms of outcomes (see table 1 above), the FSAL covered the last year of declining GDP (1999) as well as two years of rapid growth (2000 and 2001, with growth rates of 5.9 and 9.2 percent respectively). The financial sector growth was also fast after 2000 as shown in table 3 above. *Thus, this outcome was achieved, although with periods of failure, and is rated satisfactory.*
- ***Legal framework:*** the component included two main benchmarks (i) the NBU law (second tranche release condition) was approved in May 1999 (the tranche was released in September 1999), and (ii) the Banks and Banking Activity law (third tranche condition) was approved in December 2000 (the third tranche was released in February 2001). A third legislative benchmark (approval of a Deposit Insurance law was part of the “Banking Sector Structure” component and is discussed below. The two benchmarks were achieved, although with delays in both cases. In terms of outcomes the two laws had a significant positive impact on the transformation and rapid growth of the financial sector that took place starting in 1999 and continued until today. The 2003 FSAP noted that the two laws were “sound and broadly consistent with international banking practices” and that “These laws have been supplemented by a large number of other laws, presidential decrees, NBU directives and other normative provisions, resulting in a comprehensively regulated financial system”.²⁸ Thus, the *outcomes of this component were achieved, although with delays in the legislative approval and it is rated satisfactory.*
- ***Information and regulation of the banking system:***
 - (i) the introduction of international accounting standards (IAS) took place prior to approval (it was a condition of negotiations) and all reporting by banks to the NBU is now made on an IAS basis,
 - (ii) improved arrangements for loan loss provisioning and their tax treatment were established prior to Board approval; these included NBU regulations on loan classification and provisioning and modifications to the Corporate tax law to allow tax deduction of provisions. The *third tranche* condition in this component, however, (“NBU to require banks to fully provision all classified loans,” see box 1 above) was *only partly met*: one former state bank (Bank Ukraina) and one of the two state banks (Savings Bank) were not meeting the required provisions level at the time of FSAL closing. Bank Ukraina was subsequently liquidated and efforts to improve the performance of Savings Bank continued during PAL I and PAL II (see box 2 above),

²⁸ 2003 FSAP, page 31.

(iii) reorganization and strengthening of bank supervision by NBU, and improvements in off-site bank supervision (prudential standards), were met prior to Board approval, although additional improvements were still needed at the time of closing: for example, the 2003 FSAP noted that NBU should strengthen its regulatory controls over all significant bank investments and activities and its supervisory controls and limits on connected and insider lending, as well as accelerate its capacity to conduct consolidated supervision,²⁹ and

(iv) the second tranche release condition on improving on-site bank examination (completing inspections for banks accounting for 60 percent of total bank assets) was met: all commercial banks were examined annually by closing. Thus, the outcomes of this component were *substantially achieved*, and outcome is rated *satisfactory*.

- Banking sector structure:

- (i) strengthening arrangements for licensing new banks and re-licensing existing ones was largely achieved through the Law on Banks and Banking Activities and the improved procedures at the NBU. As noted above, the 2003 FSAP found the legal framework (and detailed procedures) broadly satisfactory, and recommended improvements in NBU's application of the legal framework and procedures,
- (ii) enforcement capacity and procedures to address problem banks were established at the NBU and the formal second and third tranche conditions (box 1 above) were met, although bank resolution in some cases took longer than desirable. Thus, additional improvements were required by the time of FSAL closing. The 2003 FSAP pointed out that "Bank resolution to date has not been efficient in Ukraine, although practice in this area seems to be improving. The NBU has not always properly or effectively used the legal mandate it has to quickly resolve deep insolvency problems affecting licensed banks,"³⁰
- (iii) the expected restructuring of the Savings Bank was *not achieved* (see box 2 above): some progress was made but fell well short of expectations and the third tranche condition regarding restructuring of Savings Bank was not met: a restructuring and partial release of the tranche took place instead, and restructuring of Savings Bank became part of the objectives of the PAL program (see also below),
- (iv) the conditions regarding specific interventions in former state banks were met through the Commitment Letters signed between these banks and NBU: the outcomes were satisfactory for two of the three (Prominvest and Ukrsofs) but not for the third (Bank Ukraina); in the latter case, liquidation was agreed at about the time of disbursement of the third tranche, although the formal announcement was linked to the benchmarks for PAL I (see also box 2 above and PAL discussion below), and

²⁹ *Ibid.* page 4

³⁰ *Ibid.*, page 26.

- (v) establishing a sound system of deposit insurance was *partially achieved* at the time of FSAL closing: the third tranche condition relating to adoption of a Deposit Insurance Law was *not met* and was part of the restructuring of the third tranche. The Deposit Insurance Law was approved, however, later in 2001, after FSAL closing.

Thus the outcomes of this component were only *partially achieved*, and outcome is rated *moderately satisfactory*.

Institutional Development

2.30 The main achievements in terms of institutional development include the establishing of a substantially new legal framework for the financial sector, the institutional improvements in the regulatory, supervisory, and enforcement capabilities of NBU, and the institutional improvements in the former and remaining state banks. The discussion on outcome, above, and the continuing improvements in the performance of the financial sector make the institutional development impact of FSAL *substantial*. The only main shortcoming in this area refers to the inability to address the issues related to the Savings Bank (those were subsequently addressed through the PAL program).

Outcome

2.31 *Overall rating.* On the basis of the above assessments of the high relevance of the operation, of the achievements under each of the components, and the substantial institutional development impact of the operation, the outcome of the FSAL is rated *satisfactory*.

Risk to Development Outcome

2.32 Progress in all areas covered by FSAL continued well after closing, and until today, at a pace that exceeded the assessment shortly after FSAL closing (in the 2001 financial sector review). Therefore, the risk to development outcome of the FSAL objectives, five years after the closing of the operation is rated *negligible to low*. This does not mean that the overall risks facing Ukraine's financial sector are negligible; as the 2005 FSAP Update points out, "the largest vulnerability of the banking sector stems from the downside macroeconomic risks and their potential impact on the repayment ability of borrowers, particularly given the rapidly expanding credit portfolio, notably in the real estate sector."³¹ But even considering this vulnerability, the achievements under FSAL, are expected to be sustained.

Bank Performance

2.33 The analytical work that preceded FSAL and the technical work during preparation were of good quality, and cooperation with the IMF was effective, including in the context of the FSAP and FSAP Follow-up Report; the adequacy of its coverage, particularly regarding the state and former state banks, was somewhat modest, but market

³¹ 2005 FSAP Follow-up Report, page 69.

recovery in some cases and liquidation in another (Bank Ukraina) made the achievements worthwhile. The extensions of the closing date were justified at a time when financial and overall reforms were taking place. Finally, as noted above, there were some issues with supervision ratings but the decision to extend seems reasonable based on subsequent performance of the sector. Thus, Bank performance is rated *satisfactory*.

Borrower Performance

2.34 Borrower implementation of the changes in the legislative framework for the sector was adequate, although with delays, except for the deposit insurance law, which was approved after FSAL closing. The NBU improved its regulatory, supervisory, and enforcement capabilities, and the reforms in the state and former state banks were also carried out except for Savings Bank. Macroeconomic performance was largely adequate although the EFF program went off track at several points. Overall, Borrower performance is rated *satisfactory*.

Lessons

2.35 The major lessons from FSAL are related to the importance of a sound legislative and regulatory framework in the financial system, as well as to the greater role of the country's overall economic performance, on top of market forces, than of formal technical assistance, in achieving improvements in specific financial institutions. Other lessons are related to the difficulty in restructuring state-owned banks under poor overall governance conditions. These lessons are discussed below.

2.36 *Establishing a sound legislative and regulatory framework for the financial sector is a necessary, but not sufficient, condition for financial sector development.* In Ukraine, the legislative and regulatory frameworks were gradually introduced in the late 1990s but, even by 2001, the sector was extremely small, and its depth very limited. The substantial turnaround in economic performance at the time benefited from, and provided a substantial push for the rapid expansion and improved performance of the financial sector.

2.37 *Strengthening the supervisory and enforcement capacity of the supervisory agency (the NBU in Ukraine) is essential to achieve the benefits of a sound legal and regulatory framework.* In Ukraine, the progress in NBU capacity was gradual and sustained, but the weaknesses in implementation derived from limited to poor application of a basically sound framework.

2.38 *Technical assistance to strengthen poor performing institutions has poor results without a strong demand-pull, including from market forces.* Although considerable technical assistance resources were provided to the State-owned and former State-owned banks in Ukraine during the 1990s, there was little to show for this assistance until the former state-owned banks were effectively privatized in the late 1990s (and Bank Ukraina was liquidated) and competition from other private (and foreign-owned) banks increased. For Savings Bank, the process was even slower.

2.39 *Restructuring and improving the performance of state-owned financial institutions is a slow and risky proposition in a poor governance environment.* The FSAL objectives regarding improvement of the Savings Bank were not achieved until much later (during the PAL period) due to a lack of government commitment to the reform and the pressure of strong vested interests. In Ukraine's conditions at the time of FSAL preparation, the objectives regarding restructuring of Savings Bank were unrealistic unless some earlier, more drastic decisions had been taken (for example, privatization, or splitting the bank into several smaller institutions, with privatization of some of the resulting components).

3. The PAL Program

Introduction

3.1 The PAL program was proposed in the 2000 CAS as “the flagship operation for the Base Case scenario”³² and was conceived as “a sequence of three separate operations, totaling up to \$750 million, with disbursements depending entirely on performance.”³³ The program was introduced in the CAS as an explicit change from the approach based on sector adjustment operations used under the previous CAS.³⁴ At the time, the FSAL was still ongoing and getting close to completion (the third tranche was released a few months later, in February 2001). The PAL program was proposed as a sequence of single-tranche operations, based on achieved benchmarks, about one year apart, although the CAS noted that “the actual time may be shorter or longer depending on government implementation performance and effectiveness.”³⁵

3.2 Based on lessons of past experience with the sector adjustment operations, the PAL program’s design was expected to differ from the previous approach in several ways and to have the following characteristics: (i) based on increased Government and society ownership of the reforms; (ii) concentrate on results; (iii) take inter-sector linkages and cross-cutting issues explicitly into account; (iv) be flexible to reward meaningful overall progress, or decrease Bank exposure if performance was not adequate; and (v) help increase the Government’s capacity to implement the reform program.

Objectives

3.3 The CAS noted that the PAL sequence was to be based on a shared vision of Ukraine at the end of the three-year period as a friendlier place to do business, with private investment in a better position to take place, and with social service delivery considerably improved. The overall vision was to be presented at the time of PAL I, in the Letter of Development Policy as an umbrella for the PAL sequence.

3.4 The PAL program was to focus on five thematic areas, all of which would have a substantial impact on growth, governance, and poverty reduction:

- *Financial discipline in public and private sectors*: develop and implement a strategy to eliminate the chronic non-payment problem in budget, tax obligations, and inter-enterprise arrears (with particular attention to the energy sector);

³² World Bank. 2000. *Country Assistance Strategy for Ukraine*. Report No. 20723-UA, paragraph 77.

³³ *Ibid.*

³⁴ “The main rationale for introducing a programmatic adjustment operation in Ukraine is to address the shortcomings of sector adjustment operations as described above,” *Ibid.*, paragraph 79. See also footnote 5 above.

³⁵ *Ibid.*, paragraph 78.

- *Improvements in the regulatory framework for business:* regulations facilitating the entry and operation of business; providing critical rules of the game in telecommunications, energy, finance, land and pensions; reduce the number of required licenses;
- *Transparent definition and protection of property rights:* support to Government's intent to transfer state property to private owners in a transparent manner and create institutions to protect property rights, comprehensive registration and titling of land, and implementation of the privatization law in industry;
- *Public sector accountability and effectiveness:* foster open and transparent budget processes, adoption of a transparent fiscal code, comprehensive tax reform, and continued reform of public administration and inter-governmental finance;
- *Mitigation of the social costs of transition and improvements in the delivery of social services:* pensions (reform of the basic pension system, and preparing the groundwork for a funded compulsory and a voluntary personal saving schemes), social assistance (introduce a targeted system to improve effectiveness in reaching those most in need), and health and education strategies (mobilizing private resources and improving financial management).

PAL I. Preparation, Design, and Implementation

Preparation and Design

3.5 Preparation of PAL I started shortly after the 2000 CAS was reviewed by the Board. The project concept document (PCD) was prepared in October 2000, and PAL I was appraised in January 2001. It was originally designed as a single-tranche operation, and was scheduled for Board discussion in late FY01. But in a turn of events that paralleled the preparation of FSAL (discussed above), political developments in Ukraine led to an unforeseen delay: the government (of Prime Minister Yushchenko) which came to office in December 1999, and with which the Bank had prepared the CAS and conceived the PAL program as its "flagship," fell in the Spring of 2001, and a new government was appointed in May.

3.6 The political crisis that led to the fall of the government took place after appraisal, but before negotiations of PAL I. There were concerns in the Bank regarding the extent to which the new government would continue the reform program that had been announced (and discussed with the Bank). After the new Prime Minister (Kinakh) pledged to continue the institutional and structural reforms, as well as promote the social and anti-poverty programs of its predecessor,³⁶ processing of the PAL continued, and negotiations took place in July 2001.

³⁶ The new government retained many of the previous ministers, including all the economic posts.

3.7 The design of PAL I also changed as a result of these events, and the operation was changed from a single tranche to a two-tranche operation. It was approved in this form, with a first tranche of \$150 million and a second one for \$100 million, in September 2001.

Specific Objectives and Components

3.8 The objectives and components of PAL I, and of the overall PAL program (the proposed three operations) were presented in a World Bank report for PAL I along the lines of the five thematic areas described in the CAS (see above) and in the form of specific benchmarks, already met for the first tranche of PAL I, and as conditions for release of the second tranche and indicative benchmarks for PALs II and III. The 16 benchmarks for the first and second tranches of PAL I, summarized in box 3 below, reflect the broad coverage of the operation.

Box 3. PAL I Benchmarks

Fiscal and Financial Discipline

1. *Elimination of budget offsets*
 - *First tranche* (met prior to Board approval): non-transparent budget offsets eliminated in 2001
 - *Second tranche*: disallow budget offsets in 2002 budget
2. *Reduce budget arrears*
 - *First tranche*: (i) elimination of pension arrears in September 2000 (and staying current), (ii) reducing wage and social protection arrears by at least 27 percent from the January 2000 level, and (iii) reducing or containing all other budget arrears at the January 2000 level
 - *Second tranche*: (i) stay current on pension payments, (ii) further reduce budget arrears on wages by 50 percent and on energy payments by 75 percent, and (iii) no increase in other arrears from July 2001 level
3. *Reduction of electricity and gas arrears*
 - *First tranche*: (i) debt of six Oblenergos (being privatized) to wholesale market restructured, (ii) Oblenergos given right to disconnect non-paying customers, (iii) 23,000 delinquent customers disconnected, (iv) cash collections from Oblenergos by wholesale markets increased to 50 percent, and (v) cash collections for gas increased to at least 50 percent
 - *Second tranche*: (i) quantify domestic debt to Naftogas and prepare restructuring plan, (ii) increase electricity cash collections to 60 percent, and (iii) increase gas collections to 60 percent

Regulatory Framework

4. *Improvements in the business environment*
 - *First tranche*: (i) one-stop shop for new business registration, (ii) simplified licensing procedure, and (iii) reduce number of inspections by 20 percent (from 1999 level)
 - *Second tranche*: maintain business environment (same as above)

Property Rights

5. *Transformation of ownership/organizational structure in agriculture*
 - *First tranche*: (i) Presidential decree on reforming sector (discontinuing Kolkhozes) implemented, (ii) land certificates issued to 6.5 million former Kolkhoz members and close to 1.3 million land title deeds assigned and registered, and (iii) government monopoly on agricultural inputs and outputs reduced to a tenth of pre-reform level
 - *Second tranche*: issue 1.3 million titles to specific plots of land
6. *Progress in transparent privatization in industry and energy*
 - *First tranche*: (i) tenders issued for privatization of 83 industrial enterprises, (ii) sales for controlling blocks in eight enterprises completed (under transparency criteria approved by Privatization Advisory Group, PAG), (iii) sale of six Oblenergos completed, and (iv) contract for Phase II audit of Naftogas signed

- *Second Tranche:* (i) PAG to complete a transparency review of privatizations in first three quarters of 2001, (ii) submit to Parliament list of enterprises to be privatized in 2002, and (iii) resume the process of privatizing Oblenergos
7. *Progress in telecom privatization*
 - *First Tranche:* (i) telecom privatization law passed and (ii) tender for privatization adviser issued
 - *Second Tranche:* None
 8. *Progress in resolving Bank of Ukraine problem*
 - *First Tranche:* Bank of Ukraine banking license removed and liquidator appointed
 - *Second tranche:* None
- Public Sector Efficiency and Accountability**
9. *Improve budget transparency*
 - *First Tranche:* discretionary intergovernmental transfers replaced by formula-based system
 - *Second Tranche:* (i) evaluate implementation of formula-based system in 2001 and (ii) continue new system in 2002 budget
 10. *Improve use of public resources*
 - *First Tranche:* None
 - *Second Tranche:* (i) satisfactory progress in implementing single Treasury account and (ii) discuss CFAA report and adopt action plan
 11. *Reform public administration*
 - *First Tranche:* (i) smaller, more efficient cabinet created, (ii) specialized Cabinet Committees, and (iii) Cabinet Secretariat reformed
 - *Second Tranche:* None
 12. *Elimination of tax exemptions*
 - *First Tranche:* tax exemptions granted by Cabinet revoked
 - *Second Tranche:* refrain from granting new tax exemptions
- Social and Environmental Risk Management**
13. *Institutional and technical framework for pension reform*
 - *First Tranche:* creation of unified system of personal pension accounts
 - *Second Tranche:* (i) transfer pension determination function to Pension Fund and (ii) create unified social insurance database
 14. *Improve social assistance*
 - *First Tranche:* (i) unified targeting methodology and (ii) creation of 750 social care centers
 - *Second Tranche:* None
 15. *Improve health and education*
 - *First Tranche:* (i) improved control of public health risks through two pilots, (ii) improvements in primary health care through new family medicine centers and University specialization in family medicine, (iii) health resource allocation pilot in Lviv, (iv) improved methods of education management and finance piloted in Lviv, and (v) national 12-year compulsory education
 - *Second tranche:* (i) health sector reform strategy and (ii) education sector reform strategy
 16. *Special privileges reviewed*
 - *First tranche:* (i) auxiliary social protection through special privileges analyzed and evaluated and (ii) privileges not justified on poverty and equity grounds discontinued
 - *Second Tranche:* disallow professional privileges not justified on poverty or equity grounds in 2002 budget

3.9 The benchmarks show large variations in the level of detail and depth in different areas, with a clear focus on public finance (arrears, inter-governmental transfers), energy sector improvements, privatization, and banking sector (closing of Bank of Ukraine). The agricultural sector reforms and the measures on pensions and social assistance are also important but constitute relatively early steps, while the measures on health and education appear more as a collection of ad hoc steps adopted by the government.

3.10 The benchmarks for the second tranche are much more limited than those for the first tranche (already met at Board approval), reflecting the extensive discussions between the Bank and the government during preparation, the extent of the reforms adopted during 2000 and early 2001, and the intention to reach disbursement of the second tranche shortly after the first tranche (as well as the PAL's initial design as a single tranche operation).

Implementation and Tranche Disbursement

3.11 PAL I was approved by the Board on September 20, 2001, and was declared effective the following day. The first tranche, for \$150 million, was disbursed upon effectiveness. The conditions for second tranche release (benchmarks) were seen by the government as minor, as suggested by the fact that, one week after Board approval (and six days after effectiveness) the government sent a letter to the Bank Resident representative in Kyiv,³⁷ with an attachment listing the relevant benchmarks, and indicating that all had been met (two weeks later, on October 10, 2001, the government sent a similar letter to the Country Director, noting that the Bank had not replied to their previous letter).³⁸

3.12 The Bank's first assessment of PAL implementation, and of progress in meeting second tranche conditions, was sent to the Government on October 16, 2001, noting three areas that required attention. The Bank letter noted that (i) the information received was, in most cases, as of mid-September, while the tranche release was to be made on the basis of benchmarks as of the end of October; (ii) it was important to finalize a time-bound action plan on areas of fiduciary accountability and procurement, following discussion of the Country Procurement Assessment Report (CPAR) and the Country Financial Accountability Assessment (CFAA); and (iii) progress in some key areas was not as good as expected: this applied in particular to the energy sector, and specifically to resuming the privatization of Oblenergos,³⁹ valuation and rescheduling of domestic debt to Naftogas, and "the continuing impasse on the issue of energy tariff increases for already privatized Oblenergos."

3.13 Following the review mission in late October, the government re-submitted again a request for second tranche release on November 22, 2001, stating that all conditions for tranche release had been met, and providing the details. The request addressed the items above, including the action plans on fiduciary accountability and procurement (submitted to the bank in mid-November, draft procurement law also submitted), and the energy issues. On the resumption of Oblenergos privatization, however, the letter says: "*On November 22 of this year the President of Ukraine consented in principle to the resumption of the privatization process.*" The Bank was not satisfied with this "consent

³⁷ Letter from Mr. Sumylo, First Deputy State Secretary, of September 27, 2001.

³⁸ The previous day (October 9), the Country Director had written to inform the government that a review mission would visit Ukraine in late October.

³⁹ The letter mentioned that as a minimum, the Presidential instruction of May 2001 banning privatization should be rescinded, and the 25 percent +1 state shares in the next batch of 12 Oblenergos to be privatized should be released.

in principle”, and a Presidential Decree, confirming that the ban on further privatization was eliminated, was issued on December 3, 2001.

3.14 After these last minute changes, the Bank agreed that all conditions had been met, and the Region notified the Board, on December 6, 2001, that given Ukraine’s full compliance with all the benchmarks, the Bank had informed the Borrower of the availability of the second tranche, for \$100 million. The President’s initial reluctance to abolish its previous decree and allow for the resumption of privatization in the energy sector was an initial indication of a problem that continued until the second tranche release of PAL II.

PAL I Achievements and Transition to PAL II

3.15 Given the medium-term objectives of the reform program supported by the PALs, and the “first steps” characteristics of many of the benchmarks under PAL I, its achievements are assessed in more detail as part of the assessment of the overall PAL program (see below). Implementation of PAL I, however, pointed already to several areas where difficulties had started to emerge in spite of the formal achievement of the specific benchmarks. These areas, including the energy sector reforms and the privatization of Oblenergos mentioned above, also include the transparency of the overall privatization process, and the reforms in agricultural land ownership (including titling of land). These areas were to become critical in the design, preparation, and implementation of PAL II.

3.16 On the positive side, at the time of PAL I closing, Ukraine had sustained two consecutive years of high growth, and its external sector had improved enormously, with foreign reserves doubling between 2000 and 2001, and the external debt falling to just over one-half of its level in 1999. The improvements continued throughout the period of PAL II and were summarized in table 1 (see page 2). The improved economic performance may also have had a dampening effect on the pressure to adopt politically difficult reforms. In this setting, the transition from PAL I to PAL II was slower and more difficult than had been expected in the 2000 CAS (and in the PAL I documents).

PAL II. Preparation, Design, and Implementation

Preparation and Design

3.17 At that time of the PAL I second tranche release, the Bank still saw subsequent PALs as single tranche operations basing it on results on the ground prior to Board approvals. As discussed below, however, PAL II became, once again a two tranche operation with a longer than planned preparation period (mainly due to the program with the IMF going off-track), and an equally long implementation period.

3.18 The first preparation mission for PAL II took place in February 2002, just two months after the release of the second tranche of PAL I, but the mission concluded that further preparation would take some time, and following the mission, the Bank wrote to

the Government noting that “*significantly more needs to be done before the PAL II can be appraised.*”⁴⁰

3.19 In May 2002, another preparation mission took a more optimistic view of the possible timetable and prepared a comprehensive Aide-Memoire with a proposed policy matrix and a list of “open issues.” The Aide Memoire noted (somewhat unusually) that an Operations Committee (OC) meeting had taken place in Washington on the first day of the mission, and that the OC (i) found the contents of the operation balanced, (ii) decided that it should be a single tranche operation, and (iii) concluded that additional strengthening was needed in some areas (particularly fiscal and macroeconomic sustainability).

3.20 The subsequent Bank’s letter to the Government confirming the Aide-Memoire pointed out that the main issues pending were (i) reaching agreement with the IMF on the macroeconomic program, (ii) progress in implementing a plan to reduce accumulation of tax arrears, (iii) initiating a plan to bring solvency to the Savings Bank, (iv) submission to parliament of laws on tax exemptions and privileges, and (v) completion of the energy sector restructuring plan and initiation of implementation. The letter and the Aide Memoire noted that this progress could be achieved by July, and that in this case the PAL could be considered appraised. The Aide-Memoire concludes by noting that, in this case negotiations could take place also in July, and PAL II could go to the Board in September 2002.⁴¹

3.21 In retrospect, the actual preparation time turned out to be more than a year longer than anticipated in May 2002. Discussions continued throughout 2002, and eventually PAL II was submitted to the Board in November 2003 as a two-tranche operation, with heavily back-loaded disbursements (\$75 million in the first tranche and \$172.5 million in the second tranche). By that time, Ukraine had not been able to conclude a precautionary Stand By arrangement with the IMF.⁴² PAL II was approved by the Executive Directors on December 9, 2003.

3.22 The long preparation period for PAL II, from February 2002 to December 2003 covered two governments (of Prime Ministers Kinakh until November 2002 and Yanukovitch thereafter), as well as a continuation of the rapid growth and improvements in the external sector that had started during the PAL I period. The combination of a reduced need for external financial assistance, a slowdown in the appetite for reform, and the increasing difficulty of the next steps in the PAL program (often with higher political costs following the PAL I reforms) explain the difficulties in PAL II preparation.

3.23 The delays in preparation of PAL II meant that the period of the CAS 2000 ended with only one of the proposed three PALs actually approved and completed. By early 2003 preparation of a new CAS started, including the first CAS Completion Report (CR),

⁴⁰ Letter of the Country Director to the Vice Prime Minister, “*Moving Forward on PAL Preparation,*” March 25, 2002.

⁴¹ The PID, issued at that time, also mentioned appraisal in July, and Board presentation in October 2002: see *Ukraine-Second Programmatic Adjustment Loan*, Report No. PID11302, May 3, 2002.

⁴² PAL II Program Document, Report No. 27226, November 12, 2003, paragraph 105.

which was issued in March 2003. The CR noted that the invitation to negotiate PAL II had been issued and expresses optimism regarding PAL III: *“The design for PAL III is in place and some of the benchmarks have been achieved. Should PAL II proceed as expected, PAL III is feasible in FY05.”*⁴³ As noted above, PAL II was considerably delayed in approval and implementation, and PAL III was replaced by the Development Policy Loan (DPL) I in FY06.

3.24 The 2003 CAS, completed six months after the CAS CR, and shortly before approval of PAL II emphasizes the major achievements in the five areas of the 2000 CAS, but also notes that there was a slowdown in the reform process after the early progress in 2000 and early 2001: *“However, progress has been lackluster in a number of critical areas of reform. The three PAL sequence under the 2000-2003 CAS has progressed more slowly than it could have (an outcome that was anticipated in the 2000 CAS). Only one of the three operations was approved by the Board during the CAS period; a second one is scheduled for presentation in December 2003.”*⁴⁴

Specific Objectives and Components

3.25 The objectives and components of PAL II, as those of PAL I, were those designed at the beginning of the PAL program (as part of the proposed three PALs) and already formulated in the 2000 CAS (see above). They were grouped under the same five areas of fiscal and financial discipline, regulatory framework, property rights, public sector efficiency and accountability, and management of social and environmental risks.

3.26 In line with the principles of programmatic lending, the PAL II Program Document discusses the objectives and components of the loan as a continuation of those of PAL I, and the benchmarks for the first and second tranches were compared with the achievements under PAL I and the expected outputs of PAL III.⁴⁵ In addition to the benchmarks, the “Matrix of Institutional and Policy Outcomes” included a column of expected outcomes. The benchmarks for the two tranches are summarized in box 4 below.

3.27 The list of benchmarks for PAL II is more diverse than the list for PAL I, with more unrelated items collected together under the banner of the five principles. It consists of a core of benchmarks related to arrears, energy financial reform, and pension reform, together with a mixed bag of measures often under the title of “continuation of action plans” in different areas. This reflects the difficulties experienced during preparation, as the government reform efforts had slowed down, and the Bank was continuing to promote reform but meeting with different levels of success across the five areas.

⁴³ Ukraine. CAS Completion Report FY01-03, March 2003. Paragraph 26,

⁴⁴ Ukraine CAS. Report No. 26448-UA, September 29, 2003, page 11.

⁴⁵ Box 1 “PAL Program At-a-Glance,” in PAL II Program Document, Report No. 27226, November 12, 2003.

Box 4. PAL II Benchmarks

Fiscal and Financial Discipline

Continued reduction of arrears

- *First tranche* (met prior to Board approval): pensions paid on time; wage arrears eliminated and social protection arrears reduced by 55 percent from Jan. 1, 2000; stock of other arrears reduced by 50 percent
- *Second tranche*: No increase in tax arrears by non energy sector (since Jan. 1, 2002) and energy sector (since Jan. 1, 2003); action plan implemented to improve financial discipline in energy sector; and Cabinet-approved action plan for energy sector financial solvency.

Improvement of payment discipline in electricity and gas

- *First tranche*: cash collections from power distribution companies higher than 90 percent of charges, Naftogaz collections higher than 85 percent, and submission of draft law on debt resolution in the sector
- *Second tranche*: law on debt resolution passed, obligatory participation of public enterprises in the sector in the restructuring

Legislative framework to enforced "secured interest":

- *First tranche*: adoption of mortgage finance law

Regulatory Framework

Financial sector

- *First tranche*: NBU compliance with Basel principles on bank supervision, schedule for phasing in "connected lending" principle, regulatory framework for bank supervision compliant with banking law, independent regulator for non-bank financed (NBF) institutions established, progress on MoU (of July 2003) on Savings Bank
- *Second tranche*: implementation of schedule for "connected lending" principle, enforcement of banks external auditing compliant with ISA, continuing progress on Memorandum of Understanding (MoU), adequate funding for NBF regulator

Progress towards WTO accession

- *First tranche*: legal framework and national agency for certification and accreditation, legal strengthening of copyright, public awareness campaign
- *Second tranche*: technical procedures (11) and technical standards (1,500) adopted, development of legal framework

Property Rights

Agricultural land ownership

- *First tranche*: proposals to amend draft law on "single agency", study to review quality of land titles, issuance of 3.4 million titles
- *Second tranche*: enactment of law to establish "single agency" for registration

Transparent privatization of industrial enterprises

- *First tranche*: verification of transparency by PAG review of random sample, international audit of Naftogaz subsidiaries for 2001, and contract with international auditor for 2002 audit of Naftogaz
- *Second tranche*: engage financial advisor for privatization of power distribution companies and launch tender; continued progress toward unqualified audit of Naftogaz statements for 2004

Restructuring and/or bankruptcy procedures for banks and enterprises

- *First tranche*: bankruptcy procedures initiated for 17 enterprises (among 63 largest tax debtors), continuation of liquidation of Bank Ukraina

Public Sector Efficiency and Accountability

Implementation of CFAA Action Plan

- *First Tranche*: Improved audit procedures, quarterly reporting by enterprises with 10 percent or more state ownership, pilot public consultations during budget preparation
- *Second Tranche*: adoption and publication of White paper on internal financial controls, establish oversight body for State Tax Administration, implementation of automated treasury system in all oblasts

Implementation of CPAR Action Plan

- *First Tranche:* Submission of draft law on public procurement, draft strategy for institutional development of public procurement, decisions on appeals and inspection controls to be made public, certification of public procurement specialists, Web-page on public procurement

Improved tax and revenue system

- *First Tranche:* Reduction of exemptions and privileges by at least 35 percent from Dec. 2001 level, channel at least 25 percent of gas transit fees to the budget in cash through single Treasury account
- *Second tranche:* reduction of exemptions and privileges by at least 55 percent

Management of Social and Environmental Risks*Progress in pension reform*

- *First Tranche:* adoption of Mandatory Pension Insurance Law, and of Non-State Pension Funds Law, transference of pension determination function to the Pension Fund, creation of central database (and issuance of 3 million social insurance certificates)

Better targeted social assistance

- *First Tranche:* reduction of social programs from 11 to 5, focusing on the vulnerable, targeted fuel subsidies provided in cash, submission of draft Law on Social Services

Further revisit special privileges

- *First tranche:* target benefit for public workers by income, limit housing entitlements to immediate family members of privileged persons

Improve environmental regulations

- *First Tranche:* adjustment of environmental charges in 2003 and January 2004, yearly indexation of pollution charges, pilot program of pollution prevention permits in eight enterprises.

3.28 The first tranche benchmarks reflect the accomplishments of the government during the period of preparation. The main difference with respect to PAL I is that in the earlier case, the accomplishments were those of a reformist government that had been at work for over 1-½ years after a period of slow progress: this led to a significant, accumulation of qualitative improvements in a relatively short period. On the other hand, the PAL II achievements at approval were those of a less reform-oriented government, following a period of successful reforms. In spite of the somewhat reduced government commitment, substantial progress was achieved in several areas, including the continued reduction of arrears, improved payment discipline in electricity and gas and improved targeting of social assistance, where improvements were already under way under PAL I.

3.29 The second tranche conditions of PAL II (like those of PAL I) were a much shorter list but, in the case of PAL II, some of these second tranche conditions proved much more difficult to achieve, delayed disbursement of the second tranche and required waivers (see below, under implementation).

Implementation and Tranche Disbursement

3.30 PAL II was approved on December 9, 2003, and was declared effective on December 19, 2003. Upon effectiveness, the first tranche was disbursed. Implementation of the first tranche conditions (all met at the time of Board approval) was difficult, as reflected in the longer than expected period of design and preparation discussed above.

3.31 Progress towards meeting second tranche conditions also took longer than expected. This was partly due to the increasingly difficult political situation in the run up

to the presidential elections of late 2004. Taking difficult policy reform decisions looked less and less desirable to the policy makers in this political context. As the result of the first round of elections became a contentious issue, and led to a second round of elections in December 2004, the reform program came to a halt, with some clear reversals, such as the transparency in privatization (of the steel mill) and the deterioration in fiscal performance. Yet, all supervision (status) reports for PAL II⁴⁶ rated IP and DO satisfactory throughout the period.

3.32 Between September 2004 (just before the Presidential elections) and December 2004 (after a second round of elections had taken place), there were frequent discussions regarding progress in implementation of the second tranche release conditions, and the possibility of extending the closing date (of December 31, 2004). An internal Bank review in September noted that technical group meetings were running as planned and work at the technical level was good on both sides. On accomplishments and pending issues, the political difficulties regarding the energy sector (debt resolution law and privatization of Oblenergos) were signaled as the possible sticking points.

3.33 In November 2004, the Ministry of Economy requested a Bank assessment of implementation conditions, in order to prepare an update for the Cabinet and noted that they were preparing a request for extension of the closing date.⁴⁷ The Bank response, on November 29, included a full matrix with the status of program implementation, and pointed out that the main outstanding issues were (i) the financial solvency plan for the energy sector, (ii) the energy sector debt restructuring law, (iii) the privatization of Oblenergos, (iv) the prohibition of electricity payments or tariff privileges for individual companies, and (v) the adoption of a White paper on Internal Financial Control. The letter also noted the importance of a sound macroeconomic framework.⁴⁸

3.34 The deteriorating political environment of late 2004, including the elections in October and again in December, and the contested outcomes of these elections, leading to the “orange revolution” and the eventual declaration of Viktor Yushchenko as the winner of the presidential election added to the difficulties in meeting the above tranche release conditions, and the closing date was extended to June 30, 2005.

3.35 The new government, formed in February 2005 inherited public finances that were not balanced, and the Bank estimated that, without fiscal corrections, the deficit of the general government would have reached close to 7 percent of GDP in 2005. Soon after taking office the government introduced a revised budget to reduce the consolidated deficit to 2.2 percent of GDP, mainly through increased revenues. Also, it addressed inflationary pressures by slowing down NBU purchases of the net inflow of dollars, allowing a one-off shift of the *de facto* peg to the dollar, adopted several other macroeconomic stabilization measures and indicated interest in a new precautionary arrangement with the IMF, following the one expired in March 2005 (no such

⁴⁶ There were three PSR/ISR archived, in June 2004, Dec. 2004 and June 2005.

⁴⁷ Letter of November 23, 2004 (#16-21/692) from Acting First Deputy Minister.

⁴⁸ Letter to L. Musina, Deputy Minister, November 29, 2004. The earlier Bank review in September had already noted that the IMF did not conclude the first review of the Precautionary Stand-by arrangement in its July mission.

arrangement has been pursued so far). In early June, following the improvements in the macroeconomic situation, Bank management recommended to the Board the release of the second tranche with one waiver (on the adoption of a law on debt resolution in the energy sector) and a partial waiver (on the engaging of a financial advisor for the privatization of a group of Oblenergos, and launching of the privatization tender). The Board agreed with the proposal and the second tranche release (\$172.5 million) took place on June 20, 2005.

Outcomes and Assessment of the Program

Overview

3.36 The PAL program was introduced in the 2000 CAS as its “*flagship operation for the Base Case scenario*” and its objectives were seen as closely inter-linked with those of a number of planned investment operations with which it was associated. Therefore, the assessment of the PAL program requires a review of how the two PAL operations were designed and implemented, and to what extent their objectives were met, as well as of how they influenced the achievement of “*accompanying*” objectives of the related investment operations.

3.37 The PAL program turned out to be slower in preparation and implementation than it had been expected in the 2000 CAS. Instead of three PALs in the three years of the CAS there were only two PALs covering a five-year period (PAL III was converted into a different operation, DPL I in early FY06). This indicates that the speed of the reform program was slower than initially anticipated, although progress took place in practically all areas of the program (and the economic performance exceeded the expectations at the time of the 2000 CAS). The specific benchmarks of PALs I and II, discussed in the sections above, were all achieved with the exception of the energy debt restructuring law and the privatization of the Oblenergos (whose political difficulty had already surfaced at the time of PAL I).

3.38 In some other areas, however, the formal achievement of the benchmarks fell short of achieving the intended outcomes. This is the case regarding land titling, where the institutional problems with the creation of a land-titling agency (formally part of a parallel investment operation) meant that the passing of the law (PAL II benchmark) was not enough. Also, the objective of increasing transparency of the privatization process does not seem to have been achieved in spite of the formal compliance with the procedures established and monitored by the Privatization Advisory Group (PAG) during PAL I. The minutes of the PAG meeting of December 13, 2002 provide some evidence of the problems already noticeable during PAL I. As for PAL II the ICR notes that the PAG conducted a second review in September 2004 and that “*This time, PAG was not able to come to a clear position, primarily related to the ongoing controversy surrounding Kryvorizhstal.*”⁴⁹ The 2005 re-privatization of the Kryvorizhstal steel mill, for a price five times higher than the one obtained in the earlier sale in 2004 is an indication of the governance problems in the privatization, particularly of large state enterprises.

⁴⁹ PAL II ICR, page 17. Dec. 28, 2005.

3.39 Overall, however, these shortcomings should not detract from the substantial achievements under the program, which leads to the assessment of its outcome as *satisfactory* (see below). The achievements were substantial in the areas of fiscal and financial discipline, particularly regarding the energy sector and in spite of the remaining problems in the sector, in improving the financial performance of the government and of its treasury operations, of the financial sector, through the liquidation of Bank of Ukraine, restructuring of Savings Bank (which also took longer than originally expected) and improvements in the regulatory framework, and in the elimination of tax exemptions, privileges, etc. as well as a good beginning in the reform of the pensions system. The improvements seem more moderate in areas such as property rights and business environment, at least partially because of governance issues, and in the reform of public administration.

Relevance

3.40 Relevance was very high, particularly at the outset of the program, in early 2000, when a newly installed reformist government was embarking on an ambitious reform program. Most of the items included in the program (and outlined already in the 2000 CAS) had high priority for the objectives of achieving sustained growth, poverty reduction and governance improvements. Relevance continued to be high during implementation of PAL I and preparation and implementation of PAL II: a less reformist government, facing an improved economic environment, experienced a declining appetite for reforms, and the discipline of the PAL program helped reformers within the government to advance the reform agenda in a variety of areas. Thus relevance for PAL I, for PAL II, and for the overall PAL program is rated *high*.

Quality at Entry

3.41 The PAL program was well prepared based on a good assessment of the experience with adjustment operations in the previous CAS period, and included issues of high priority for the country, particularly in the areas of fiscal and financial discipline (including the energy sector), elimination of arrears, pension reform, improvements in public financial management, and in the financial sector. Collaboration with the IMF was good throughout the period, particularly in the financial sector. Cooperation with other financiers, the EU and EBRD, was also extensive, covering in areas related to trade, energy, and the financial sector.

3.42 At the same time, some components, such as the health and education strategies in PAL I and the World Trade Organization (WTO) accession component, added in PAL II, seem to be less suited for a major “core” program of adjustment operations and might have been better pursued through other instruments (lending or non lending), thus making the PAL program simpler. Also, some (energy privatization, land titling, transparency in

privatization) were already known potential “trouble spots” at an early stage and could have been addressed more effectively, depending on their priority within the program.⁵⁰

3.43 Overall, the quality at entry of PAL I, of PAL II and of the PAL program are rated *satisfactory*.

Outcomes by Objective and Component

3.44 The outcome of each of the five major objectives/components is summarized below:

3.45 *Fiscal and Financial Discipline*. This was one of the most important and successful components of the PAL program. Main items for PAL I and PAL II included:

- ***PAL I:*** (i) *elimination of budget offset*, (ii) *reduction of budget arrears*, and (iii) *reduction of electricity and gas arrears*. Non-transparent budget offsets were disallowed in mid-2000 and completely eliminated in the 2001 budget. Budget arrears decreased by more than half from their level in 2000 (wage arrears were fully eliminated, social sector arrears reduced by 55 percent and other arrears reduced by 50 percent). Finally, electricity and gas cash collections exceeded their targets of 60 percent of current charges (by the time of PAL II approval Wholesale Electricity Market cash collections were above 90 percent of current charges, and those of Naftogaz were above 85 percent). Thus, the targets were all achieved or exceeded, and the outcome of this component is rated *highly satisfactory* for PAL I.
- ***PAL II:*** (i) *continued reduction of arrears*: tax arrears of non-energy enterprises decreased from .9 percent of GDP in January 2002 to .3 percent in April 2005, while wage and social protection arrears (originally 4 percent of GDP) were fully eliminated; (ii) *further improvement of payment discipline in electricity and gas*: cash collections for electricity increased from 90 percent to 95 percent, and for gas from 85 to 97.5 percent, by the end of 2005; (iii) *establish a legislative framework to enforce “secured interest” including adoption of a mortgage finance law*: this objective was also achieved (the law was approved prior to PAL II approval) and a main outcome has been the rapid growth in the volume of mortgage financing (from \$453 million in 2003 to \$638 million in 2004 and \$2.1 billion in 2005); and (iv) *one benchmark under this component (adoption of an energy sector debt restructuring law) was not achieved* at the time of PAL II closing and required a waiver for the second tranche release, but was adopted shortly thereafter. The outcome of this component is rated *satisfactory* for PAL II.

3.46 *Regulatory Framework*. This component was modest for PAL I but more substantive for PAL II, particularly in the financial sector (and WTO accession). Major items for each of the operations were:

⁵⁰ In some cases, it would be preferable to avoid formal conditions where success was deemed unlikely, instead of providing formal support for a dubious process: this is likely the case for “privatization transparency.”

- **PAL I: improvements in the business environment** (one-stop shop, simplified licensing, etc.). One stop registration was introduced, with regulations requiring that time required should not exceed five working days, and new licensing procedures were established following a new (2000) licensing law. Surveys of newly registered business by the United States Agency for International Development (USAID) and the International Finance Corporation (IFC) found that the official registration costs went down from \$192 in 1997 to \$22 in 2001 with the number of days required dropping from nearly 35 to about 12, and the number of inspections from 30 to 12. Thus, the benchmarks were met and there were improvements as a result, although they appear to be modest due to continuation of bureaucratic behaviors. The outcome of this component is rated *satisfactory*.
- **PAL II: (i) improvements in the regulatory environment for the financial sector:** in the supervision and enforcement area, NBU continued to expand application of the Basel Core Principles for capital adequacy, exposure, provisioning and has initiated work on connected lending (the latter, however, is hampered by inadequate information on bank ownership). Restructuring of the Savings Bank continued under the MoU and the bank achieved profitability and capital adequacy in late 2005 (including a government capital injection). Finally, the Commission for Financial Services and State Regulation of Financial Service Markets (the regulatory agency for NBFIs) was established and is operating (although with limited funding and limitations related to the division of labor with other regulators—NBU and the Securities and Exchange Commission) and **(ii) progress toward WTO accession:** a legal framework for a system of certification, accreditation and confirmation of correspondence to international standards was approved, legislation on intellectual property compliant with trade-related intellectual property rights (TRIPS) (the WTO rules on TRIPS) was also approved, and an agency for accreditation was created. Thus, the achievements in the financial sector were substantial and there was progress in the WTO process. The outcome of this component is rated *satisfactory*.

3.47 *Property Rights.* This component was highly relevant for improving governance, and of major importance in both PAL operations, but achievements were modest. Achievements were somewhat more substantial in PAL I than in PAL II, but there were problems under both operations. Under PAL I initial steps were taken in some areas, while under PAL II formal achievement of benchmarks did not always result in the intended outcomes. Improving the transparency of the privatization process was only partially achieved, at best, in spite of the benchmarks being met (in PAL I) or partially met (in PAL II). Major items included:

- **PAL I: (i) agriculture reform including discontinuation of Kolkhozes and issuing of land certificates and land titles:** The first steps in land reform were achieved as Kolkhozes were abolished, land certificates were distributed to more than 6.5 million former members and nearly 2 million land titles were issued by the end of 2001 although the quality and usefulness of the land titles issued was limited due to the absence of an effective Cadastre and land registration agency; **(ii) progress in transparent privatization in industry and energy:** as noted in the

implementation section, progress on this item, particularly regarding transparency was limited, and problems with energy privatization emerged already at the time of second tranche release; (iii) *progress in telecom privatization*: Parliament approved a law allowing a strategic investor to acquire a minimum of 25 percent shares through a competitive process and later increase the amount to 50 percent, but approval of the law took place before the establishment of clear rules in the sector (regulation, tariffs, etc.). In spite of the law (but fortunately, given the absence of market regulation) the then monopoly company (Ukrtelecom) is still owned by the government; and (iv) *progress in resolving the Bank Ukraine problem*: the liquidation of Bank Ukraine was agreed and implemented. The outcome of this objective is rated *moderately satisfactory*.

- **PAL II:** (i) *agricultural land ownership, including issuing more land titles and enacting a law to establish a single agency for registration*: for this item, the law was passed (and thus, the benchmark achieved) but continued administrative opposition (from the Ministry of Justice) prevented the law from becoming operative; (ii) *transparency of privatization (with PAG oversight) for industry and continue privatization in energy*: improved transparency was not achieved during the period through 2004, as noted above, (although a major re-privatization in late 2005, after PAL II closing, corrected part of the problem and in the energy sector, delays in the debt restructuring law required a waiver for second tranche release (the law was approved shortly thereafter). Despite approval of the law, continuing privatization in the energy sector has been postponed (reflecting a long-standing difficulty with this objective, which started during PAL I second tranche release); and (iii) *initiate bankruptcy procedures for several enterprises and continue liquidation of Bank Ukraine*: only the outcome of the third item was fully achieved. The outcome of this component is rated *moderately unsatisfactory*.

3.48 *Public Sector Efficiency and Accountability*. This component was both relevant and successfully achieved under both operations (although a sustainability issue has emerged regarding public procurement—see below). Major items included:

- **PAL I:** (i) *improved budget transparency (introducing a formula for inter-governmental transfers)*: the formula-based calculation of transfers was introduced in the 2001 Budget law for the oblast (province) level, and in the 2002 budget was expanded to lower units (rayon); (ii) *improve the use of public resources (implementing a single Treasury account)*: the single Treasury account was fully operational in all the oblasts by the end of 2001; (iii) *public administration reform*: the main achievement is the streamlining of the Council of Ministers (CoM), the creation of CoM Committees, and the improvements in the functioning of the CoM Secretariat and; (iv) *elimination of tax exemptions*: the CoM cancelled 256 earlier CoM resolutions granting tax exemptions. All benchmarks were achieved, and progress and impact were substantial. The outcome of this component is rated *highly satisfactory*.
- **PAL II:** (i) *implementation of the CFAA Action Plan*: an external oversight body for the State Tax Administration was established, an automated treasury system was implemented in all oblast treasury offices, and a concept paper on internal

financial control, compliant with the EU *acquis communautaire* was approved by the CoM; (ii) *implementation of the CPAR Action Plan (including draft law on procurement)*: the use of competitive bidding process was expanded, with exceptions (single-source selection) reduced to 25 percent of the number and 35 percent of the value of contracts. On procurement, however, subsequent legislative actions (after PAL II closing) have created serious risks and raise question about sustainability of progress on this area; and (iii) *improved tax and revenue system (including further reduction of exemptions and privileges)*: sector/industry specific tax exemptions were reduced by more than 55 percent since January 2002. Thus, all benchmarks were achieved and improvements were considerable. The outcome of this component is rated *satisfactory*.

3.49 *Management of Social and Environmental Risks*. This component was a mixture of different sub-components, some of which were closely linked to the core reforms in the PAL program (for example, the pension system reform). Other sub-components, however, were self-standing activities that could have been handled outside of the PAL program through other operations, or even through analytical work and policy dialogue (for example, in the health and education areas, that were not continued in PAL II). Major items included:

- **PAL I:** (i) *pension reform*; (ii) *improved targeting of social assistance*; (iii) *improved health and education (mostly activities already under way plus the preparation of two sector strategies)*; and (iv) *reduction of social protection privileges not justified on poverty and equity grounds*. All benchmarks were fully met and progress on the pension and social assistance reform was substantial and opened the way to further reforms under PAL II. The outcome of this component is rated *satisfactory*.
- **PAL II:** (i) *pension reform*; (ii) *better targeted social assistance*; (iii) *further reduction of special privileges*; and (iv) *improve environmental regulations*. Items (i) to (iii) were the continuation of reform programs started under PAL I; all benchmarks were met and the outcomes achieved. Item (iv) was a list of actions already taken prior to the first tranche (with no second tranche benchmarks). The outcome of this component is rated *satisfactory*.

Institutional Development

3.50 The institutional development impact was *substantial* for PAL I and PAL II, because of both operations' role in supporting institutional change, including the change from a culture of arrears, poor collections and offsets, as barter, to one based on timely monetary transactions. Institutional development was also achieved in public sector agencies (Treasury, pension system), and continued in the banking sector, including the NBU, other regulatory agencies and the Savings Bank. Finally, the PAL operations also had a positive institutional development impact through the "Working Groups" in which staff from different government ministries and agencies worked together and gained an understanding of the inter-relations between different parts of the reform program that their units were pursuing.

Outcome

3.51 Based on the above, including the high relevance of the program, the outcome by specific component, and the institutional impact of the PAL program, the outcomes of PAL I and PAL II are rated *satisfactory*. The above discussion also shows that the achievements of PAL I, and particularly of PAL II were limited by several weaknesses: these are visible not only in the delays and waivers for the release of the second tranche of PAL II, but also in the gap between compliance with benchmarks and achievement of outcomes in land titling, transparency in privatization and energy privatization. Overall, however, these shortcomings should not detract from the substantial achievements under the PAL program, which leads to the assessment of its outcome as *satisfactory*.

3.52 The achievements were substantial in the areas of fiscal and financial discipline, particularly regarding the energy sector, (in spite of the limited progress towards privatization), in improving the financial performance of the government and of its treasury operations, of the financial sector, through the liquidation of Bank of Ukraine, restructuring of Savings Bank (which took longer than originally expected) and improvements in the regulatory framework, and in the elimination of tax exemptions, privileges, etc. as well as a good beginning in the reform of the pensions system. The improvements seem more moderate in areas such as property rights and business environment, at least partially because of governance issues, and in the reform of public administration.

Risk to Development Outcome

3.53 The current assessment of the PAL program also confirms that the risk that the achievements of the program may not be maintained is *negligible to low*. The progress achieved in all areas has continued without reversals (with the exception of the procurement law), and progress has continued in several areas supported by a subsequent adjustment operation (DPL I, not covered by this PPAR). The recent issues in the procurement area are serious and need serious attention.

3.54 Needless to say, the challenges facing Ukraine's continuing economic growth, poverty alleviation and governance improvements remain high, and a substantial agenda for further reform continues to exist in all areas covered by the PAL program. This suggests opportunities for continuing Bank engagement. After five years of very rapid growth and improvements in the financial sector, and in the fiscal and external accounts, in 2005 there was a weakening of the country's economic performance. Although the economy recovered in 2006 (with higher growth and lower inflation, but also with the current account balance turning negative) there are both external and internal risks that may require an acceleration in the agenda for reform. In the external side this includes the possibility of an adverse terms of trade effect while in the financial sector substantial vulnerabilities still exist. Finally, the protracted political difficulties throughout 2006 and in early 2007 introduce another element of risk. This risk is still assessed as low at the present but could become more serious were the impasse to continue for a prolonged period.

Bank Performance

3.55 Bank performance under PAL I and PAL II was *satisfactory* in spite of a few shortcomings discussed in the preparation and implementation sections above. For PAL I design and quality at entry were good but some items were included (for example, in the health and education sector) that could have been better addressed through other instruments. For PAL II design did not pay adequate attention to the early signs of trouble with electricity privatization (which eventually required a waiver). In both PALs, the “transparency of privatization” was a difficult issue: the objective was too ambitious and yet the implementation was too lax (in spite of the PAG “endorsement” under PAL I). Supervision of PAL II rated the operation satisfactory throughout, in spite of these issues. Finally, in PAL II, the design of the component regarding land titling failed to appropriately account for the administrative opposition to the “single agency” approach by the Ministry of Justice. At a more institutional level, the Region’s decision in both PALs to move to a two tranche approach after having started the design (of the program and of each of the PALs) as a single tranche operation, reduced flexibility in the program.

3.56 The above shortcomings, which lead to ratings for Bank performance below the “highly satisfactory” ratings in the ICRs of PAL I and II, do not detract, however, from the good quality of the Bank’s work under the PAL program: the detailed work in multiple components, at the design and implementation level, in difficult country conditions fully justify the satisfactory rating of what was designed as, and turned out to be, the “*flagship operations*” of the two CAS periods. A related issue is to what extent was the Bank prepared and capable of using the PAL program as the linchpin of the CAS program and benefit fully of the inter-linkages with related investment operations. The poor experience with investment operations during the PAL program period shows that this is an area where further work is needed in future adjustment operations (i.e. under the ongoing DPL program).

Borrower Performance

3.57 Borrower performance was generally good but fluctuated substantially over the 5-year period of the PAL program, along with the political events of the period. Overall, performance was better during the early part of PAL I (that is, during its preparation period) than in later periods, as discussed in the implementation section. At the technical level, performance of the working groups was good overall, but the quality of decision-making fluctuated with the political country’s rhythm. Compliance with benchmarks was particularly good in the “financial discipline” area but with widespread delays in many other areas. The poor performance regarding “transparency of privatization”, and the consistent delays and reluctance to further privatization in the energy sector were present under both PAL I and PAL II, and were stronger under PAL II. The bureaucratic in-fighting regarding the single agency for land titling was another problem with borrower performance under the second operation. With good performance in all other areas, borrower performance in PAL I is rated *satisfactory* and under PAL II *moderately satisfactory*. This latter rating is lower than that assessed in the ICR review by IEG.

Lessons

PAL Program

3.58 Three major categories of lessons emerge from this assessment of the PAL program: one is related to its links to the rest of the Bank's program in Ukraine, including some related investment operations, one emerge from some of the specific program shortcomings mentioned above and, finally, the last lesson is related to the design and tranching of PAL I and II.

3.59 *Links and complementarity between the PAL program and investment lending need reinforcing.* The 2000 CAS presented the PAL program as the centerpiece of Bank assistance, with investment operations complementing this assistance in specific sectors. While this was a well thought through approach, in practice, the PAL program attempted to cover too many issues and areas, while the investment projects became too isolated and outside of the main dialogue. Paradoxically, this may have contributed to worsen the implementation of some investment projects. Looking forward, the core adjustment program should concentrate only on *core* policy issues, while some investment and other sector operations should focus on the related institution building objectives. In other sectors, the reform program in health and education, and in the environmental area, could have been more adequately pursued through other instruments, both lending and non-lending (and including project specific as well as sector investment operations). Similarly, in the area of private sector development, carrying the dialogue on policy reform and the support for institutional development through project or sector-level instruments, could have achieved better results. An additional advantage of this approach would have been to simplify the very broad-based PAL operations.

3.60 *Politically difficult issues are noticeable during the early stages of program implementation and when crucial to the success of the program should be addressed early.* Several of the shortcomings noted above (privatization of Oblenergos, law—and implementation—regarding land titling, transparency in privatization) were potential deal breakers in 2004/05 but had already emerged at the beginning of the PAL program. When these “sticky issues” are crucial to the success of the program they need early attention rather than postponement. In the case of the planned privatization of Oblenergos, the “brinkmanship” that required a last minute Presidential Decree prior to the release of the second tranche of PAL I should have been seen as an indication of the substantial political opposition to the objective, and more serious consideration should have been given to how to address it under PAL II. Regarding the transparency of privatization objective, an over-ambitious objective from the very beginning, there were early indications that the impact of the Bank and of the “benchmarks” in the PAL program would be limited at best. In the event, the formal benchmark led to accepting a dubious outcome, thus creating a reputational risk for the Bank (conferring Bank legitimacy to a poor governance situation). As in the lesson above, over-reaching may result in a worse outcome. Similarly, in the area of land titling and creation of a single land titling agency, the roots of the problem were in the existence of a strong opposition within at least one part of the government (the Ministry of Justice) to the proposed solution.

3.61 *Tranching was not fully consistent with the PAL program approach (and brought no obvious advantages).* The PAL program was conceived as a series of single tranche operation based on a medium-term program and achieved results. The tranching of PAL I and II was an ad hoc Bank response to uncertainty, which could have been equally or better addressed through adjustments in the timing and/or amount of each PAL. In each case, the initial design was for a single tranche, and the two-tranche approach was introduced as a result of unexpected events or perceived risks for the operation. But as the Bank's movement to Development Policy Lending has started to show, single-tranche operations based on demonstrated, achieved reforms and outcomes results in increased flexibility, to respond to the inevitable changes in the pace of a country's reform program. The new series of DPL operations should benefit from using the original approach of the PAL program.

Overall Lessons (including FSAL)

3.62 In addition to the FSAL and PAL program lessons discussed above, the assessment of the three adjustment operations in Ukraine between 1998 and 2005 suggests some common lessons of experience.

3.63 *Both sector-specific and broad-based multi-sector adjustment operations can be successful, when adequately linked to the country's reform program and to the Bank's assistance strategy.* The FSAL was successful because it targeted a crucial sector in the country, and allowed the removal of a major binding constraint, at a time when a broader reform program was also introduced and implemented by the government. The PAL program was specifically designed to support the major components of the government program and was able to help the government move forward with these major components in a well sequenced manner: when constraints on growth are multi-sectoral, cross-sector operations, albeit with selective thematic focus may be the preferred way to go.

3.64 *Sector-specific adjustment operations require an adequate overall policy environment to achieve their intended results.* The FSAL was more successful than the earlier SECALs approved during the 1996 CAS period, because shortly after its approval, a broader policy reform effort started (following the September 1998 economic and financial crisis in Ukraine, and the coming to office of a reform-minded government in 1999). Also, the approval of FSAL immediately after the September 1998 crisis, and in parallel with the agreement on an EFF arrangement between the Government and the IMF, made it into a central piece of the economic reform program.

Annex A. Basic Data Sheet

FINANCIAL SECTOR ADJUSTMENT LOAN (LOAN NO. 4391-UA)

Key Project Data (amounts in US\$ million)

Financial

	<i>Appraisal estimate</i>	<i>Actual or current estimate</i>	<i>Actual as % of appraisal estimate</i>
Total project costs	300	260	86.67
Loan amount	300	260	86.67
Cofinancing	--	--	--
Cancellation	--	--	--
Institutional performance	--	--	--

Project Costs and Financing

<i>Project cost by Tranche</i>	<i>Appraisal Estimate</i>	<i>Actual Estimate (Disbursed)</i>	<i>Percentage of Appraisal</i>
First tranche	US\$100 million	US\$100 million	100%
Second tranche	US\$100 million	US\$100 million	100%
Third tranche	US\$100 million	US\$ 60 million	60%
TOTAL	US\$300 million	US\$260 million	87%

Project Dates

	<i>Original</i>	<i>Actual</i>
Initiating memorandum	07/18/96	07/18/96
Negotiations	02/12/98	02/12/98
Board approval	09/15/98	09/15/98
Signing	09/15/98	09/15/98
Effectiveness	12/14/98	09/18/98
Closing date	12/31/99	02/15/01

Staff Inputs (staff weeks)

<i>Stage of Project Cycle</i>	<i>Actual/Latest Estimate</i>	
	<i>No. Staff weeks</i>	<i>US\$ ('000)</i>
Identification/Preparation		517.0
Appraisal/Negotiations		172.0
Supervision		374.0
Completion		53.0
Total		1,116.0

Note: The current MIS does not provide information on the actual staff weeks spent during the project cycle.

Mission Data

	<i>Date (month/year)</i>	<i>No. of persons</i>	<i>Staff days in field</i>	<i>Specializations represented</i>	<i>Performance rating</i>	<i>Rating trend</i>	<i>Types of problems</i>
Identification/ Preparation	06/96	5		Task Manager (1), Economist (1), Accounting Specialist (1) Banking Specialist (2)			
	10/96	5		Task Manager (1), Operations Officer (1), Banking Specialist (3)			
	03/97	9		Task Manager (1), Operations Officer (1), Accounting Specialist (1), Economist (1), Banking Specialist (5)			
	06/97	5		Task Manager (1), Accounting Specialist (1), Banking Specialist (3)			
	07/97	3		Task Manager (1), Banking Specialist (2)			
Appraisal/	11/97	5		Task Manager (1), Operations Officer (1), Accounting Specialist (1), Banking Specialist (2)			
Supervision	11/98	2		Task Manager (1), Banking Specialist (1)	S	S	
	05/99	3		Task Manager, Banking Specialist (2)	S	S	
	07/99	2		Task Manager (1), Banking Specialist (1)	S	S	
	03/00	5		Task Manager (1), Director (1), Banking Specialist (3)	U	U	
	06/00	4		Task Manager (1), Banking Specialist (1), Financial Specialist (2)	S	S	
	10/00	5		Task Manager (1), Banking Specialist (1), Financial Specialist (2)	U	U	
	12/00	3		Task Manager (1), Banking Specialist (1) Financial Specialist (1)	S	S	
Completion		1		Financial Specialist (1)			

PROGRAMMATIC ADJUSTMENT LOAN (PAL I) (LOAN No. 4639-UA)

Key Project Data (amounts in US\$ million)

Financial

	<i>Appraisal estimate</i>	<i>Actual or current estimate</i>	<i>Actual as % of appraisal estimate</i>
Programmatic Adjustment Loan (PAL I)			
Total project costs	250	250	100
Loan amount	250	250	100
Cofinancing			
Cancellation			
Institutional performance			

Project Costs and Financing

<i>Project cost by Tranche</i>	<i>Appraisal Estimate</i>	<i>Actual Estimate (Disbursed)</i>	<i>Percentage of Appraisal</i>
First tranche		US\$150 million	
Second tranche		US\$100 million	
TOTAL			

Project Dates

	<i>Original</i>	<i>Actual</i>
Programmatic Adjustment Loan (PAL I)		
Initiating memorandum	05/18/00	10/31/00
Negotiations	10/02/00	07/23/01
Board approval	11/28/00	09/20/01
Signing		09/20/01
Effectiveness	09/21/01	09/21/01
Closing date	12/31/02	12/31/02

Staff Inputs (staff weeks)

<i>Stage of Project Cycle</i>	<i>Actual/Latest Estimate</i>	
	<i>No. Staff weeks</i>	<i>US\$ ('000)</i>
Identification/Preparation	85.6	73.0
Appraisal/Negotiations	111.7	611.3
Supervision	70.9	106.3
Completion	5.0	15.0
Total	278.62	805.3

Mission Data

	<i>Date (month/year)</i>	<i>No. of persons</i>	<i>Staff days in field</i>	<i>Specializations represented</i>	<i>Performance rating</i>	<i>Rating trend</i>	<i>Types of problems</i>
Identification/ Preparation	03/00 – 06/01	16		Task Team Leader (1), Economists (2), Social Sector (3), Energy Sector (2), Financial Sector (2), Private Sector Development (2), Environment (2), Agriculture (2)			
Appraisal	06 - 07/01	16		Task Team Leader (1), Economists (2), Social Sector (3), Energy Sector (2), Financial Sector (2) Private Sector Development (2), Environment (2), Agriculture (2)			
Supervision	09/01	3		Task Team Leader (1), Economists (2)			
Completion	09/02 – 03/03	3		Task Team Leader (1), Economists (2)			

Other Project Data

Borrower/Executing Agency:

FOLLOW-ON OPERATIONS

<i>Operation</i>	<i>Loan no.</i>	<i>Amount (US\$ million)</i>	<i>Board date</i>
Second Programmatic Adjustment Loan	4722	250	12/09/03

PROGRAMMATIC ADJUSTMENT LOAN (PAL II) (LOAN No. 4722-UA)

Key Project Data (amounts in US\$ million)

Financial

	<i>Appraisal estimate</i>	<i>Actual or current estimate</i>	<i>Actual as % of appraisal estimate</i>
Total project costs	250	250	100
Loan amount	250	250	100
Cofinancing			
Cancellation			
Institutional performance			

Project Costs and Financing

<i>Project cost by Tranche</i>	<i>Appraisal Estimate</i>	<i>Actual Estimate (Disbursed)</i>	<i>Percentage of Appraisal</i>
First tranche		US\$75 million	
Second tranche		US\$172.5 million	
Third tranche			
TOTAL			

Project Dates

	<i>Original</i>	<i>Actual</i>
Initiating memorandum	01/16/02	05/13/02
Negotiations	06/30/03	07/21/03
Board approval	09/17/02	12/09/03
Signing		12/17/03
Effectiveness	12/19/03	12/19/03
Closing date	12/31/04	06/30/05

Staff Inputs (staff weeks)

<i>Stage of Project Cycle</i>	<i>Actual/Latest Estimate</i>	
	<i>No. Staff weeks</i>	<i>US\$ ('000)</i>
Identification/Preparation	62.78	176.4
Appraisal/Negotiations	149.74	342.4
Supervision	52.56	98.7
Completion	3.0	9.1
Total	268.08	626.6

Mission Data

	<i>Date (month/year)</i>	<i>No. of persons</i>	<i>Staff days in field</i>	<i>Specializations represented</i>	<i>Performance rating</i>	<i>Rating trend</i>	<i>Types of problems</i>
Identification/ Preparation	05/02	12		Task Team Leader (1), Procurement Specialist (1), Economists (3), Project Officers (4), Program Assistant (1), Extended Term Consultants (2)			
Appraisal	05/02	28		Task Team Leader (1), Procurement Specialist (1), Financial Management Specialist (1), Sector Specialist (11), Economists (2), Research Analyst (1), Project Officers (6), Extended Term Consultants (1), Consultants (3), Program Assistant (1)			
Supervision	12/03 – 06/05	13		Task Team Leader (1), Procurement Specialist (1), Economists (4), Project Officers (3), Extended Term Consultants (2), Consultant (1), Program Assistant (1),	S	S	
Completion	11/05 – 04/06	1		Task Team Leader (1), Extended Term Consultants (1), Consultant (1)			

Other Project Data

Borrower/Executing Agency:

FOLLOW-ON OPERATIONS

<i>Operation</i>	<i>Loan no.</i>	<i>Amount (US\$ million)</i>	<i>Board date</i>
Development Policy Loan (Formerly PAL III)	4799	251.26	07/05/2005