

# STRATEGY FOR UKRAINE

## 1995-96

### SUMMARY

#### SYNOPSIS

The EBRD's principal sector priorities in Ukraine for 1995-96 are as follows:

**Private sector development:** The EBRD will seek to support renewed privatisation by providing financing and technical services for the most promising newly privatised enterprises, while also supporting expanding or new SMEs. The Regional Venture Fund concept seems promising in a Ukrainian context. Considerable technical cooperation would be required to support fund management, the restructuring of target enterprises and management strengthening, including handling of corporate environmental issues and liabilities. The Bank will stand ready to support multilateral initiatives.

**Financial sector development.** The Bank will: (i) assist the most promising private banks to develop to standards of international creditworthiness; (ii) extend the range of financing facilities available to private enterprises through these banks; (iii) provide equity finance to the most promising banks; and (iv) support initiatives to provide equity finance to local private enterprises.

**Agriculture:** Priorities in this key sector will be: (i) seeking to establish private sector structures that replace the collapsing state order and procurement system; (ii) encouraging the design of integrated private agricultural projects through the production/ processing/distribution chain; (iii) improving the sector's access to term financing and investment funds; and (iv) supporting the development of new infrastructure, especially to provide market-based outlets for private farmers.

**Infrastructure:** Operations will focus on selective rehabilitation of energy, transport, telecommunications and municipal infrastructure. Least-cost justifications will be a prerequisite for Bank support. Emphasis will be on introduction of modern technology in power generation and telecommunications and on modern control systems. Special emphasis will be given to projects that help improve nuclear safety and to proposals that provide infrastructure through private investment structures. Free economic zone creation will be explored.

**Selected private investments:** The EBRD will continue to support private investment proposals in manufacturing industries that have a high demonstration effect and where it can mobilise financing from international banks. Proposals involving strategic sectors (e.g. metals, electronics, electrical equipment and shipbuilding) will be given special attention, as will military conversion.

Increased use will be made of technical cooperation to promote project development (of local private and public sector projects) and to support enterprise restructuring, institutional strengthening and post-privatisation support.

*This document is based on the EBRD's Strategy for Ukraine, approved on 21 February 1995, which is for official use only.*

# 1 STRATEGY

## 1.1 LINKING THE STRATEGY TO THE SCENARIOS

Three scenarios are considered for the strategy:

- **Baseline:** Gradual implementation of reform reflecting variable political consensus.
- **High case (optimistic):** Sufficient political consensus to drive rapid reform.
- **Low case (pessimistic):** Political gridlock, policy drift and recurring economic instability.

EBRD strategy assumes the baseline scenario, but is flexible.

### **Low case (pessimistic) scenario**

EBRD operations would be cut back sharply to niche operations. Priorities would change as follows:

- Increased emphasis on policy discussions with the Government to encourage the removal of the most serious obstacles to private sector development;
- Relative shift from investment to technical cooperation projects, with emphasis on institution building, reform design and strengthening implementation capacity;
- Reduced emphasis on developing unsecured credit lines through private banks and on identifying banks suitable for equity participation;
- Greater selectivity in financing public sector investment, because of likely greater resistance to structural reforms and tariff adjustments;
- More emphasis on enclave-type private sector operations that are export-oriented and hence shielded from the poor business environment.

### **High case (optimistic) scenario**

EBRD operations could expand rapidly. Priorities would change as follows:

- Less attention to technical cooperation initiatives with longer-term payoffs;
- More emphasis on developing and using financial intermediaries and on developing new financial instruments, markets and participants;
- Increased financing of individual private sector projects, notably in agriculture;
- Greater receptivity to finance public sector infrastructure under full cost recovery with transfer of management, and where feasible ownership, to private sector.

# 2 KEY OPERATIONAL OBJECTIVES

## 2.1 PRIVATE ENTERPRISE DEVELOPMENT

### **Promotion of SME development**

Since SMEs are too small to work directly with the EBRD, indirect delivery mechanisms will be developed. The Ukraine Fund and the SME Line of Credit provide indirect channels for reaching SMEs with equity and term credit. A Ukraine Fund II is envisaged in about a year, when the first fund is expected to be fully

committed. Other new venture capital funds are also planned, targeting larger private enterprises or industrial subsectors, including high technology and defence conversion. Future SME lines of credit would be in the form of unsecured loans to private banks that have graduated to international creditworthiness.

The Bank will pursue with the Government the removal of important obstacles to SME development. It will also increase its cooperation with bilateral and multilateral sources to offer SMEs a package of technical cooperation to make the best use of the financial support provided through Bank operations.

### **Post-privatisation support**

The EBRD will build on the experience gained since 1992, when it established the first resident advisory unit in the State Property Fund. The unit has assisted in drafting privatisation legislation and in pilot privatisation cases. This early experience will be disseminated to a broad audience in 1995 through publication of a brochure on *Privatisation in Ukraine: Early Examples*.

With a restart to privatisation in 1995, the Bank will stand ready to support a growing number of fledgling private enterprises. It could finance directly the most promising larger enterprises, especially high-technology and export-oriented enterprises. For those enterprises that are too small for direct Bank involvement, various venture capital funds are foreseen. These would normally target a specific industry or size range. By providing capital, and to various degrees technical services, the funds could materially improve the survival rates of the most promising newly privatised enterprises and spur their development.

### **Restructuring**

First, the Bank will consider equity participation and term lending to support the restructuring of larger private enterprises, provided they have a clear technology advantage and export potential. Possibilities for implementing simplified Special Restructuring Programmes will be explored. An international joint-venture partner (with a proven record) to participate in the restructuring will be a prerequisite. Co-financing with other sources of external financing will be sought.

Second, the Bank will be prepared to consider equity participation in enterprise restructuring funds, focusing on reform-minded regions. Such funds would initially take a majority equity stake, manage the enterprise for 2-3 years to turn it around and regain profitability, then divest and become minority shareholders, then move on to other enterprises. Considerable technical cooperation support would be required to support fund management, the restructuring of target enterprises and management strengthening (including as regards handling of corporate environmental issues and liabilities). The feasibility of developing one or more funds will thus depend strongly on the extent of donor support. It will also depend, crucially, on invigorated progress by Government on privatisation.

## **2.2 FINANCIAL SECTOR**

The strategy builds on the US\$ 121 million SME Line of Credit signed in December 1994. The EBRD will seek to ensure that its operations contribute to an overall package of international assistance which is coherent and focused on main issues. EBRD activities will have a particular focus on operations that promote development of private banks and improve the access of SMEs to the normal range of financial services they require. Demonstration and multiplier effects will be sought in providing

financing, supplemented where necessary by technical cooperation. The objectives of the strategy reflect the pivotal role of financial intermediation in the transition process and are project based. The EBRD will:

- Support development of a wide range of financial markets, instruments and participants, including foreign participation, and seek to promote the integration of Ukraine's financial sector into international financial markets.
- Continue to focus on development of private financial institutions that show promise of becoming capable of efficiently mobilising resources (internally and externally) and of allocating credit, and other means of financial support, according to market-based criteria.
- Be project focused.
- Selectively initiate technical cooperation projects. As a rule, these will be to finance activities required for project preparation and implementation.

Various **instruments** will be used. The most important instruments foreseen are:

- Credit lines (coupled with technical cooperation) to private banks, initially under a sovereign guarantee, but subsequently directly to individual private banks as these become creditworthy.
- Trade financing facilities to promote private sector trade and closer cooperation between Ukrainian banks and their correspondent banks.
- Equity stakes in private banks and/or finance companies providing term lending to SMEs, as banks become creditworthy.
- Equity participations in private venture capital funds. First, to provide post-privatisation support to new and recently privatised SMEs, coupled with advisory services. Second, to carry out restructuring of larger privatised companies.
- Support, through guarantees, for efforts by private banks to mobilise domestic savings, both in local and foreign currency.
- Equity participations in private Ukrainian banks, if possible with foreign participation, will add competition and innovation to financial markets.

### **2.3 AGRIBUSINESS**

Despite the difficult business environment, a highly motivated private sector is emerging. To support it, the Bank will invest in private projects that:

- Replace the state order system and the state-administered agroindustrial complex;
- Create competition in marketing and in supply of inputs and machinery;
- Are quick yielding, attract foreign investment and technology, and are replicable;
- Have a high demonstration effect and highlight the need to relax investment constraints.

To put this strategy into effect, the Bank will:

- Overcome linkage constraints by supporting projects that adopt an integrated approach which can often be used to attract private capital from abroad;
- Work in progressive oblasts where there is demonstrated support for reform;
- Work bottom-up through private entrepreneurs with a demonstrated ability to realise objectives (rather than top-down through existing state structures);
- Work with crops and in marketing and processing areas that are not restricted by national strategic considerations;
- Work with other IFIs and donor agencies active in supporting agriculture.

Emphasis will be given to development of integrated projects that provide access, in a market context, to improved seeds and fertilisers and to modern storage and processing facilities. This emphasis will, however, not be to the exclusion of other priority projects such as improving access of the sector to term financing and investment funds, and improving markets for inputs and outputs.

## **2.4 ENERGY**

### **Energy sector**

EBRD objectives are to help reduce the economy's energy intensity, facilitate the closure of Chernobyl and improve environmental performance. Priorities are to:

- Improve performance, efficiency and environmental performance of power generation and in commercially structured projects sponsored by private investors;
- Promote improved end-use efficiencies, and more rational use of energy through pricing reform and energy efficiency initiatives;
- Help improve the reliability of the power and gas transport systems;
- Support reorganisation of the sector;
- Assist development of domestic fossil fuel reserves.

This strategy will provide direct support to the G-7 Action Plan for Ukraine, which proposed a comprehensive package of nuclear safety upgrades, tariff increases, rehabilitation of thermal plant and completion of modern nuclear plants under construction to facilitate the earliest feasible permanent closure of Chernobyl.

Envisaged EBRD support for the Plan will comprise a proposed NSA project and support for priority non-nuclear projects, including improvement of energy efficiency. The EBRD's involvement will depend on whether proposed projects are consistent with its operational policies and strategies and its criteria.

A least cost analysis, now under way, will help Ukraine define investment priorities in more detail. The Bank will also assist with rehabilitation of thermal plant, to promote introduction to Ukraine of advanced coal generation technology. Proposals for combined heat and power projects are also under consideration. Efficiency improvements will be pursued through pricing reforms, which will be secured in loan conditionality. The Bank will also seek to launch viable projects to promote improvements in demand-side efficiencies.

## **Nuclear Safety Account (NSA)**

In support of the G-7 Action Plan, the NSA has started developing a project for the Chernobyl Nuclear Power Plant. Subject to the agreement by the NSA donors, a grant from the Account will finance preparation for decommissioning of Units 1-3 and immediate safety upgrades at Unit 3. Preparation for decommissioning of Units 1-3 will include, as a first stage, essential facilities for spent fuel storage, waste treatment plants and a power and steam generating unit. Preparation of the project in this area will benefit from close cooperation with the European Union and bilateral programmes. Short-term safety improvements at Unit 3 will include essential safety equipment to allow safer operation until closure.

A grant of up to US\$ 200 million has been pledged by the G-7 in support of the Plan, which would include a replenishment of the NSA to finance the proposed project. This complements ECU 100 million grants from TACIS and possible EURATOM loans of ECU 400 million.

## **Energy conservation**

Improving energy efficiency, both in terms of supply and demand, is a priority objective for the EBRD. Selected rehabilitation of energy supply infrastructure will be important (especially through introduction of new-generation technology) to cut supply losses and improve conversion efficiencies. Progress on tariff reform will be a condition for Bank support of rehabilitation projects. The Bank also aims to launch an initiative to directly improve demand-side efficiency in large industries where energy tariffs are approaching international levels (e.g. fertilisers). The initiative will seek to use a private investment vehicle to achieve significant savings in these industries through leasing modern conservation equipment. Use of energy-saving companies and third-party financing companies will be explored.

The Bank will also emphasise the need to consider in parallel investments on both the supply and the demand sides, through least-cost planning consistently applied in the framework of an Integrated Energy Planning Policy.

## **2.5 INFRASTRUCTURE**

### **Transport**

Substantial restructuring of the transport system will be necessary to meet the country's changing economy and customers' needs. Main priorities are:

- Improvement of multi-modal Trans-European corridors, focusing on the rehabilitation and upgrading of existing routes;
- Separation of regulatory and operational activities in the aviation sector, improvement of navigation facilities and development of air transport services;
- Reform and restructuring of the railway sector, including clarification of the respective responsibilities of the state and the railway enterprise;
- Restructuring of urban transport enterprises and the implementation of performance agreements between the enterprises and the respective municipalities.

The Bank will focus on projects that have revenue-earning potential, that can be used to demonstrate a market-oriented approach to the provision of transport services, and that are demonstrably a best-cost means of alleviating particular bottlenecks. Environmental aspects of projects will also have to be dealt with explicitly. The main

focus will be on removal of critical transport bottlenecks and in strengthening linkages with Ukraine's new European trading partners.

### **Telecommunications**

Bank objectives will be to:

- Upgrade network capacity and quality, in particular for international communication - a potentially significant source of foreign currency earnings;
- Promote private participation in the sector. This will be crucial to attract much needed financing and encourage transfer of modern technology and know-how;
- Support government efforts to reorganise sector structure, increase domestic tariffs, and plan future privatisations of the state-owned operators. To this end, the Bank will assist the ministry in drafting a new telecommunications law and licensing statutes, and in setting up a new regulatory body.

### **Municipal infrastructure and environment**

Corporatisation of municipal utilities will be an essential first step, to improve revenue generation and operational performance. A clear development programme embodying these objectives and with a focus on cost recovery will be the prerequisite for a loan targeting water supply and sewerage investments in a reform-minded municipality. Industrial and commercial investments will incorporate environmental components where appropriate, to bring environmental performance into line with modern standards.

A guidebook of environmental requirements for investors in Ukraine is now under preparation. The Bank's environmental standards database is being extended to include Ukraine.

### **Property and tourism**

The EBRD will focus its efforts on financing the development of modern hotel and office facilities to accommodate the growing business community.

While the Bank's primary emphasis will be on Kiev, it is also open to proposals for hotel and office projects in secondary cities, notably Odessa in view of the city's considerable potential for tourism. It is unlikely to consider projects in the retail or industrial sectors in the near term.

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