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INFORMATION

From:	General Secretariat of the Council
To:	Working Party of Financial Counsellors
Subject:	Exceptional MFA Ukraine - Disbursement of the first and sole instalment

Please find attached an Information Note from the Commission services on the implementation of the Macro-Financial Assistance (MFA) operations to Ukraine, under Decision (EU) 2022/1201 of the Parliament and of the Council of 12 July 2022.

The note presents the assessment carried out for the release of the EUR 1 billion loan under this MFA programme.

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EUROPEAN COMMISSION

EXCEPTIONAL MACRO-FINANCIAL ASSISTANCE TO UKRAINE:

DISBURSEMENT OF THE FIRST AND SOLE INSTALMENT

(Information Note to the European Parliament and to the Council)

1. Introduction

As part of its response to the ongoing unjustified and unprovoked Russian war of aggression against Ukraine, in its Communication "Ukraine: Relief and Reconstruction" from 18 May the European Commission announced an exceptional Macro-Financial Assistance to Ukraine for up to EUR 9 billion. The European Council of 23 and 24 June endorsed this additional assistance. As a first step towards the implementation of this exceptional MFA to Ukraine, on 1 July 2022 the European Commission adopted a proposal for a Decision by the European Parliament and the Council on providing exceptional macro-financial assistance (MFA) to Ukraine of up to EUR 1 billion.

To account for the extraordinary circumstances triggered by the Russian war of aggression against Ukraine, this exceptional MFA operation differs from regular MFAs in several important aspects. First, it comes as a single instalment with strengthened concessional elements (longer maturity of up to 25 years on average and a Union subsidy for the interest rate and administrative fees for the duration of the current MFF 2021-2027). Second, the exceptional assistance is not formally linked to a disbursing IMF programme and its disbursement is not conditional upon structural policy measures. At the same time, the set-up of more stringent reporting requirements has been requested to ensure that, also in the current extraordinarily challenging context, the funds are spent in a transparent, accountable and efficient manner. It is clear that there are limits to how much information the Ukrainian authorities may want to make publicly available in the context of the Russian war of aggression, so this reporting is in the first instance meant to inform the European Commission. Once the situation has stabilised and reconstruction efforts are more firmly underway, the intention is that this reporting system should become publicly available. Moreover, the political pre-condition still applies. Third, the draft Memorandum of Understanding (MoU), negotiated *ad referendum*, has been tailored to better reflect the challenges raised by the ongoing situation of martial law.

The Member States Committee on MFA endorsed the Memorandum of Understanding (MoU) underpinning this exceptional MFA operation in its meeting on 15 July 2022. The European Commission and Ukraine signed the MoU on 19 July through exchange of electronic copies and the MoU entered into force. The disbursement of the first and sole instalment is conditional on the continued fulfilment of the political precondition.

In addition to inflicting tremendous damage to the economy, Russia's war of aggression against Ukraine has caused the sovereign to lose access to the international capital markets. The resulting underlying balance-of-payments funding gap is estimated by the authorities and the IMF to reach around USD 39 billion for the whole of 2022.[1] In line with that analysis, Ukraine could finance, through a safe draw-down on its official international reserves that ought not to threaten its macro-financial stability, USD 9 billion of this gap. Bilateral and multilateral commitments of financial support pledged to Ukraine in the context of the G7 Finance Ministers and Central Bank Governors meeting on 18-20 May have reached almost USD 20 billion. Germany provided a grant for direct budgetary support of EUR 1 billion. Further commitments by EU Member States include a loan of EUR 400 million by France, a loan of EUR 200 million by Italy, and support of EUR 252 million by Portugal. Overall, either directly or through international financial institutions, Member States have pledged EUR 1 937 million of grants, EUR 900 million of loans and EUR 408 million of guarantees, of which EUR 1 762 million have been disbursed by 25 July[2]. In order to make a contribution

[1] As confirmed by the IMF to the European Commission in an assessment letter received on 3 June 2022.

[2] On the basis of information received from 16 Member States by 25 July 2022.

toward financing the remaining estimated funding gap of Ukraine for the whole of 2022 of about USD 10 billion, the Commission has announced its intention to present a proposal for an exceptional MFA operation of up to EUR 9 billion to Ukraine.

In order to address the immediate and most urgent funding needs of Ukraine, as a first step, on 4 July the Commission submitted to the European Parliament and the Council its proposal for a Decision to provide exceptional MFA of up to EUR 1 billion to Ukraine, in the form of a highly concessional long-term loan. The European Parliament and the Council adopted the Decision on 12 July 2022,[3] thereby authorising the seventh MFA operation in Ukraine since 2014. This exceptional MFA of up to EUR 1 billion aims to provide immediate financial support in a situation of acute funding needs and to ensure the continued functioning of the most critical functions of the Ukrainian state. As a second step, the Commission intends to present a proposal in relation to the remainder of this highly exceptional package as soon as possible.

In accordance with the consultation and information requirements of the aforementioned MFA Decision, this note informs the European Parliament and the Council of the state of play with the exceptional macro-financial assistance to Ukraine, in particular the disbursement of the first and sole instalment of EUR 1 000 million. The note first describes the most recent economic and financial developments in Ukraine (section 2) and reports on the fulfilment of the political pre-condition (section 3). Section 4 provides background information on the signed MoU. Finally, the fifth and last section concludes. The usual section on progress with an IMF programme has been omitted this time as there is no additional information to report upon in addition to what was included in the note submitted to the European Parliament and to the Council in the context of the emergency MFA operation earlier this year.

2. Recent economic and financial developments

The economic situation of Ukraine has deteriorated dramatically following Russia's war of aggression. The estimated damage to physical infrastructure exceeds already EUR 100 billion, including some important industrial facilities (in steel, coke, oil and other sectors), transport infrastructure and buildings.[4] More than 7 million people have left Ukraine since the Russian aggression, mainly women and children (of which about 2 million have in the meantime returned to Ukraine), while the number of internally displaced persons exceeds 6 million. Ukrainian Azov and Black Sea ports remain blocked by Russian military action, depriving Ukraine of much-needed export revenues (and with knock-on effects on food supply and food price inflation well beyond its border).

Ukraine's GDP is unofficially estimated to have decreased by 35-40% in March-April year-on-year. Enterprise surveys carried out by the central bank indicate that after the shock of the first weeks of war, economic activity has picked up moderately in the calmer regions. While many enterprises have resumed their business, most of them remain below the pre-war capacity use level, indicating supply chain disruptions and loss of markets as key impediments to production recovery. Moreover, the financial situation of many companies

[3] Decision (EU) 2022/1201 of the European Parliament and of the Council of 12 July 2022 on providing macro-financial assistance to Ukraine, OJ L 186, 13.7.2022, p. 1–7.

[4] These estimates are based on data collected by the Kyiv School of Economics, in cooperation with the Ministry of Economy of Ukraine and the Office of the President of Ukraine and published on the dedicated platform https://kse.ua/russia-will-pay/.

becomes increasingly difficult. The average forecasts for GDP contraction for the whole of 2022 are now around 35%, although with big differences between forecasters, reflecting divergences in the assumptions on the length and scope of the war.[5]

Inflation increased to 18.0% year-on-year in May. Higher inflation is caused by transport disruptions, shortages of certain products and higher production costs, while weaker domestic demand and the fixed exchange rate reduce the inflationary pressures. The National Bank of Ukraine (NBU) suspended the inflation-targeting framework for the duration of the conflict and kept its main refinancing rate at 10% until 3 June, when it raised it to 25% to discourage the demand for foreign exchange that started to build up in the second part of May. It also promised to acquire government war bonds in case of insufficient private demand and actually purchased the equivalent of around USD 7.7 billion of these bonds in March (USD 0.9 billion), April (USD 1.7 billion), May (USD 1.5 billion) and June (USD 3.6 billion). The notable acceleration in the NBU's purchases reflects lower risk appetite from investors who seemingly found the yield of around 11% offered by the Treasury insufficient. Part of the subsequent monetary budget financing was, however, absorbed by NBU FX sale interventions, which account for an aggregate decline of the official international reserves by more than USD 6 billion, i.e. 22%, since the beginning of the war.

In an attempt to maintain its stock of foreign reserves, the National Bank of Ukraine fixed the exchange rate of the hryvnia at the pre-invasion rate of 29.25 hryvnia for one USD and introduced numerous restrictions on forex transactions and on imports at the very start of the war. To protect the national currency, and especially as demand for foreign currency picked up notably in the second half of May, the NBU increased its main refinancing rate from 10% to 25% as of 3 June. By end-May 2022, the value of exports of goods and services in 2022 has decreased by 15% and of imports by 3% only relative to the same five months in 2021. This contributed to a trade deficit of almost USD 4 billion. However, thanks to the persistent flows of stable primary income (structurally high remittances) and secondary income (exceptional foreign credits), the current account recorded an overall surplus of USD 3.6 billion in the first five months of 2022, as opposed to a slight deficit of USD 57 million in the corresponding period in 2021. Despite the current account surplus and significant inflows of official financing, the sizable capital outflows triggered by the war resulted in a decline of the official reserve assets of Ukraine by the equivalent of USD 5.5 billion in the first five months of 2022, bringing it down to USD 22.8 billion by end-June (corresponding to 4 months of imports). On 21 July, the NBU devalued the national currency by 25% against the US dollar, while keeping the fixed exchange rate regime.

Though sizable, the official foreign financial assistance actually disbursed to Ukraine has thus been insufficient to prevent the continuous drawdown on the country's foreign reserves. As of early July, the IFIs (IMF, World Bank and the EIB) had disbursed USD 3 billion, while bilateral support disbursed by national sovereigns reached USD 6.7 billion. The aggregate EU assistance to the state budget, prior to the disbursement of this exceptional MFA, amounted to EUR 1.2 billion or around USD 1.4 billion. Altogether, official foreign assistance reached USD 11 billion, which is roughly half of Ukraine's overall state budget financing since the beginning of the war. The remaining funds of USD 11.5 billion were provided by the NBU (USD 7.7 billion) and the domestic commercial banks (USD 3.8 billion).

[5] The IMF presented their updated forecast, which underpins the assessment of the overall underlying balance-of-payments funding gap of Ukraine for 2022 in an assessment note sent to the European Commission on 3 June.

3. Political pre-condition

Pursuant to Article 2 of the MFA Decision, a *"pre-condition for granting the Union's macro-financial assistance shall be that Ukraine respects effective democratic mechanisms – including a multi-party parliamentary system – and the rule of law, and guarantees respect for human rights."* As confirmed by the European External Action Service, Ukraine's constitution and legislation enshrine the principles of democratic pluralism and multi-party political system, the rule of law and respect of fundamental rights and freedoms.

Regarding effective democratic mechanisms, Ukraine[6] is an open society, where elections are held freely and largely in line with international standards. The presidential and early parliamentary elections in 2019 were assessed positively, as were the local elections in October 2020. The elections were competitive and characterised overall positively as free and fair by domestic and international observers, although some irregularities were recorded and legal shortcomings identified. COVID-19 posed an additional challenge to the organisation of the elections. Work on amendments to the Electoral Code to implement previous international and domestic recommendations continued within a working group in Parliament, which included also civil society experts. Media freedom has significantly improved since 2014 as ongoing reforms continue to strengthen the legislative environment for journalists and outlets. However, several challenges remain, as further work is needed to strengthen the pluralistic environment and to investigate the attacks against journalists and civic activists effectively.

Human rights are generally well respected. At the same time, some important national and international laws and conventions still need to be ratified and implemented. Steps have been taken to strengthen gender equality. The ratification of the Istanbul Convention in June 2022 marked an important step forward in creating conditions to protect women and girls from all forms of sexual and gender-based violence. The police is overall effective in protecting Pride Parades even though some individual attacks occurred. Freedoms of religion and assembly are generally respected. Legislative changes, which remain outstanding, include a ban on all forms of discrimination, inter alia discrimination based on the grounds of sexual orientation and gender identity, as well as the development of the new Labour Code. As regards the rights of persons belonging to ethnic, linguistic, religious and national minorities, Ukraine has taken some steps aiming to implement the recommendations of the Venice Commission. However, an overarching Law on national minorities remains to be adopted. Severe human rights violations take place in the areas not under the control of the Ukrainian Government, following the illegal annexation of the Crimean peninsula and acts of aggression by Russian armed forces since 2014. Large scale atrocities and violations of international humanitarian law have been committed in Ukraine by the Russian armed forces following Russia's full-scale invasion on 24 February 2022. On 16 March 2022, the International Court of Justice ordered provisional measures in the case Ukraine v. Russia ordering Russia to suspend its military operations started on 24 February on the wrong claim of genocide in Ukraine to justify its invasion, with which Russia did not comply.

Regarding the rule of law, reforms in the area of the judiciary and the fight against corruption have advanced. Ukraine has continued to strengthen anti-corruption institutions and adopted in 2021 two key laws on reforming and cleansing the High Council of Justice (HCJ) and the High Qualification Commission of Judges (HQCJ). Two commissions with international experts' participation – the HCJ Ethics Council and the HQCJ Selection Commission – have

[6] All remarks in this section refer to the government controlled areas of Ukraine. The situation is quite different in the non-government controlled areas in the East as well as in the illegally annexed Crimea.

been created and the vetting of candidates for HCJ has been launched. Ukraine also adopted its Anti-Corruption Strategy up to 2025 in June 2022. The Constitutional Court of Ukraine (CCU) is yet to be reformed in line with the Venice Commission recommendations, in particular a transparent and merit-based selection procedure for CCU judges should be introduced. The selection process for the new head of the Specialized Anti-Corruption Prosecutor's Office (SAPO) needs to be finalised and the winner of the competition appointed. The selection of the new head of the National Anti-Corruption Bureau (NABU) needs to be organised in a transparent and merit-based manner aiming at filling this important position as soon as possible, and allowing NABU to fulfil its crucial anti-corruption functions in an independent and effective way.

Overall, Ukraine can be considered to meet the political pre-condition for MFA.

4. Background information on the signed Memorandum of Understanding

The MoU that the Commission negotiated, *ad referendum* and on behalf of the European Union, with the Ukrainian authorities after the entry into force of Decision (EU) 2022/1201 reflects the exceptional nature of this macro-financial assistance, which should not be considered a precedent for future MFA operations. An overall average maturity of up to 25 years and the possibility for coverage of interest rate and administrative fee payments by the Union budget strengthen the concessional nature of the assistance. Moreover, the exceptional circumstances of the Russian war of aggression against Ukraine call for enhanced flexibility. In that context and unlike regular MFA operations, this exceptional macro-financial assistance is not formally linked to a disbursing IMF programme. Policy conditionality has proven to be a key value added of macro-financial assistance and should continue to be so, also in the context of the package of exceptional MFA to support Ukraine. Nevertheless, to facilitate the swift provision of the first part of the package via the current proposal in a situation of urgent funding needs, the assistance is not linked to structural policy conditionality.

Yet, to maximise the positive contribution of this exceptional MFA and also with a view to supporting relevant preparations for the reconstruction efforts, the assistance is linked to the setting up of a system of reporting requirements that aims to ensure that funds received are spent in an efficient, transparent and accountable manner. Article 6 of the MoU ensures that the Ukrainian authorities provide monthly reports on revenues and expenditures of the state budget at the level of the major expenditure headings. These reports should also include details on the administrative and financial management measures in place, including the internal controls. Moreover, the Ukrainian authorities are committed to address, adequately and swiftly, any shortcoming detected in the context of the operational assessment to be carried out during the implementation of this exceptional MFA.

During the availability period of this exceptional MFA operation, the Commission shall evaluate, where appropriate based on consultations with the Ukrainian authorities, the IMF and other competent international organisations, the suitability and good standing of the reporting system as requested for in Annex I. It will also be informed by an operational assessment to be carried out by external consultants. The Ukrainian authorities are committed to ensure the proper implementation and functioning of the reporting system for the entire period of the assistance. In its evaluations, the Commission shall focus, in particular, on mechanisms in place to ensure the proper flow, timeliness, accuracy, and adequacy of the information provided. The MoU empowers the Commission to take appropriate measures pursuant to the loan agreement in case the implementation of the reporting system has been found deficient. These measures could include the cancellation of the assistance, which would imply a request for its early repayment.

Finally, given the exceptional circumstances in Ukraine, the MoU specifies in its Article 14 that the assistance is implemented on the understanding that the Ukrainian authorities are committed to phasing out the temporary emergency measures in the area of economic and financial policy that have been imposed for the duration of the war, at the appropriate time and with an adequate sequencing, especially with regard to the monetary policy and exchange rate framework, financial sector regulation, governance of state-owned enterprises, freedom of capital movements, and the tax and trade excise regimes. The same article of the MoU ensures that the authorities are committed to reinstating the established economic and financial policy institutions in their pre-war mandates as soon as martial law is lifted.

5. Conclusion

Ukraine continues to fulfil the general political pre-condition for MFA (respect for effective democratic mechanisms, including a multi-party parliamentary system, the rule of law and human rights).

Against this background, and considering the exceptional nature of the underlying MFA Decision, the Commission adopted a decision on 22 July 2022 to release the first and sole instalment of EUR 1 billion to Ukraine and a decision to borrow the corresponding funds on the capital markets.[7] With this disbursement, to be finalised in two financial transactions on 1 and 2 August, the EU contributes to the financing of the substantial external funding gap of Ukraine in the current unprecedented circumstances. The Commission continues to monitor the situation in Ukraine and intends to present a proposal in relation to the second part of this highly exceptional MFA package as soon as possible.

[7] In order to optimize the average interest rate on the instalment, the disbursement takes place in two tranches that are transacted on two consecutive days.