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INFORMATION

From:	General Secretariat of the Council
To:	Working Party of Financial Counsellors
Subject:	Exceptional MFA Ukraine - Memorandum of Understanding EU-Ukraine

Delegations will find attached an Information Note from the Commission services on the Memorandum of Understanding (MoU) between the European Union and Ukraine, under Decision (EU) 2022/1628 of the Parliament and of the Council of 20 September 2022 providing Macro-Financial Assistance (MFA) to Ukraine.

The note presents the conditionality attached to the MFA operation. After consulting the Member States Committee on 28 September, the MoU was adopted on 29 September and entered into force on 4 October, with the signature of both parties.

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EUROPEAN COMMISSION

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EXCEPTIONAL MACRO-FINANCIAL ASSISTANCE TO UKRAINE

MEMORANDUM OF UNDERSTANDING

(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 (MFA) 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 MFA to Ukraine of up to EUR 1 billion. The European Parliament and the Council adopted the Decision on 12 July 2022.[1] The full amount of this first part of the exceptional MFA was disbursed in two equal tranches on 1 and 2 August 2022. As a second step albeit stopping short of the full implementation of the exceptional MFA package to Ukraine, on 14 September 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 5 billion.

To account for the extraordinary circumstances triggered by the Russian war of aggression against Ukraine, this exceptional MFA package differs from regular MFA operations in several important aspects. First, it comes with strengthened concessional elements (longer maturity of up to 25 years on average and, if requested, 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. However, it is linked to progress with implementing policy actions and reporting requirements, as detailed in the Memorandum of Understanding (MoU), negotiated *ad referendum*, which also has been tailored to better reflect the challenges raised by the ongoing situation of martial law. Third, together with the previous exceptional MFA loan of EUR 1 billion, the loans under this exceptional MFA of up to EUR 5 billion will be covered by paid-in provisions under the Union's budget for 9% of their value and additional, callable national guarantees by Member States, based on their GNI key, for 61% of their value.

The European Parliament and the Council adopted the Decision to grant exceptional MFA to Ukraine of up to EUR 5 billion on 20 September 2022.[2] This exceptional MFA of up to EUR 5 billion, which has an availability period of one year and is to be disbursed in a small number of instalments, aims to contribute to the remaining funding gap of Ukraine in a situation of acute needs and to ensure the continued functioning of the most critical functions of the Ukrainian state. In view of the urgent financing needs of Ukraine in the remainder of 2022, the assistance is (subject to the conditions enabling this being fulfilled) expected to be fully disbursed by the end of the year.

As regards financial support to Ukraine from the International Financial Institutions, it amounts so far to USD 1.4 billion disbursed by the IMF under its Rapid Financing Instrument and USD 929 million by the World Bank. Following its initial rapid support, the IMF continued to engage with the authorities on technical and policy discussions. The preparation for unrolling capacity development activities as the situation permits also continued. Meanwhile, many international donors have expressed the expectation that the Fund should

[1] 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.

[2] Decision (EU) 2022/1628 of the European Parliament and of the Council of 20 September 2022 on providing macro-financial assistance to Ukraine, reinforcing the common provisioning fund by guarantees by Member States and by specific provisioning for some financial liabilities related to Ukraine guaranteed under Decision No 466/2014/EU, and amending Decision (EU) 2022/1201, OJ L 245, 22.9.2022, p. 1–13.

resume a larger role in financing, at the very least to ensure net positive financial flows to Ukraine. The Fund has presented a new Food Shock Window under the Rapid Financing Instrument (RFI), for a number of eligible countries, as well as a proposal for a Staff Monitored Program with Executive Board Involvement (PMB), which both are expected to benefit Ukraine. Preparations are underway to have the food shock window in place by this year's autumn meetings. The IMF's preferred option would be to proceed with a two-stage approach to support Ukraine, where a combined engagement under the Food Shock Window with an accompanying BMP would constitute a first step. The second step would be an upper credit tranche (UCT)-quality programme (a Stand-by Arrangement or an Extended Fund Facility), that could be envisaged once conditions allow and where the BMP would allow the Fund to test a fiscal framework in this challenging context as well as the authorities capacity to react to changing conditions that could pave the way for the fully-fledged programmes.

The purpose of this note is to provide background information to the European Parliament and to the Council on the MoU. 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 assesses the social impact of the MFA operation in light of the MoU.

2. Recent economic and financial developments

The Russian war of aggression damaged profoundly the Ukrainian society and the economic potential of the country. The destruction of physical capital and infrastructure, which is estimated to have resulted by 1 June in reconstruction and recovery costs of USD 349 billion,[3] is a serious impediment to future economic growth. The massive human exodus of 4.3 million people who sought temporary protection abroad and of more than 7 million internally displaced has a dire impact on labour supply. A prolonged war would trigger further capital and labour depletion, and hence larger reconstruction needs.

The war is imprinting a heavy toll on Ukraine, whose macro-economic performance was muted already in peace times. After a milder-than-expected COVID-19 related recession of 4% in 2020, the incomplete rebound in 2021, where real GDP increased by 3.4%, kept the economy below its pre-pandemic size.[4] The war-driven contraction of the economy by 15.1% y-o-y in Q1 2022 accelerated to 37.2% in Q2. In the absence of official data, independent company surveys suggest that capacity utilisation in industry is down to 75%, while heavy impairments to logistics are a serious bottleneck to both international and domestic trade even if EUs 'solidarity lanes' have contributed to ensuring exports, in particular of grains, coming back to close to pre-war levels recently. Overall, the situation is weighing heavily on private investment, which the foresters' consensus suggests might contract by more than half by the end of the year, from an already depressed level (Ukraine used to undertake less than half the investment effort than its peer economies). Bringing investment to sustainably higher levels will be among the formidable challenges of the reconstruction period.

In the context of a suspended inflation-targeting framework amidst a fixed exchange rate regime since the start of the war, the National Bank of Ukraine has stepped up its direct

[3] https://www.worldbank.org/en/news/press-release/2022/09/09/ukraine-recovery-and-reconstruction-needs-estimated-349-billion.

[4] It is worth noting that, by end-2021, the Ukrainian economy was still 6% behind its 2013 size. This means that it failed to overcome the 16% contraction from the 2014-2015 recession.

financing of the budget and devalued the domestic currency. In a situation where the sovereign has lost access to international capital markets and international support has only partially filled the substantial funding gap, the NBU has provided almost USD 10 billion to the state Treasury. This significant amount represents two thirds of the domestically issued war bonds, for which private demand is subdued due to the low proposed yields. The overall monetary financing of about USD 15 billion, i.e. 45% of the state budgetary financing since the beginning of the war, resulted in a significant depletion of the official international reserves by almost USD 9 billion by July 2022 compared to the level at the end of 2021. To halt the erosion of reserves, the NBU increased its main refinancing rate from 10% to 25% in June and devalued the hryvnia by 20% from 29.2549 to 36.5686 UAH for 1 USD in July, in line with market trends. These policy measures managed to improve confidence in the future value of the domestic currency, with reserves having increased by USD 3 billion in August to USD 25.4 billion, i.e. about 4 months of imports.

In the context of elevated and rising inflation, the domestic currency is expected to continue to lose purchasing power. Consumer prices inflation reached 23.8% in August, due to the continuous increase in the money supply in the context of amplified scarcity of goods, the hryvnia devaluation and a high global inflation. The growth rate of the money supply in the broad sense (aggregate M3) accelerated to 17.1% in July, from around 11% before the start of the war. Producer prices inflation hit 53.5% in February, when data was published last. If this trend has continued since then, it is set to have depressed the operating incomes of many companies, thereby further eroding their capacity to self-finance the future reconstruction.

The scale of deterioration of the fiscal outlook depends on the duration of the conflict and its impact on the economic activity. The budget deficit reached USD 12.6 billion in January-July and is projected to reach about 20% of GDP for the year as a whole. In January-July, tax revenues contracted by 5% relative to the same period in 2021. However, the overall state budget income increased by 17% due to stronger non-tax revenues and foreign grants. Total expenditure for the first seven months of 2022 increased by 53%, due to the skyrocketing defence spending (+560%) and for public order and security (+126%). The scarcity of public resources and corresponding rationalisation efforts have taken a toll on healthcare and education spending, as well as on capital expenditure. The war is expected to completely reverse the slow and painstaking gains in fiscal consolidation since 2015, with public debt approaching 90% by the end of the year after having stood at 49 % of GDP in 2021.

Having lost access to international capital markets, the State Treasury of Ukraine relies exclusively on official foreign assistance and monetary financing. While in the first two months of 2022 the issuance of new bonds in the domestic market barely reached a roll-over rate of 23% in hryvnia and 4% in foreign currency, the situation has improved since then. By August, the roll-over rates, relative to the whole of 2021, reached respectively 128%, 36% and 56% for the UAH-, USD- and EUR- denominated bonds. Thus, overall, domestic investors seem to stick to their support for the war effort, despite average yields on new domestic UAH debt of around 23%, which is below the NBU's main refinancing rate.

Thanks to the sizable positive net income from abroad, the current account recorded a surplus of USD 4.4 billion in the first seven months of 2022. In the same period, the trade balance deficit widened to USD 10 billion, driven by a strong contraction of exports of goods (-28% year-on-year in nominal terms) due to activity disruptions and transport and supply chain difficulties. While imports of goods also contracted (-16%), imports of services increased by 70% to USD 13 billion, primarily driven by refugees' personal travel expenditure abroad. Primary and secondary income altogether registered a net inflow of USD 14.4 billion, thereby accounting for the overall current account surplus. This sizable net positive income from abroad was sustained, inter alia, by stable remittances of almost USD 8 billion and substantial official international assistance in the form of grants.

After a notable recovery in 2021, foreign investment has collapsed since the outbreak of the war. The incoming foreign direct investment shrank by almost 90% year-on-year in the first seven months of 2022. Portfolio investment in Ukraine contracted by almost USD 4 billion and went negative. Other investments in the country reached USD 4 billion and were driven primarily by the additional government borrowing of USD 5.5 billion. Yet, due to the additional hoarding of foreign cash for almost USD 7 billion (+205%) and accumulation of trade credits for more than USD 8 billion (+760%), the financial account transactions for the first seven months of 2022 resulted in an aggregate outflow of almost USD 12.8 billion. The gap to the current account inflow of USD 4.4 was financed through a depletion of the official international reserves by USD 8.4 billion.

The future macro-economic and financial developments depend crucially on the duration of the war and the ensuing destruction. In 2022, the GDP is expected to contract between 35% and 50% in real terms, with the unemployment rate possibly rising to 15%. Inflation could hit 30% by the end of the year, which would significantly erode domestic savings. The fiscal deficit is expected to reach around 20% of GDP in 2022. The future reconstruction needs and the overall scarcity of private capital in a country where under-investment has been a chronic issue even in peace times will make it challenging to return to balanced public finances in the medium term. The domestic banking sector, weakened by non-performing loans and liquidity constraints in the current situation, could not provide meaningful amounts of financing without endangering the macro-financial stability of the country and further deteriorating the purchasing power of the domestic currency. These developments imply two medium-term challenges. First, given the limited capacity of the government to honour its outstanding financial liabilities, a debt restructuring becomes the central scenario for the post-war period. Second, the tremendous reconstruction needs, in the range of several times the pre-war annual GDP, pose a major difficulty to securing the necessary financing and the subsequent transfer of real resources.

Ukraine	2017	2018	2019	2020	2021	Latest	Dates
Nominal GDP, USD millions	112,202	130,844	154,136	155,495	200,144	N/A	
Nominal GDP per capita, USD	2,639	3,095	3,666	3,700	4,762	N/A	
Real GDP, % change	2.5	3.4	3.2	-4.0	3.4	-37.2	Q2
Consumer price inflation, %, end of period	18.1	9.8	4.1	5.0	10.0	23.8	August
Consumer price inflation, %, average	15.9	13.9	7.9	2.7	9.4	17.1	August
Key monetary policy rate, %, end of period	14.5	18.0	13.5	6.0	10.0	25.0	August
Unemployment rate, LFS, %	9.5	8.8	8.2	10.1	9.7	N/A	
General government balance, % of GDP	-1.4	-1.9	-2.2	-5.4	-3.4	N/A	
Public expenditure, % of GDP	35.5	35.1	34.5	38.0	35.2	N/A	
Gross Public debt, % of GDP	71.8	60.9	50.2	60.8	55.4	N/A	
Current account balance, % of GDP	-2.2	-3.3	-2.7	3.4	-1.3	N/A	
Official international reserves, USD billion	18.8	20.8	25.3	29.1	27.5	25.4	August
International reserves, months of imports	3.2	3.3	4.8	4.9	6.1	4.0	August
Gross external debt, % of GDP	102.9	87.7	79.0	80.8	69.3	N/A	
Net foreign direct investment, % of GDP	3.3	3.5	3.2	-0.1	3.2	N/A	

Sources: National authorities; Commission staff calculations

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[5] 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, including the first reading of the media law end-August as an important step in approximating Ukrainian legislation with EU audio-visual media services legislation. 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. Russia's full-scale invasion of Ukraine has led to the adoption of martial law in Ukraine, which may temporarily restrict some individual rights and fundamental freedoms in times of war.

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 been created and the vetting of candidates for HCJ has been well on track, including recent appointments of two new HCJ members of high integrity by the Parliament. 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. A draft law to this end has been registered in the Parliament and will be assessed

[5] All remarks in this section refer to the government-controlled areas of Ukraine.

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by the Venice Commission. The Head of the Specialised Anti-Corruption Prosecutor's Office (SAPO) was appointed on 28 July 2022. Also, the commission for selecting the new Director of the National Anti-Corruption Bureau (NABU) with three Ukrainian and three international members started its work in August 2022.

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

4. Background information on the 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) 2022/1628 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 for the package of exceptional MFA 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 war circumstances 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, which has proven to be a key value added of macro-financial assistance, is attached to this second part of the exceptional MFA package to Ukraine. Given the specific war circumstances, however, it is limited to relevant conditions that are deemed feasible and which could be expected to be implemented by end-November with a reasonably high degree of certainty. This would enable the disbursement of the full assistance in a limited number of instalments by the end of the year, thereby providing an important response to the pressing funding needs of Ukraine.

To maximise the positive contribution of this exceptional MFA and also with a view to supporting relevant preparations for the reconstruction efforts, the package of exceptional MFA is linked to the setting up and use of a system of reporting requirements that aims to ensure that funds received are spent in an efficient, transparent and accountable manner. Article 4 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 package.[6] The Commission intends to launch the work on this Operational Assessment in early October, with first findings expected before year-end.

During 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 Section "A. Reporting requirements on the use of funds received under this assistance" of Annex I. 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 withhold the disbursement of an instalment until the

[6] Preparatory work on this Operational Assessment has started already and the final report by the external consultant is expected for end-November.

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Country proves satisfactory compliance with the reporting requirements and policy conditions.

Moreover, given the exceptional war 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 and banks, 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.

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Finally, Section “B. Policy conditions” of Annex I contains seven policy measures, as described below. This limited set of conditions has been carefully assessed in relation to their relevance and feasibility in the current situation and in the envisaged timeframe for the assistance.

ECONOMIC RESILIENCE AND STABILITY

Action 1

Prepare a roadmap for phasing out the temporary emergency measures in the area of economic and financial policy that have been imposed for the duration of the war, especially with regard to the monetary policy and exchange rate framework, financial stability, corporate governance of state-owned banks and enterprises, freedom of capital movements, and the tax and trade excise regimes.

As part of the policy response to the war and its impacts, the Ukrainian authorities introduced many emergency measures that suspended the existing well-functioning framework in economic and financial policy-making. In the area of monetary policy, inflation-targeting and flexible exchange rates have been temporarily abandoned, while capital controls were introduced to safeguard stability. In the field of fiscal policy, the painstaking progress toward public debt consolidation from the last five years has been reversed, including due to a VAT and customs duties moratorium between March and July. Progress in corporate governance reform has been halted too, due to difficulties with filling the independent Board positions in the current situation. As regards the regulation and supervision of financial sector intermediaries, the authorities introduced forbearance measures with respect to capital adequacy.

While these emergency measures have their rationale in the context of the war economy, they are nevertheless a step back in the setting up of an adequate institutional framework for a functioning market economy. By committing to this Action 1, the authorities recognise the need to re-stablish proper foundations for policy-making, in preparation for the recovery and reconstruction period and in particular as this will strengthen Ukraine’s integration to the European Union having successfully obtained the status of a candidate country in June 2022. A roadmap for the removal of the temporary emergency measures, which will develop considerations on adequate prioritisation and sequencing and be milestones-based rather than bound by specific deadlines given the war-related uncertainty, is an important preparatory step for a return to the pre-war institutions and for their future improvement.

Action 2

Develop an action plan on identification of the crucial obstacles for SME development.

Small and medium-sized enterprises (SMEs) are an important element to obtain a more diversified and dynamic economic structure in Ukraine. The future restructuring of the country will rely, above all, on the domestic nexus of businesses through which the future recovery will happen. This highlights the importance of improving the business climate in Ukraine, as a major prerequisite for the return to peace times. In 2020, SMEs accounted for 64.6% of employment and 52.8% of value added in Ukraine.

In 2017, the Cabinet of Ministers adopted an SME Development Strategy until 2020, followed by an Action Plan for implementation. Six strategic directions of this strategy included creating a favourable environment for SME development, access to finance, simplifying tax administration, promoting skills-building and entrepreneurship, promoting SME exports, competitiveness and innovation. The Ukrainian National Economic Strategy until 2030 sets a list of strategic goals for SME development. The draft SME strategy until 2025 is yet to be adopted.

The implementation of these strategies brought some improvements for SMEs. For instance, in order to improve access to finance, the Ukrainian government has established a Business Development Fund financing the 5-7-9% interest subsidy programme, a state loan guarantees portfolio, anti-crisis support to SMEs to overcome the effects of the Covid pandemic, etc. Ukraine has also progressed in simplifying taxation for SMEs, by establishing an automatic mechanism of VAT refunds. Support programmes have been developed to promote skills-building and entrepreneurship culture, for instance in schools.

However, the regulatory framework for SMEs is still characterized by a high level of over-regulation inherited from the Soviet system, despite some progress in recent years. Insufficient enforcement of competition rules and the dominance of SOEs in many sectors hinder the development of SMEs. More could be done to improve financial literacy, to foster social entrepreneurship, and to stimulate life-long learning.

The objective of Action 2 is to develop an updated report and an action plan on the most crucial obstacles to SMEs emergence and functioning, taking into account the current situation – the impact of the pandemic and of the ongoing war. This action plan will propose practical solutions to overcome key barriers faced by Ukrainian SMEs.

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Action 3

Approve the methodology and criteria for evaluating candidates for the positions of independent members of the supervisory boards of state-owned banks (SOBs) and ensure the progress on the selection of supervisory boards of state owned banks. Continue cooperation through the SOB Nomination Commission with the participating International Financial Institutions and other international partners, implementing jointly agreed methodology (compliance assessment, merit ranking, deliberations and voting) and seeking consensus among voting and non-voting members of the Commission, to ensure transparent and professional merit-based selection of high-quality independent professionals to the supervisory boards of the SOBs.

State-owned banks will play a crucial role in the recovery and reconstruction of Ukraine. This makes their sound management an issue of paramount importance. The three-year term of all Supervisory Board (SB) members at the three Ukrainian state-owned banks (SOBs) expired in June 2022, which implies that twenty-seven SB members, of which eighteen are in the quota of independents, will need to be reappointed or replaced. The previous processes from 2019 and 2021 of appointing independent SB members showed procedural vulnerabilities and risks. Moreover, both the Government and Parliament have showed weak ownership of the SOB corporate governance reforms, notably by not removing possibilities for undue interference in decision-making processes relating to state shareholding in SOBs. Significant staff turnover at the National Bank of Ukraine added to such risks. In this context, it is very important to strengthen good corporate governance at the SOBs, through commitment to the international standards and best practices, where so is possible with the current war context in mind.

The majority-independent SBs of the state-owned banks are a key feature of the SOB corporate governance reforms enacted in 2018. In particular, the SBs are tasked with implementing the shareholder's strategy, free from political interference in their daily operations. The independent Boards are also key for the effective restructuring of the SOBs, which contributes to an optimal allocation of credit in the economy, increased private investment and economic growth. The inclusion of highly qualified foreign professionals can help to speed up this restructuring process and to ensure effective independence from political interference.

The recent engagement of IFIs and international partners (EU, US) with the Ministry of Finance and the relaunched Nomination Commission for SBs of state-owned banks brought about progress in the Boards' succession planning for 2022. A Nomination Commission working group is expected to agree draft amendments to the Cabinet of Ministers resolutions 159 (on the Procedure for the Competitive Selection of an Executive Search Company for the Nomination of Candidates to Positions of Independent Supervisory Board Members of State-owned Banks) and 267 (on the Procedure for Determining Candidates for the Positions of Independent Supervisory Board Members of State-owned Banks), taking into account the joint recommendations by IFIs and partners. This condition aims at ensuring the completion of this process in a sound manner and continuing cooperation to ensure professional merit-based selection of high-quality independent professionals to the supervisory boards of the SOBs.

GOVERNANCE AND RULE OF LAW

Action 4

Make good progress in the integrity vetting of candidates to the vacant High Council of Justice (HCJ) positions by the Ethics Council and the selection of candidates to the High Qualification Commission of Judges of Ukraine (HQCJ) following a transparent and meritocratic process, including access to all relevant data and adequate external oversight by the civil society.

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The effective reform of the judicial self-governing bodies is the key pillar of the judicial reform in Ukraine. An accountable judiciary is essential for improving public trust and the investment climate, which in turn will be of crucial importance going forward in view of Ukraine's enhanced investment needs in the recovery and reconstruction phase. The lack of integrity within parts of the judiciary remains a key impediment to foreign investment in Ukraine, given that integer judicial governance bodies are a prerequisite for gaining investors' trust and increasing Ukraine's overall resilience. This condition aims at ensuring that the judicial self-governing bodies become operational and re-start the effective selection and vetting of judges, as foreseen in the broader judicial reform.

The Parliament of Ukraine adopted two laws in July 2021 concerning the vetting process of members in the two key judicial governance bodies, the High Council of Justice (HCJ) and the High Qualification Commission of Judges (HQCJ). These laws are fully in line with the relevant recommendations of the Venice Commission. In line with these laws, the Ethics Council, the body conducting integrity assessment of the current and future members of the HCJ, was set up in November 2021, while the HQCJ Selection Commission was established in September 2021. In both the Ethics Council and the Selection Commission, independent experts nominated by international donors have a temporary but decisive role to play.

After a suspension of work of both bodies following the start of Russia's full-fledged war of aggression against Ukraine on 24 February 2022, the Ethics Council restarted its work in April 2022. The integrity check of the HCJ members was finalised on 7 May 2022 and out of 16 HCJ sitting members, only 4 remained, including 1 *ex officio* member – the President of the Supreme Court, while 12 members resigned voluntarily in early 2022. Several competitions for the new HCJ members have been launched by the HCJ appointing bodies and the Ethics Council has been conducting the integrity vetting of candidates. Three new members of the HCJ were appointed in August 2022, two by the Verhovna Rada and one by the Congress of Academia. Overall, there is good progress. Civil society is actively monitoring and supporting the reform by providing information on candidates. The Ethics Council should continue assisting the HCJ appointing bodies in the selection of HCJ members of high integrity, so that the renewed HCJ can become fully operational by the end of 2022 - early 2023. The HQCJ Selection Commission re-launched the HQCJ selection process in July 2022 and received more than 300 applications. The selection of these candidates should be finalised in early 2023.

These reforms have the potential not only to build an independent and accountable judiciary, but also to reduce the influence of vested interests who used the current judicial governance system to undermine the rule of law in Ukraine. This condition requests making progress on the integrity vetting and the competitive selection, with the view of making the renewed judicial self-governing bodies fully operational.

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Action 5

To increase institutional independence and operational effectiveness of the Specialized Anti-Corruption Prosecutor's Office (SAPO), conduct necessary administrative procedures to restore and further reinforce SAPO's professional staff.

The efficient and independent functioning of the key anti-corruption institutions in Ukraine remains crucial for ensuring the efficient use of funds for the future recovery and reconstruction of the country, and for improving the climate for much needed foreign investment. Large-scale, high-level corruption continues to have a negative impact on the development prospects of Ukraine. In the fight against corruption, SAPO is the key prosecution authority for addressing high-level corruption cases, in co-operation with NABU and the High Anti-Corruption Court. Its effective and independent functioning will be crucial for Ukraine in building a stronger track-record on prosecution and convictions of high-level corruption, which is also one of the main elements of the anti-corruption recommendation included in the Commission's opinion on Ukraine's application for EU membership from June 2022.

SAPO, whose head was appointed successfully this summer, is established as an autonomous structural unit of the Office of the Prosecutor General (OPG) with its own budget and procedural powers but continues to be dependent on the OPG both organizationally and procedurally. Due to the ongoing war and temporary outflow of established staff as well as unfilled vacancies, there is a lack of professional prosecutorial staff in SAPO, which undermines its performance. This needs to be addressed as a matter of priority, not to lose highly qualified and experienced staff and to allow a fast and efficient work of the institution under the new progressive leadership. The condition requires conducting necessary administrative procedures to restore and further reinforce SAPO's staff.

ENERGY

Action 6

Develop a plan for gas purchases and storage to prepare for the 2022/23 heating season, including identification of sources for gas and the necessary financing.

Gas plays a major role in the Ukrainian economy as a source of energy for households and industry. Before Russia's aggression, gas accounted for 30% of the domestic energy consumption in the country. The majority of gas is produced domestically by the state-owned Naftogaz group companies and by other producers. For the replenishment of the needed storage levels for the coming winter, a substantial amount of gas needs to be stored and, if necessary, imported.

This condition therefore requires the preparation of a realistic plan for gas purchases and storage for the 2022/23 heating season, including the identification of sources for gas and the necessary financing. The actual demand for gas depends on several factors including winter weather conditions, the speed of possible economic recovery, saving measures for households (such as lower temperatures in centrally heated buildings). The Ukrainian government has already secured some funds from international donors for gas purchases. Such a plan, including the related necessary financing, is of crucial importance for Ukraine's economic resilience, fiscal sustainability and energy security, and to prevent Naftogaz from accumulating financial losses in the current situation which is already entailing enormous pressure on Ukraine's public finances.

Action 7

The energy regulator (NEURC) should develop a plan of gradual measures to ensure settlements with producers of electricity from renewable energy sources, as well as to gradually adjust the electricity transmission tariff to the level that will cover all economically justified costs of the Transmission System Operator.

Russia's unjustified war of aggression against Ukraine has severely affected electricity generators in the country, including partial destruction of assets located in the combat areas and temporary occupied territories and falling demand and supply. The operators, including the renewable electricity sector, already incurred substantial financial losses.

Commercial electricity exchanges between Ukraine and the neighboring EU countries became possible since 30 June 2022, following the successful synchronization of Ukraine's power system with the Continental Europe and after fulfilment of the technical preconditions. Ukraine started exporting electricity to the EU, and the volumes of trade capacity are being gradually increased. A new law allows the Ukrainian Transmission System Operator, Ukrenergo, to distribute the income from auctions of cross-border transmission capacity to pay for services on the balancing market, to the Guaranteed Buyer for renewable electricity, as well as for maintenance and increasing the transmission capacity of interconnectors.

The first part of this condition requires the energy regulator (NEURC) to develop a plan of gradual measures to ensure settlements with producers of electricity from renewable energy sources. This is important to ensure viability of the renewable energy production in Ukraine, to maintain the green production base and improve energy security, but also in view of future e.g. green hydrogen projects.

The second part of the condition requires the energy regulator to gradually adjust the electricity transmission tariff to the level that will cover all economically justified costs of the Transmission System Operator (TSO). Tariffs that would allow to recoup all costs are needed for the financial and operational independence of the TSO. Financial independence is needed and a precondition for having received the certification by the European Energy Community (which can be revoked) as an operational license. This operational TSO license is also a condition for any electricity exports from Ukraine to the EU, which is contributing significantly already now to the financing of the Ukrainian electricity sector.

5. Social situation in Ukraine and expected impact of this MFA operation

Consistent with the Commission's commitment to improve the assessment of the social impact of the EU's macroeconomic adjustment programmes,[7] this section provides additional information on the socio-economic situation and policies in Ukraine and discusses the possible social impact of the MFA operation.[8]

Social indicators and social policies

Russia's war of aggression against Ukraine is having a devastating impact on both the economic and social conditions in Ukraine. More than 7 million persons have been displaced internally, while more than 4 million have applied for temporary protection abroad. This human exodus, which has affected already some 30% of the population, in the context of massive capital destruction, is causing tremendous suffering and implies a generalised

[7] This is also laid down in the Inter-Institutional Agreement on Better Law-making by the European Parliament, the Council and the European Commission of 13 April 2016.

[8] The social impact of this operation will also be assessed as part of the ex-post evaluation of the operation that the Commission will conduct within two years after its completion.

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impoverishment, in addition to being a significant disturbance to the labour market. In these exceptional circumstances, foreign aid in all its forms is critical for alleviating the heavy toll that falls, in particular, on the most vulnerable. Available social data largely relate to the pre-war situation and are therefore complemented by qualitative considerations as appropriate.

In terms of economic and social development, Ukraine is a lower middle-income country, with a GNI per capita that declined abruptly from USD 3,800 in 2013 to USD 2,660 in 2018, largely due to the 2014-2015 crisis.[9] Lately, it had increased back to USD 4,860 in 2021. While inequality was less pronounced in pre-war Ukraine than in many lower middle-income countries in other parts of the world, the Gini index has been increasing moderately from 24.8% in 2010 to 25.6% in 2020. Absolute poverty abated, with the share of population living with or below USD 6.85/day (at the 2017 purchasing power parity) declining from 15% in 2016 to 7% in 2020. Based on the nationally defined poverty lines, the poverty rate decreased from 8.6% in 2014 to 1.4% in 2020.[10] However, the ongoing war is likely to reverse this positive development and significantly so. Moreover, more than 30% of the population lives in rural areas, where the availability of social services is of much poorer quality than in towns and cities and this share is likely to have increased significantly over the past months.

Over the last decade, life expectancy at birth progressed from 70.3 years in 2010 to 71.8 years in 2019 (77.0 years for women and 66.9 years for men), thereby indicating some improvement in relevant dimensions of lifestyles and in the quality of health services. The infant mortality rate declined from 10.1 to 6.9 per 1,000 live births over the period 2010-2020 and tuberculosis and diabetes prevalence declined, too. Smoking prevalence has moderated and total annual alcohol consumption per capita decreased substantially from 14.3 litres of pure alcohol in 2010 to 8.3 in 2018. The share of youth not in education, employment or training declined from 17.7% in 2013 to 16.8% in 2020. The tendency of all these indicators suggests a general, yet slow, improvement in the social conditions in Ukraine prior to the start of the war, which was consistent with the pace of the economic development of the country.

In the area of health services, government expenditure had been increasing and represented 11.7% of general government spending in 2021. The private health expenditure is considerable and reached 52% of overall health expenditure in 2018. Hospital beds declined from 9.4 to 7.3 per thousand between 2010 and 2017. During the same period, the number of physicians decreased from 4.9 to 4.4 per thousand. Overall, hospital medical equipment and general medical services were a major issue of concern already prior to the war and during the pandemic, suggesting that strategic health policies of the government need improvement.

In the area of public education, government expenditure was stable at around 6% of GDP in the last decade. Secondary school enrolment remains very high at 96%, based on data from 2014. However, the statistical capacity score, which is a proxy for the quality of educational outcomes, has been deteriorating steadily from 88% to 72% between 2011 and 2020. While society has progressed quickly towards digitalisation, with 70 persons out of 100 using internet in 2019 (up from 23 persons in 2011), the number of fixed broadband subscriptions has increased from 6.5 per 100 people in 2010 to 18.6 per 100 people in 2020 only. Thus, pupils and teachers in Ukraine might face a challenging transition to the digitalised methods

[9] Based on the World Bank's Atlas 2016 figures (GNI per capita is the gross national income, converted to US dollars using the World Bank Atlas method, divided by the population).

[10] Given that poverty is defined in comparative terms relative to the distribution of incomes, a decline in the poverty rate does not imply a general improvement in welfare.

of education that the COVID-19 crisis has brought to the fore and that are set to remain relevant for some groups in the context of the war.

Social protection and labour market programmes covered more than 71% of the population in the pre-war situation, which means that more than two thirds of Ukrainians received some form of government-sponsored social benefits. Maternity leave in Ukraine is very generous and lasts 126 weeks, with 100% of wages paid as maternity benefits. There are more than 11 million pensioners in Ukraine (more than 25% of the population), with the average pension having reached around EUR 115, i.e. 29% of the average salary, as of early 2020. While the old age-dependency ratio has been deteriorating from 42.5% in 2010 to 49.8% in 2021, it remains well below the world and peer averages.

Social impact of the exceptional MFA

This exceptional macro-financial assistance to Ukraine contributes to financing the remaining funding gap of Ukraine until the end of 2022 and responds to the immediate and most urgent funding needs of the country triggered by Russia's unjustified war of aggression. The funds received under this assistance will support the most critical functions of the Ukrainian state, including in the provision of social and welfare services. Together with the other elements of official foreign assistance, it contributes to some smoothening of the social impact of the war and of the adjustment to the much deteriorated economic and social conditions. By preserving macroeconomic stability as well as the economic and social resilience of Ukraine, this exceptional MFA improves the foundation for the tremendous reconstruction effort that will be necessary in the future.

This exceptional MFA operation for Ukraine of EUR 5 billion (2.5% of the 2021 GDP) is part of a larger official assistance effort that involves all IFIs and many bilateral national sovereigns. It contributes to enabling the country to maintain its integrity and to continue to provide the critical state functions that are of particular importance in this period of significant economic upheaval with ensuing tremendous social challenges. The MFA operation also contributes to building confidence by helping the country limit the drawdown of its official international reserves, as much as the situation allows for.

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Subject to the opinion of the Committee, the Commission intends to proceed with the signing of the Memorandum of Understanding.

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Electronically signed on 23/09/2022 20:29 (UTC+02) in accordance with Article 11 of Commission Decision (EU) 2021/2121