



EUROPEAN COMMISSION

**MACRO-FINANCIAL ASSISTANCE TO UKRAINE
DISBURSEMENT OF THE SECOND INSTALMENT**

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

1. Introduction

Following an official request from Ukraine,¹ on 9 March 2018 the European Commission adopted a proposal for a Decision providing further Macro-Financial Assistance (MFA) to Ukraine of up to EUR 1 billion in loans. The Decision was adopted by the European Parliament and the Council on 4 July 2018,² authorising the fourth MFA operation in Ukraine since 2014.³

The first tranche of EUR 500 million of this fourth MFA operation was released on 30 November 2018, after the Ukrainian authorities fulfilled the associated policy conditions, as laid down in Annex I of the Memorandum of Understanding (MoU) between the European Union and Ukraine, which was signed on 14 September 2018. The Commission submitted an Information Note on the fulfilment of the conditions to the European Parliament and the Council on 30 November 2018 and – in accordance with the Joint Statement of the three institutions attached to the MFA Decision – published it.⁴

The disbursement of the second EUR 500 million tranche of the MFA operation is conditioned on the 12 structural reform actions agreed with the Ukrainian authorities in Annex I of the MoU. These policy measures fall in four thematic areas: public finance management; good governance and fight against corruption; sector reforms and state-owned enterprises; and social policies. Based on information submitted by Ukraine and its own independent assessment, the Commission has concluded that the policy measures have been implemented successfully.

In accordance with the information requirements of the aforementioned MFA Decision, this note informs the European Parliament and the Council of the status of the MFA operation in Ukraine, in particular the disbursement of the second loan instalment of EUR 500 million. In line with the aforementioned Joint Statement of the European Parliament, the Council and the Commission and with the practice followed for the first disbursement, the note will be made public. The note first describes recent macroeconomic developments in Ukraine (Section 2) and reviews the status of Ukraine's cooperation with the IMF (Section 3). Section 4 presents the state of play with the political pre-condition for granting MFA. Section 5 contains the assessment of the degree of implementation of each of the 12 specific MFA conditions. For each condition, a short summary of the rationale that backed the negotiation of the condition in 2018 precedes the implementation assessment itself. Section 6 concludes.

¹ Letter of 29 November 2017 from the Finance Minister Danyliuk to Vice-President Dombrovskis.

² Decision (EU) 2018/947 of the European Parliament and of the Council of 4 July 2018 providing further macro-financial assistance to Ukraine, OJ L 171 06.07.2018, p. 11.

³ The previous three operations totalled EUR 3.4 billion, of which EUR 2.8 billion was disbursed: EUR 1.6 billion in 2014-2015 (under MFA I and II) and two tranches of EUR 600 million each in July 2015 and April 2017 (under MFA III).

⁴ https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/international-economic-relations/enlargement-and-neighbouring-countries/neighbouring-countries-eu/neighbourhood-countries/ukraine_en#macro-financial-assistance

2. Recent macroeconomic developments

After a significant improvement in Ukraine's macroeconomic situation over the past few years, **the outlook deteriorated rapidly in March 2020** following an abrupt government reshuffle which coincided with the outbreak of the global **coronavirus crisis**. Real GDP growth reached 3.2% in 2019, inflationary pressures moderated, the hryvnia appreciated and international reserves strengthened. However, following the loss of confidence around a government reshuffling in early March and the coronavirus outbreak and ensuing containment measures, the earlier exchange-rate appreciation was quickly erased. In this context, the demand to hold hryvnia weakened and the National Bank of Ukraine (NBU) intervened, which reduced official international reserves. Following virus containment measures since mid-March, similar to those adopted in other countries, economic activity has been curtailed. Analysts expect a deep recession in 2020 (with the forecast GDP fall ranging between 4% and 9%).

Following the recession of 2014 and 2015 when Ukraine lost more than 16% of GDP, **the economy returned to growth** in 2016 and subsequently **gained momentum**. Real GDP grew by 3.2% only in 2019, after a disappointing fourth quarter (+1.5%). While the economic revival was demand-driven, **gross fixed capital formation has remained low** at its historically subdued level of about 17% of GDP. The economic expansion occurred primarily in the construction, agricultural and retail sectors, while industrial output was lagging behind.

The **unemployment rate decreased** to 8.2% in the fourth quarter of 2019 from its peak at 10.1% in early 2017. Thanks to a year-on-year growth rate of 11.8% in March 2020, implying an increase in real terms of about 9.5%, the average nominal wage reached the equivalent of around EUR 400.

Inflation of consumer prices has decelerated significantly from 14.1% in January 2018 to 2.1% in April 2020. The decline in industrial producer prices inflation has been even steeper, going down from 22% to -4.2% during the same period. The National Bank of Ukraine has been **successful in reaching its medium-term inflation target** of 4% to 6% by end-2019. Considering that monetary policy had been very tight, as evidenced by the level of the key interest rate, which was increased to 18% in September 2018, the National Bank started an easing cycle in April 2019. In light of falling inflation and lower inflation expectations, the policy rate was lowered to 13.5% by year-end. It was further decreased to 8% as from end-April 2020. This policy was mirrored in a correspondingly lower cost of borrowing for the government and is expected to result in higher volumes of credit to the private sector too in 2020. However, in the context of risk repricing in emerging markets amidst the coronavirus crisis, the government cost of borrowing increased in April by more than 130 basis points up to 11.2% after almost no new issuance of debt in March.

Ukraine has remained **a very open economy**, even though the combined volume of imports and exports of goods and services has decreased from 107.8% of GDP in 2015 to 90% in 2019. The decline in exports has been more pronounced than that of imports, which explains why the negative goods and services balance has widened from 2.6% of GDP in 2015 to 7.8% in 2019. The current account deficit has been much smaller (1.9% of GDP in 2017, 3.3% in 2018 and 0.7% in 2019) thanks to significant and growing foreign income flows, primarily driven by remittances from abroad.⁵ Inflows of foreign direct investment (FDI) remained relatively low at USD 2.5 billion or 1.7% of GDP in 2019. However, portfolio and

⁵ There was an exceptional payment of USD 2.9 billion in December 2019 from Russia's Gazprom to Ukraine's Naftogaz in settlement of legal disputes. If corrected for this extraordinary item, which has also affected the increase in official international reserves, the current account deficit would have been 2.8%.

other investments, both private and official, were sufficiently strong to ensure that the overall balance with foreign residents has been positive and grew to USD 6.0 billion or 3.8% of GDP in 2019.⁶

The support from Ukraine's multilateral and bilateral partners, coupled with a gradual return of private financial flows, helped Ukraine **decrease its gross external debt** from 129% of GDP in 2015 to 79.1% in 2019 and **replenish its international reserves**. Official reserves increased from USD 17.8 billion in July 2018 to USD 27.0 billion in February 2020, equivalent to 4.2 months of goods and services imports. The strong external liquidity inflows resulted in higher demand for the hryvnia, which appreciated by 14.7% against the US dollar in 2019. To moderate the appreciation and support reserves, the National Bank intervened in the forex market and bought USD 7.9 billion from domestic banks in 2019, up from USD 1.4 billion in 2018. This tendency continued in the first two months of 2020, when the NBU bought USD 800 million in forex, but reversed in March, when the relative demand to hold the hryvnia weakened significantly due to temporary loss of confidence in the context of the coronavirus crisis. The domestic currency depreciated by 18% in the first quarter of 2020 relative to the US dollar, and the NBU sold more than USD 2 billion in the spot forex market in March. Confidence has been strengthening gradually since then, the currency appreciated by 4% and reserves have been replenished somewhat, to USD 25.7 billion in April.

The Ukrainian government has made significant **progress in the consolidation of its public finances** in the past five years. The overall fiscal deficit, including the operating deficit of the oil and gas company Naftogaz, was reduced from 10% of GDP in 2014 to 1.4% in 2017 and 1.9% in 2018. Prudent fiscal policy and budget execution continued in 2019: the Ministry of Finance reported a central government cash deficit of UAH 81 billion for the year (2.0% of GDP), below the budgeted target of UAH 91 billion. Fiscal consolidation has also helped reduce general government debt to 51.6% of GDP in 2019 (down from 81% at end-2016). The government's 2020 fiscal deficit target, initially set at 2.09% of GDP prior to the coronavirus crisis, was subsequently revised upwards to 7.5% of GDP, including crisis measures for the equivalent of EUR 2.5 billion. In 2019 the government issued UAH 227.6 billion of debt on the domestic primary market, i.e. 114% more than in 2018, at average yields, all maturities included, that declined from 19% in January to 11.6% in December. The cost of funding in US dollar and euro has decreased too, respectively from 6.5% to 3.7% and from 4.5% to 2.2%. Following the political crisis from end-February and the coronavirus crisis from March, the Eurobonds yields almost tripled before stabilising at around 7.5% in early May.

Aside from safeguarding macroeconomic stability through the coronavirus crisis, the main policy challenges ahead concern the **structural bottlenecks to investment**, capital accumulation and gains in competitiveness. The fight against corruption has intensified, including thanks to the launch of the dedicated anti-corruption court and the reboot of the operational anti-corruption agencies. Governance reforms in state-owned enterprises and banks have contributed to a better allocation of resources and strengthened competition. Reforms in the energy sector have removed price distortions. Yet, despite these achievements, challenges remain related to demonopolisation, even-handed protection of property rights, cutting vested oligarchic interests and reducing the regulatory burden. Addressing these remaining challenges is crucial to improve the business climate and to attract and retain investors. The sustainability and inclusiveness of economic growth in Ukraine both depend on the extent to which these remaining structural bottlenecks to investment are successfully removed.

⁶ Respectively USD 3.1 billion and 2.2% of GDP if corrected for the Gazprom transfer of USD 2.9 billion.

Table: Key macroeconomic data

	2014	2015	2016	2017	2018	2019
Real GDP change, %	-6.6	-9.8	2.4	2.5	3.3	3.2
Consumer price inflation, %, end of period	24.9	43.3	12.4	13.7	9.8	4.1
Key monetary policy rate, %, end of period	14.00	22.00	12.00	14.50	18.00	13.50
Unemployment rate, % LFS	9.3	9.1	9.3	9.5	8.8	8.1
General government balance, % of GDP	-4.5	-1.6	-2.3	-1.4	-1.9	-2.0
Public debt, % of GDP	70.3	79.7	81.2	72.3	61.0	51.6
Current account balance, % of GDP	-3.5	1.8	-1.4	-2.2	-3.4	-0.7
International reserves, USD billion, end of period	7.5	13.3	15.5	18.8	20.8	25.3
International reserves, months of imports	1.8	3.0	3.0	3.2	3.2	4.0
Gross external debt, % of GDP	94.7	129.4	120.5	103.0	87.7	79.1
Foreign direct investment, % of GDP	0.2	3.3	3.5	2.3	1.8	1.7

Sources: National Bank of Ukraine; State Statistics Service of Ukraine; Dragon Capital; Commission staff calculations.

3. Progress with the IMF programme

In March 2015, the IMF approved a four-year Extended Fund Facility (EFF) programme for Ukraine of USD 17.5 billion, out of which USD 8.4 billion was disbursed. This programme was replaced in December 2018 by a Stand-by Arrangement for a total of USD 3.9 billion, out of which USD 1.4 billion have been disbursed. Following the 2019 parliamentary elections, the new government started negotiations on a new programme with the IMF.

On 7 December 2019, the IMF announced that it had concluded a staff-level agreement with the Ukrainian authorities on a new, three-year programme under the Extended Fund Facility for USD 5.5 billion. Subsequently, due to the coronavirus crisis, the IMF expressed a preference for an 18-month Stand-by Agreement, which would allow for more policy flexibility in the ongoing global crisis context.

In the past few months, Ukraine has been working on the prior actions agreed with the IMF to enable the passage of the programme to the IMF Board for approval. In October 2019 Ukraine passed legislative amendments to re-criminalise illicit enrichment after the Constitutional Court had struck this provision down earlier in the year. The adoption of the 2020 budget in line with IMF parameters in November 2019, later revised in April 2020 due to the coronavirus crisis, was an important milestone for macroeconomic policy under the programme. Moreover, to improve revenue collection, the laws establishing the State Customs Service and the State Tax Service as two legal entities that include the regional customs and tax offices were adopted in January 2020. In April 2020 Ukraine also passed a long-awaited land market reform law to boost agricultural investment and productivity and enable the use of land as collateral for lending. On 13 May, the Parliament adopted legislative amendments limiting the scope of the judiciary to reverse bank resolution decisions – the latter as part of a broader fall-back plan in case of adverse court rulings on past government decisions for bank resolutions (including PrivatBank’s nationalisation in 2016). With the enactment of these banking law amendments by the President on 21 May, the last remaining prior action required by the IMF programme has been fulfilled. The IMF announced a staff-level agreement on the new Stand-by Arrangement on the same day. The new agreement is subject to approval by the IMF Executive Board, which is expected to discuss it in early June.

4. 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 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. Media freedom has improved since 2014. While steps have been taken to increase funding for the public broadcaster, further work is needed to strengthen the pluralistic environment and to investigate the attacks against journalists and civic activists effectively.

Regarding **human rights**, Ukraine has continued the implementation of the 2015-2020 National Strategy and Action Plan on Human Rights, although at a slow pace, and a number of concerns persist. Freedoms of religion and assembly are generally respected. Steps have been taken to strengthen gender equality, and domestic violence has been criminalised. The most severe violations take place in the areas not under the control of the Ukrainian Government, following the illegal annexation of the Crimean peninsula and the conflict in the east provoked by Russia’s destabilising actions.

Regarding the **rule of law**, reforms in the area of the judiciary and the fight against corruption have advanced. Anti-corruption related legislation has been adopted (e.g. re-criminalisation of illicit enrichment, protection of whistle-blowers). Ukraine has continued to strengthen anti-corruption institutions by relaunching the National Agency for Prevention of Corruption and through operationalisation of the High Anti-Corruption Court. Ukraine has also embarked on a reform of the judiciary and prosecution. Further actions are needed to bring the judicial reform in line with recent Venice Commission recommendations and to ensure full implementation and sustainability of these reforms, including with regard to the banking fraud in PrivatBank where criminal prosecution of those responsible has not yet taken place. Asset recovery in the banking sector is also being addressed by means of MFA policy conditionality.

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

5. Specific Policy Actions from the Memorandum of Understanding for the Disbursement of the Second Tranche of EUR 500 million

PUBLIC FINANCE MANAGEMENT

Condition 1

*With a view to improving domestic revenue mobilisation, the Cabinet of Ministers of Ukraine will adopt a medium-term **reform plan for the tax and customs administration** with clear deliverables to ensure tax compliance, tax audit, customs and cross-border cooperation and enforcement, and staff integrity.*

Rationale for the condition

The State Fiscal Service (SFS), which was in charge of administering taxes, customs duties and mandatory pension contributions until 2018, was lacking sufficient operational and institutional capacity. With the technical support of the IMF, initial steps to reform the SFS were implemented in 2015 and 2016. However, a comprehensive strategic medium-term reform plan that would contribute to improving the overall efficiency and integrity of the

service was still missing. In the longer term, such a reform should help to eliminate systemic deficiencies that undermine tax compliance, to improve business planning and thus to support the investment climate.

Implementation

On 18 December 2018, the Cabinet of Ministers approved a resolution on reorganising the State Fiscal Service by dividing it into two separate central bodies, i.e. the State Tax Service and the State Customs Service. On 27 December 2018, the Cabinet of Ministers approved a broad reform strategy for both newly created services, through a decree on the Conceptual Directions for Reforming the System of Bodies Implementing State Tax and Customs Policy.

On 5 July 2019, the Cabinet of Ministers approved the action plans for implementing the aforementioned strategies for both bodies, following a consultative process that included the EU and other international donors. These action plans, which aim at facilitating the institutional reform of the State Tax Service and the State Customs Service, have a medium-term horizon and focus on delivering the following results:

- Optimise the organisational and functional structures of the Services;
- Improve the procedure of administrative appeal;
- Introduce staff development and anti-corruption measures;
- Develop risk management, tax control and audit services;
- Enhance the transfer pricing analysis capabilities of the Services;
- Harmonise and simplify customs procedures;
- Promote effective customs clearance and e-technologies;
- Improve the effectiveness of international customs cooperation.

Since then the EU has supported the tax and customs services in the implementation of their strategy and action plan, notably through the EU4PFM project.

Assessment: the condition can be considered as met.

Condition 2

*To ensure a better balance between **customs control and trade facilitation**, (a) adopt changes to the Customs Code of Ukraine with a view to introducing an Authorised Economic Operator programme and (b) submit to the Parliament the draft law on the implementation in the national legislation of Ukraine of the provisions of the Convention on a common transit procedure and the Convention on the simplification of formalities in trade in goods, enabling Ukraine to start the procedure for its accession to these Conventions and apply a new computerised transit system.*

Rationale for the condition

With the objective to facilitate trade across borders, including with the EU as envisaged under the Association Agreement, Ukraine has had long-standing plans to introduce an Authorised Economic Operator (AEO) programme in line with the World Customs Organisation Framework of Standards to Secure and Facilitate Global Trade. This would allow simplifying and speeding up customs controls for a number of accredited economic operators with high-quality control standards. While envisioned in the new Customs Code of Ukraine from 2012, the AEO status had not been implemented. Under the previous MFA programmes, Ukraine initiated steps to prepare the relevant legislation and norms to facilitate the introduction of the AEO programme so that Ukrainian AEOs could participate in the

formation of so-called safe supply chains and increase their competitiveness on external and internal markets.

Joining the Common Transit Convention and introducing a new computerised transit system (NCTS) are other important trade facilitation measures and were overdue under the Association Agreement. After the first legislative initiative in that direction (draft law No. 5627 of December 2016) was rejected by the Rada, the preparation and submission of a new draft law was required.

Implementation

The Ukrainian authorities worked closely with Commission services on drafting the laws introducing the AEO and introducing the common transit system, which resulted in the adoption in the legislation compliant with EU legislation in this field.

The law No. 141-IX “On Amendments to the Customs Code of Ukraine on Certain Issues of Functioning of Authorised Economic Operators” was adopted by the Parliament on 2 October 2019 and signed by the President of Ukraine on 4 November 2019. The Ukrainian Ministry of Finance together with experts from the EU4PFM programme developed a comprehensive roadmap for launching the AEO programme including development of secondary legislation, IT tools, training of customs officials and information to exporters. The roadmap is being implemented in 2019-21, in cooperation with the Commission (DG TAXUD) and several EU Member States.

The draft law No. 1082 “On the Regime of Common Transit and introduction of the national electronic transit system” was submitted to the Parliament on 29 August 2019. It was adopted by the Rada on 12 September 2019 and signed by President of Ukraine on 23 September 2019 (law No. 78-IX). A pilot system is expected to become operational in 2020. Implementation of the NCTS in Ukraine is supported by the EU-funded EU4PFM project. Several steps have been implemented: the scope for further NCTS development was agreed, technical requirements for the NCTS-compatible National Transit Application software have been drafted, and a list of functional modules has been defined.

Assessment: the condition can be considered as met.

Condition 3

*To ensure progress with the minimum OECD requirements on **fighting tax evasion**, submit to the Parliament of Ukraine and ratify the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.*

Rationale for the condition

In order to counter tax avoidance, Ukraine joined the implementation of the OECD’s Base Erosion and Profit Shifting (BEPS) Action Plan in January 2017 and committed to implementing the so-called minimum standards for this initiative. In this context, the government adopted a BEPS national roadmap in December 2017. In July 2018, the (then acting) Minister of Finance signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the so-called Multilateral Instrument, MLI).⁷

⁷ <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>

Implementation

The law No. 2692-VIII “On Ratification of the Multilateral Convention on the Implementation of Measures Concerning Taxation Agreements with the Purpose of Counteracting the Erosion of the Base of Taxation and Removal of Profit from Taxation” was adopted on 28 February 2019.

Assessment: the condition can be considered as met.

GOOD GOVERNANCE AND FIGHT AGAINST CORRUPTION

Condition 4

Operate a fully functional verification system for electronic asset declarations of persons authorised to perform functions of the state and local self-government proving effective in detecting undeclared income and assets, based on automated verification software and automated access to information held in relevant state registers. On this basis, verify at least 1,000 declarations of high-level officials (including from the executive, the Parliament and the judiciary) and adopt the corresponding verification decisions.

Rationale for the condition

A compulsory electronic declaration system for public officials was introduced in Ukraine in 2016 with the aim to expose cases of public officials and their family members holding assets that cannot be reconciled with their incomes. Ukraine chose to cast the net wide: around 900,000 officials are required by law to submit an asset declaration in April every year. As a result, the electronic database of asset declarations currently contains 3.5 million declarations from four vintages (2016-19).

The National Agency for the Prevention of Corruption (NAPC) was mandated by law to verify these declarations, but the verification lacked credibility, scale and speed.⁸ Thus, an upgrade of the verification system was needed, most notably through automating the exchange of information with relevant databases of other public authorities. The numerical target of 1,000 declarations verified was meant to ensure that the verification system has become operational and is actively used to check the asset declarations of most high-level officials.

Implementation

A milestone in Ukraine’s corruption prevention effort was the adoption of the so-called NAPC relaunch law (No. 140-IX) in October 2019. It dismissed the old NAPC Management Board, as this collegial body was seen as paralysing the organisation, and replaced it with a single head. Following the entry into force of the law, a transparent selection process for a new head was undertaken with the participation of EU and other international experts, which resulted in the appointment of Oleksandr Novikov, who took office in January 2020.

The law also amended a number of legal provisions to make the verification of asset declarations more effective. It removed legal obstacles to: (i) NAPC’s automatic access to three further state registers (power of attorney, inheritance and civil status), which helps to make the automated cross-check of declarations more comprehensive; and (ii) the full remote access of the National Anti-Corruption Bureau of Ukraine (NABU) to the database of

⁸ European Union Anti-Corruption Initiative, *The Business Process of Verifying E-Asset Declarations at the National Agency on Corruption Prevention of Corruption*, September 2017.

declarations, which facilitates the investigative work of NABU's detectives. Technical issues have been resolved and, as of December 2019, NABU and the NACP have direct remote access to all necessary databases. This creates positive conditions for them to carry out their investigative and analytical mandates fully.

In parallel, the NACP changed its rules of logical and arithmetic control of declarations and its procedure of control and full verification of declarations between August 2019 (adoption) and October 2019 (entry into force) under close scrutiny of the European Commission.⁹ In the automated part of the verification ("system of logical and arithmetic control"), each declaration is first checked for internal consistency and receives a risk score on this basis (Component 1). In Component 2, declarations are cross-checked against other state registers to verify whether the information contained therein (e.g. on car or land ownership) matches the data held in other public databases (e.g. the vehicle register or land cadaster).

According to the NACP's amended rules, the risk score of each declaration from Component 1 is updated in accordance with the findings of Component 2. On the basis of the combined risk score, declarations then undergo full (manual) verification in sequence of the degree of risk identified by the automated system. This risk-based approach is calibrated with adequate capacity to pursue other pertinent cases – such as in follow-up to external notifications (e.g. from investigative journalists) of possible undeclared assets or illicit enrichment. Cases are assigned randomly to authorised NACP staff.

With respect to the verification of 1,000 high-level officials' declarations, the NACP reached this target in October 2019. The 1,005 adopted decisions concern 291 Members of Parliament, 278 high-level judges and 436 high-ranking executive officials. Out of the 674 declarations that have led to irregularities, 72 cases totalling UAH 7.4 billion have been submitted to police for investigation in view of a possible criminal charge.

Assessment: the condition can be considered as met.

Condition 5

*Progress in making the **High Anti-Corruption Court of Ukraine** operational in line with the law "On the High Anti-Corruption Court" by (a) making significant progress with the selection of qualified and independent judges for this Court (at least submission by the High Qualification Commission of Judges of Ukraine to the High Council of Justice of the recommendations on the appointment of candidates for judge according to the results of the competition), and (b) ensuring that the Court has the financial resources to conduct its mission as prescribed by the law.*

Rationale for the condition

The High Anti-Corruption Court (HACC) was widely seen as a missing element in the anti-corruption enforcement chain, given the relative weakness of Ukraine's judiciary¹⁰ and the

⁹ The decisions can be found on the NACP website, <https://nazk.gov.ua/wp-content/uploads/2019/10/02.08-2304.pdf> and <https://nazk.gov.ua/wp-content/uploads/2019/10/02.08-2305.pdf>.

¹⁰ According to the World Bank Governance Indicators 2018, Ukraine scores 24 out of 100 (highest) with regards to the rule of law. This is worse than the average 36 score for lower middle income countries to which Ukraine belongs. It should also be noted that Ukraine's ranking has worsened by more than 3 ranking points since 2008. This is in contrast with developments in other Eastern Partners (save for Moldova), which witnessed significant improvements in their rule-of-law ranking over the same period.

fact that few public officials have been convicted of corruption so far. Under strong international pressure, including from the EU, the law on the HACC was adopted in June 2018. The MFA conditionality therefore focused on making the HACC operational.

Implementation

The HACC was registered as a newly created entity on 22 February 2019. On 11 April 2019, the President of Ukraine appointed 38 judges to the HACC, including its Appeal Chamber (decrees No. 128/2019 and 129/2019), following a transparent selection process involving international experts. Following recruitment of administrative staff, the HACC started its work on 5 September 2019 and delivered its first verdict on 30 October 2019.

To prevent overloading the HACC with minor legacy cases that would risk blocking its work, the Parliament of Ukraine adopted law No. 100, initiated by the President, which regulates the referral of cases to the High Anti-Corruption Court. It limits the HACC's jurisdiction to those cases that were either fully investigated by the NABU or started after the launch of HACC. This enables the court to focus on the top cases initially and to receive lower-level cases later and gradually.

To ensure that the Court has the financial resources to conduct its mission as prescribed by the law, the 2019 State Budget allocated UAH 318 million to the HACC. This amount finances all needs related to completing the formation of the HACC and its appropriate functioning. The 2020 State Budget provides UAH 374 million to the HACC.

Assessment: the condition can be considered as met.

Condition 6

*To ensure an improved framework for fighting and **preventing money laundering**, adopt an anti-money laundering law in line with the EU-Ukraine Association Agreement. The anti-money laundering law will, in particular, oblige reporting entities (such as banks, notaries and lawyers) to report, to the specially designated agency, on discrepancies between, on the one hand, data on clients' ultimate beneficial owners (controllers) contained in the Unified State Register of Legal Entities, Individual Entrepreneurs and Public Associations and, on the other hand, information received by the reporting entities as a result of due diligence of their clients.*

Rationale for the condition

The EU-Ukraine Association Agreement (Article 20) provides for the implementation of relevant international standards in the area of preventing and combating money laundering and terrorism financing, in particular those of the Financial Action Task Force (FATF) and standards equivalent to those adopted by the EU. In other words, the Association Agreement foresees a gradual approximation of Ukraine's legislation on anti-money laundering (AML) to the EU acquis. The Ukrainian authorities had been working for some time on implementing Directive (EU) 2015/849 (the fourth AML Directive) and Regulation (EU) 2015/847 (the Fund Transfers Regulation). In parallel, the fifth AML Directive was being developed in the EU and was adopted on 30 May 2018 (Directive (EU) 2018/843). To achieve legal approximation, the Ministry of Finance had been developing a draft AML law

that was awaiting approval by the government and submission to the Ukrainian Parliament.¹¹ The condition aimed to ensure the effective adoption of the AML law.

The adoption of the AML law would make it more difficult to benefit from the proceeds of illicit activity, including corruption. Moreover, the AML law could help with more stringent checks on companies' beneficial ownership data. As recommended by EU-funded experts in July 2018, the AML law should oblige so-called reporting entities to report cases of discrepancies between information provided to them by their clients and corresponding information on beneficial ownership in the Unified State Register on Legal Entities, Individual Entrepreneurs and Public Associations (USR). The obliged reporting entities will notably include providers of financial services (such as banks) and certain non-financial services (such as auditors and notaries). This reporting requirement will not only increase the accuracy of data on beneficial ownership in the USR but will also ensure the investigation of suspicious cases.

Implementation

The Ministry of Finance drafted a new AML bill between late 2018 and mid-2019, taking into account the recommendations of international experts. On 25 September 2019 the government submitted the draft law to the parliament (No. 2179). After intensive discussions (more than 1,300 amendments were submitted), the AML law was adopted in the parliament on 6 December and signed by the president on 27 December 2019.

The final adopted version mostly complies with the provisions of the EU's fourth AML Directive and even includes several new aspects from the fifth AML Directive. While there are some discrepancies related to the size of fines for financial institutions, in particular banks, the newly adopted maximum fines of EUR 5 million are 5,000 times higher than the fines under the previous Ukrainian AML legislation. Thus, the new law marks a significant step forward in terms of the dissuasive effect of financial sanctions.

The new AML law also contains obligations for reporting entities (such as banks) to notify the authorities on discrepancies between information on the ultimate beneficial owners of clients as contained in the Unified State Register of Legal Entities, Individual Entrepreneurs and Public Formations and information on the ultimate beneficial owners they obtain as a result of customer due diligence. Such notification has to take place no later than on the 10th working day of the month following the month in which the discrepancies become apparent.

As part of the AML legislative package, amendments were also made to the Law of Ukraine "On State Registration of Legal Entities and Individual Entrepreneurs and Public Formations." These amendments oblige:

- the state registrar to verify the data provided by a company on their beneficial owners against information from other state registers;¹²
- existing companies to provide the state registrar with information on the ultimate beneficial owner and the ownership structure within three months from the entry into force of the law, thus aiming to address a legacy problem with missing information on older companies; and

¹¹ In principle, the draft law uses the fourth AML Directive as a benchmark, although in some areas provisions may already reflect forthcoming developments in the EU framework under the fifth AML Directive.

¹² The State Register of Civil Status of Citizens; the Unified State Demographic Register; the State Register of Individual Taxpayers; the Unified State Register of Court Judgements; and the Unified Information System of the Ministry of Internal Affairs on the search of missing persons and stolen (lost) documents.

- companies to update information on their ultimate beneficial owners and ownership structure annually or within 30 working days of any changes, as well as to submit to the state registrar the documents confirming such changes.

Overall, the adopted AML law strengthens the transparency of business ownership structures in Ukraine. More generally, even though the size of fines partly falls short of the EU's fourth AML Directive, the law represents a significant improvement of the framework for preventing and fighting money laundering.

Assessment: the condition can be considered as broadly met.

SECTOR REFORMS AND STATE-OWNED ENTERPRISES

Condition 7

*With a view to **reducing the high level of non-performing loans (NPLs)** in the banking system of Ukraine, including in state-owned banks, the National Bank of Ukraine will develop a resolution on the management of non-performing assets in banks. The Ukrainian authorities will also continue their efforts on **asset recovery**, including by pursuing action through the courts where appropriate and by reporting publicly and comprehensively on a semi-annual basis on asset recovery in state-owned banks, with the first report to be published at the latest in the first quarter of 2019.*

Condition 8

*To improve corporate **governance in state-owned banks**, their supervisory boards will be granted appropriate powers and have a majority of independent members, to be selected on a competitive and transparent basis. To this end, the Parliament of Ukraine will amend Article 7 on state-owned banks of the Law "On Banks and Banking Activities", in line with the corresponding provisions of draft law No. 8331, with a view to swift implementation of the new system of corporate governance in state-owned banks.*

Rationale for the conditions

These two related conditions aim at improving the soundness and stability of the banking sector in Ukraine. Banks in Ukraine were hit by a severe recession in 2014 and by specific risks stemming from related-party lending. The share of non-performing loans soared quickly, and reached above 50% of the total portfolio. The small institutions that failed to raise additional capital were liquidated and the number of banks decreased from 180 in 2014 to below 80 in 2018. In order to preserve the stability of the sector, the largest bank, PrivatBank, where related-party lending had been endemic,¹³ was nationalised in 2016 in light of persistent undercapitalisation. Aside from PrivatBank, the largest state-owned banks are the savings bank Oschadbank, the export-import bank Ukreximbank and Ukrgasbank specialising in energy efficiency lending. These four state-owned banks account for 54% of total assets and 65.4% of all non-performing loans (NPLs) in the Ukrainian banking system, as of end-June 2019.

¹³ In January 2018, an investigation by Kroll confirmed earlier NBU estimates that the suspected fraud including through related-party lending schemes at the bank had led to a loan loss of USD 5.5 billion (around 5% of GDP).

In this context, reducing the level of NPLs and strengthening the governance of state-owned banks are interrelated priorities. More specifically, the accountability for the performance of fully state-owned banks (Oschadbank and Ukreximbank) needed to be transferred from the Cabinet of Ministers to individual supervisory and management boards.¹⁴ Supervisory boards could then set key performance indicators for the management, so that state-owned banks pursue business objectives and make further progress in limiting related-party lending and addressing the issue of NPLs. In parallel, the National Bank of Ukraine was expected to develop guidelines on NPL resolution, which would apply to both public and private banks.

On asset recovery, according to the NBU, the fiscal cost of the banking crisis in Ukraine in 2014-16 amounted to around 14% of the GDP, mainly attributable to the nationalisation of PrivatBank¹⁵ and the capitalisation of the other state-owned banks, as well as to compensation of guaranteed retail depositors (households)¹⁶ by the Deposit Guarantee Fund (DGF). While specific progress on asset recovery depends on decisions in court, the condition sought to establish greater transparency through regular progress reports.

Implementation

The adoption of Law No. 2491-VIII “On Amendments to Certain Legislative Acts of Ukraine on Improving the Functioning of the Financial Sector in Ukraine” was a milestone for improving the governance of state-owned banks. While the Parliament of Ukraine had already adopted the draft law on 5 July 2018, the President signed the law on 7 November 2018 only. The law provides for a thorough revision of the mechanisms of corporate governance of state-owned banks. Its provisions aim at creating a management system that is sheltered from political influence. For the State-owned banks, some of the initially appointed independent members of the supervisory boards did not pass the fit and proper test of the National Bank of Ukraine and were not confirmed. Following new proposals, all Boards were duly constituted in December 2019.

To improve the management of NPLs, the NBU approved Resolution No. 97 on 18 July 2019. The Resolution was developed with the technical assistance of the World Bank and is based on the approaches advocated by the ECB in its “Guidelines to banks on non-performing loans” (March 2017). Preceding the adoption, the NBU organised an extensive consultation process with local banks on technical aspects.

Regarding asset recovery in the state-owned banks, the Ministry of Finance has started to publish semi-annual information on key performance indicators, including NPLs and ongoing court cases, for each of the four banks. The first such report was published on the official website of the Ministry of Finance on 28 February 2019.¹⁷ Following consultations with the European Commission, an extended version of the report was published on 24 April 2019. Subsequent reports were published in September 2019 and April 2020.

¹⁴ The Law on Banks and Banking Activities defines a “state-owned bank” as a fully owned bank created by a decision of the Cabinet of Ministers. In the case of PrivatBank, which is 100% owned by the state but was not created by a decision of the Cabinet of Ministers, supervisory and management boards were exceptionally put in place as part of the resolution and nationalisation in 2016. In Ukrgasbank the state owns 95% of the stock.

¹⁵ The capital shortfall at PrivatBank before the nationalisation was USD 6.0 billion (nearly 5% of the GDP) and was reduced to USD 5.5 billion by wiping out the previous shareholders and bailing in the related-party depositors.

¹⁶ Up to a threshold of UAH 200,000 (or around EUR 6,700 at that time).

¹⁷ <https://mof.gov.ua/en/zviti-po-derzhavnih-bankah-fin>

Based on a ruling from a London Court on 15 October 2019, PrivatBank has a “good arguable case” to pursue its former shareholders, whose assets had been subject to a worldwide freeze, to recover USD 3 billion, including interest. The current management of the bank and the authorities remain committed to recovering the maximum of taxpayers’ money, despite the former owners’ efforts to use all possible legal means to overturn the nationalisation and even to seek compensation. In cooperation with the IMF, the government has put in place a contingency plan to safeguard financial stability and taxpayers’ money; the plan is to be activated in case of an adverse ruling in one of the pending court cases related to claims by those responsible (former shareholders and/or managers).

Assessment: Conditions 7 and 8 can be considered as met.

Condition 9

*Make significant progress in **implementing the electricity market law**, including in the preparation of Ukrenergo for certification as an independent transmission operator and in the separation of control over power generation (notably Energoatom and Ukrhydroenergo) and power transmission (notably Ukrenergo).*

Rationale for the condition

The Electricity Market Law of 2017, supported by a condition in the previous MFA for Ukraine (MFA III), introduced the liberalised electricity market model inspired by the EU Third Energy Package. It provided, inter alia, for a stronger role of the market in the electricity sector, for unbundling electricity generation and supply from its transmission and distribution, and for transparent market pricing. The law required the operation of the electricity retail market from 1 January 2019 and of the wholesale electricity market from 1 July 2019. For the latter one, more than 200 regulatory, organisational and operational measures needed to be developed and adopted in line with a roadmap prepared by the government.¹⁸

The current MFA condition aimed at achieving significant progress in the implementation of the Electricity Market Law. In particular, it focused on Ukrenergo, the transmission system operator (TSO), which in the new market model has a key function as an independent grid operator ensuring non-partial third party access to the grid, adequate investments in infrastructure development and the use of market based balancing services.

Implementation

Regarding *the separation of control over power transmission and power generation*, the Cabinet of Ministers decided in November 2018 to transfer Ukrenergo from the Ministry of Energy, which controlled also generation companies, to the Ministry of Finance. This fulfilled the requirement of institutional unbundling.

As regards *preparing Ukrenergo for certification as an independent TSO*, Ukrenergo and the Ukrainian authorities worked successfully on the Ukrenergo Reorganisation Plan, adopted in March 2019 and progressively implemented since then. The plan provided, inter alia, for transformation of the unitary state-owned enterprise into a joint stock company, which was one of the main conditions for certification. While 100% of Ukrenergo shares remain in state ownership, reporting and governance requirements for joint stock companies apply. The

¹⁸ <http://kc.er.gov.ua/index.php/main/284>

shares of Ukrenergo were issued in August 2019. In October 2019 the National Energy and Utilities Regulatory Commission (NEURC) issued a preliminary decision on the certification of Ukrenergo. Following an opinion from the Energy Community Secretariat issued in February 2020, the Ukrainian authorities prepared and submitted to the Parliament an amendment to the electricity market law to enable the completion of the certification process.

More broadly, on 1 January 2019, the retail market was opened to large consumers in line with the provisions of the Electricity Market Law. The wholesale market was opened on 1 July 2019. In the opinion of the Energy Community Secretariat,¹⁹ the new market started operations without major technical problems. The main market segments were introduced: bilateral, day-ahead, intraday and balancing markets. 53% of electricity generated in Ukraine was traded on the open wholesale market in the first two months after its opening. The system became more transparent thanks to the availability of more data.

In order to enable the functioning of the wholesale electricity market, development of the necessary software for the balancing market (Ukrenergo) and for the market operator (Energorynok) has been progressing with the help of external contractors. The majority of the modules of the software had been developed and tested before the market opening, and are now used by market operators and participants.

At the same time, a number of issues hamper the functioning of and competition in the market. One of them is the current oligopolistic market structure. Another distortion is created by an excessive scope of the Public Service Obligation (PSO) Act, which obliges state-owned generators to sell at low, regulated prices a big share of nuclear (90% in 2019 and 85% in 2020) and hydroelectricity (35%) to the Guaranteed Buyer. This electricity is then provided to households and other small users.²⁰ Other issues include unsolved old debts for electricity purchases, limited possibilities for access to the unused grid capacity that also hampers cross-border trade and – despite improvements – still insufficient availability of data.

Overall, while further steps will need to be taken in order to ensure effective functioning and competition in the electricity market, the wholesale market has been in operation since July 2019. Its introduction has increased transparency in electricity sector. The important decision to split Ukrenergo away from the Ministry of Energy constitutes significant progress in the implementation of the electricity market law.

Assessment: the condition can be considered as broadly met.

¹⁹ Energy Community Secretariat, Ukrainian electricity wholesale market opening: A critical assessment of the first two months, available at <https://www.energy-community.org/dam/jcr:59a73f6c-93ab-463f-a6d9-439e5b8ad672/Ukrainian%20electricity%20wholesale%20market%20opening.pdf>

²⁰ As a result, a small number of large generators are present in the non-regulated market segments thus increasing the market concentration of the thermal power plants owned by a vertically integrated company (DTEK). Supply deficits in the day-ahead market occurred regularly during the first months of operation at certain hours and certain days, while the share of the most expensive market segment (balancing) increased.

SOCIAL POLICIES

Condition 10

*To ensure adequate healthcare coverage at sustainable cost, implement the **reform of healthcare financing**, including through the signature of at least 600 contracts, between the National Health Service of Ukraine and relevant providers, for the provision of primary healthcare.*

Rationale for the condition

A reform of healthcare financing was initiated in 2017 under the principle “the money follows the patient”, with a view to improving efficiency and quality of healthcare provision. The main law, on state financial guarantees for medical services, was adopted in October 2017. One of the key tasks of the newly established National Health Service of Ukraine (NHSU) was to conclude contracts with healthcare providers for provision of primary healthcare services. To this end, state-owned medical institutions were transformed into municipal non-profit enterprises (“autonomisation”), which enabled them to sign healthcare services contracts with the NHSU. In a second stage of the reform, contracts between these autonomised and other healthcare providers and the NHSU had to be concluded. At the time of designing the conditionality (July 2018), around 160 of these contracts had been concluded, while the NHSU was planning internally to finalise 400 additional contracts by end-2018. This condition aimed at incentivising the implementation of the reform.

Implementation

As of end-March 2020, 1,539 contracts had been concluded between health-care institutions licensed to conduct business activities in medical practice and the NHSU. As a result, around 29.8 million Ukrainians (71% of the population) have now a choice of doctor for the provision of primary medical care. UAH 23.2 billion were paid to primary care-providers for medical services since the launch of the reform in 2018 (UAH 3.5 billion in 2018 and UAH 15.3 billion in 2019).

In addition, to support the effective transition to the new funding system, a platform for the collection and exchange of medical and financial information in electronic form, the eHealth system, was created. The system enables a real-time analysis of the state of health of the population, which in turn will make it possible to adjust plans for the purchase of medical services and drugs and to spend money more efficiently. In order to implement the reform effectively at regional level, five interregional departments of the NHSU are in the process of being set up.

While the organisation of the health sector remains a controversial political issue in the country, the new government has emphasised that it intends to pursue the reform.

Assessment: the condition can be considered as met.

Condition 11

*Improve **targeting, efficiency and fairness of social benefits** to the advantage of those most in need, notably (a) through effective implementation of the resolution No. 329 of the Cabinet of Ministers of Ukraine, dated 27 April 2018, on improved targeting of Household Utility Subsidies (applying exclusion criteria, verification of applications) and (b) by launching the process of monetisation of subsidies at household level, through a pilot project.*

Rationale for the condition

The largest social assistance programmes in Ukraine is the Housing and Utility Subsidy (HUS) programme, aimed at supporting vulnerable households with their energy bills. Previous MFA and IMF programmes supported compensation measures for consumers targeted at offsetting the impact of gas and heating price increases. In result of expansion of HUS, in 2017 it accounted for 2.3% of GDP and was provided to half of country's households (over 6 million). However, according to World Bank analysis,²¹ the targeting of the HUS required improvement as almost 50% of its budget was allocated to households with above-average income.

To address this issue, the Cabinet of Ministers adopted resolution No. 329, dated 27 April 2018, on improved targeting of HUS in April 2018. It established tighter eligibility criteria for granting benefits based on asset ownership (e.g. exclusion of owners of big houses / apartments and new cars). At the same time, social services were carrying out a large-scale verification of applications to combat fraud. The condition supported the implementation of these steps towards improved targeting of HUS to people in need, and thus to make the use of the available budget more efficient.

A second pillar of the planned reform aimed at improving the transparency of subsidies and at providing economic incentives for energy savings through monetisation of HUS at the household level, i.e. by providing subsidies directly to households rather than to the energy providers to eligible consumers. At the time of designing the conditionality, the authorities were planning to introduce HUS monetisation gradually from January 2019 through a pilot scheme in selected regions.

Implementation

In order to better target the allocation of the housing and utility subsidies, the Ministry of Social Policy verified households' eligibility for HUS in 2018 based on the above-mentioned resolution No. 329. The procedure assigning housing subsidies was further refined and simplified by the resolution of the Cabinet of Ministers No. 841 dated 17 October 2018. As a result of these verifications and better targeting, the number of households eligible for HUS was reduced from 6.9 million in early 2018 to 3.9 million at the end of 2018 and to 3.3 million in March 2020. The amount of HUS subsidies was substantially reduced from UAH 62.2 billion in 2018 to UAH 15 billion in 2019. This decrease can be attributed to a lower number of eligible households, but also to lower gas and heating prices in 2019.

With respect to the direct payment of subsidies to households, from the beginning of 2019, the Ministry of Social Policy has launched and gradually expanded the monetisation of subsidies, i.e. providing subsidies directly to households and not to the energy providers. In the first months of the year, the subsidies were transferred to individual accounts of the subsidy recipients and could be spent only for payment of utility bills. From March 2019 the majority of households started receiving the subsidy in cash. From October 2019 a full-scale monetisation has started, where all households receive subsidies through cash payments and by transfer to bank accounts in state-owned Oschadbank.

Assessment: the condition can be considered as met.

²¹ World Bank, *Social Assistance in Ukraine: Options for Reform*, presentation delivered on 12 April 2018.

Condition 12

*The Cabinet of Ministers of Ukraine will adopt the Action Plan on the implementation of the strategy of **integration of internally displaced persons** and sustainable solutions on internal displacement covering the period until 2020.*

Rationale for the condition

In December 2017, Ukraine adopted a long-awaited comprehensive strategy on integration of Internally Displaced Persons (IDPs), known as “Strategy of Integration of Internally Displaced Persons and Implementation of Long-Term Solutions to Internal Displacement until 2020”. The strategy was prepared by the Ministry of Temporarily Occupied Territories and IDPs and was meant to be implemented in the period 2018-2020. Funding is provided by both the state budget of Ukraine and by international donors. To become fully operational, the strategy needed an Action Plan. The dedicated Ministry was tasked with its preparation, in consultation with other government departments, local authorities and the general public.

Implementation

The Cabinet of Ministers of Ukraine approved the Action Plan on the implementation of the IDP Integration Strategy and on the implementation of long-term decisions on internal displacement for the period up to 2020 on 21 November 2018 (Order No. 944-p). In 2019 several measures implementing the Action Plan were enacted or prepared, including those aimed at easing payment of social benefits to IDPs, compensation for damaged property, provision of affordable housing.

Assessment: the condition can be considered as met.

6. 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). Performance under the IMF programme can be considered satisfactory, given the implementation of agreed prior actions and a new staff-level agreement on 21 May 2020 (described in Section 3). Moreover, as described in detail in Section 5 of this note, Ukraine has met all 12 specific policy conditions for the disbursement of the second instalment of MFA.

Against this background, the Commission adopted a decision on 26 May 2020 to release the second instalment to Ukraine and a decision to borrow the corresponding funds in capital markets. With this disbursement, the EU contributes to the economic stabilisation of Ukraine, while also affecting the country’s social situation positively.