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Ex-ante evaluation statement on EU macro-financial assistance to Ukraine

Accompanying the document

Proposal for a Decision of the Council providing macro-financial assistance to Ukraine

{COM(2014) 182 final}

1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Introduction

The Ukrainian economy has been in recession since the second half of 2012, with only one quarter of positive growth in the end of 2013, which was quickly reversed in the first two months of 2014 as a result of the deterioration of the political and security situation.

The Ukrainian government lost access to international financial markets during 2013 as confidence dropped in view of the widening fiscal and current account and in the absence of much needed reforms, including as regards utility tariffs, adjustments of the exchange rate of the hryvnia (UAH) and business climate. The unwillingness of the authorities to commit to reforms also prevented them from concluding a financing agreement with the IMF.

Ukraine's government bond rating was initially downgraded by Moody's from B3 to Caa1 in September 2013 and by S&P and Fitch in November from B to B-. Since then, S&P further downgraded Ukraine to CCC+ on 28 January 2014 and to CCC on 21 February, Moody's to Caa2 on 31 January and Fitch to CCC on 7 February, entering into a default risk category. Ukraine now has three C-level ratings, which is the first such occurrence in Ukraine's rating history. As a result of large debt repayments in the fourth quarter of 2013 and beginning of 2014 and of the central bank's interventions to defend the currency peg against the dollar, reserves have dropped dramatically to USD 15.5 billion at the end of February, leaving Ukraine with a very weak and rapidly worsening balance-of-payments situation. The current political crisis has very damaging effects on Ukraine's already precarious economic and financial stability. The de facto interruption of Russia's assistance under its USD 15 billion package agreed last December, and the announced end to the reduced gas prices granted by Gazprom from April 2014 onwards, will deteriorate the situation even further. Under these circumstances Ukraine faces a serious risk of default in the near future.

At the same time, during the month of February and following mass protests on-going since end-November, the government resigned in February. A new government was approved by the Verkhovna Rada on 27 February and there was a reversal to the 2004 Constitution. Despite these changes, Ukraine has not been able to return to political stability since the sovereignty and territorial integrity of Ukraine has recently been violated by the Russian Federation.

The new government immediately invited the IMF to come for a fact finding mission and discussions on a comprehensive reform programme going forward. The new government has publicly committed itself to begin implementing significant and comprehensive reforms before the 25 May presidential elections. Although the political process at the moment is volatile, so far it shows clear signs of a commitment to economic reforms.

Against this background, the Ukrainian authorities are seeking financial assistance from the multilateral and bilateral creditors and donors to support a reform programme, currently under preparation, that would reduce economic vulnerabilities, boost international reserves and foster economic growth. The IMF sent a staff mission to Ukraine in the beginning of March and is expected to play the key role in the preparation of this programme and mobilisation of international financial assistance to Ukraine. In the next weeks, the IMF and the Ukrainian authorities are expected to come to an agreement on an economic programme that will be supported by a financing arrangement.

It is expected that the external financing needs of Ukraine will exceed the funding likely to be provided by the IMF. In this context, the European Commission announced on 5 March 2014 a package of financial support to Ukraine, that was welcomed by the EU Heads of State or Government the day after. One of the elements of the package is a new Macro-Financial Assistance (MFA) programme in the amount of up to EUR 1 billion.

The European Commission submits to the Council a proposal to grant MFA to Ukraine amounting to a maximum of EUR 1 billion. The assistance would take the form of medium-term loans, with no grant component being envisaged given that Ukraine does not meet the eligibility criteria for the use of grants in MFA operations.

The proposed EU MFA is intended to help Ukraine cover part of its urgent external financing needs in the context of the stabilisation and reform programme currently under preparation, reducing in this way the economy's short-term balance of payments and fiscal vulnerabilities. The proposed assistance would support the urgent fiscal consolidation and external stabilisation and encourage the implementation by the authorities of structural reforms aimed at improving the overall macroeconomic management, strenghtening economic governance and transparency and improving conditions for sutainable growth.

The proposed MFA is in line with the aims of the Eastern Partnership and the orientations of the new European Neighbourhood Policy (ENP). It would signal to the other countries in the region that the EU is ready to support countries embarking on political reforms, in moments of economic difficulties.

1.2. Ukraine's macroeconomic situation

After 5 quarters of consecutive decline, **real GDP** grew by 3.3% y/y in 4Q2013, leading to flat growth for the year 2013. The poor performance of the economy was due to a combination of a bad harvest, decline in steel exports and delayed domestic reforms. According to the IMF, it is believed that growth negative in January and February. Due to the volatile situation forecasts for 2014 range from -5% to +3% depending on assumptions. Macroeconomic adjustments, including fiscal consolidation and exchange rate flexibility, will have contractionary effects, but on the other hand, the foreseen IMF arrangement would increase confidence that could lead to FDI inflows quite quickly. Still, Russia's policy towards Ukraine signifies a substantial downside risk to growth.

Inflation has been very low in the last few years, reaching 0.3% at end-2013; however inflationary pressure has increased in 2014. CPI was 0.5% in January and 1.2% in February and the National Bank of Ukraine (NBU) expects it could reach 10% or more by end-2014, as a result of the depreciation of the hryvnia (UAH) and the expected increase in energy tariffs for households.

The **fiscal deficit**, including Naftogaz operational deficit, was estimated at 6.5%-7.5% of GDP in 2013, largely as a result of continued energy subsidies, which amount to 7% of GDP, but also as a result of the economic slowdown. Capital expenditure was cut by 40% in 2013, while VAT revenues dropped by 7%. The 2014 budget was passed by the Rada in early January, but was based on unrealistic assumptions of growth and inflation and is currently being revised by the Ministry of Finance in close cooperation with the IMF. Revenues in January-February 2014 amounted to 82% of what was planned in the budget, suggesting that expenses need to be cut by around UAH 80 billion, or 15-17% in 2014. In addition, the gas import price from Russia will be increased on 1 April to at least 400 USD per 1000 cubic meters, putting significant strain on the budget. However, the Minister of Finance has made assurances that gas tariffs for households and district heating companies will be increased before the 25 May elections, alleviating this pressure. An additional issue is arrears, both of VAT refunds to corporates and overdue subsidy payments to utility companies, amounting to UAH 12bn and UAH 8bn respectively.

There has been strong pressure on **the local currency** since the outbreak of the crisis. The NBU has allowed the hryvnia to depreciate significantly (by about 25%) in February. Part of this was a deliberate devaluation of the official exchange rate on 7 February from the 7.99 UAH/USD that had been kept since July 2012 to 8.708 UAH/USD. Later the depreciation of the currency sped up as a result of the NBU's inability to intervene due to very low foreign exchange reserves. In agreement with the IMF, the NBU is now pursuing a policy of non-intervention, except in cases of significant exchange rate movements. It is also maintaining a number of capital controls, but says it will refrain from introducing new ones. The hryvnia remains volatile, despite these measures. Further significant devaluation of the currency would risk deterioration of credit portfolios and capital of banks and would not necessarily rebalance the current account as much of exports are dependent on imported inputs. In addition, the Ukrainian economy is consumption-driven (75% of GDP) and devaluation with accompanying inflation would likely have a contractionary effect on GDP.

The current account deteriorated significantly in 2013 to an estimated deficit of 10% of GDP reflecting mostly decreased exports. The NBU expects a significant narrowing of the current account deficit in 2014 as a result of adjustments connected to the foreseen IMF arrangement, including fiscal consolidation. Yet, current account financing needs will remain substantial in the short run – at least USD 4 billion before the end of the second quarter of 2014. Net FDI is estimated to have dropped further from 5.0% of GDP in 2012 to 2.6% of GDP in 2013 and was near 0% in January 2014.

External debt was estimated at 76.7% of GDP at end-2013. Only about one-third of it is owed or guaranteed by the public authorities (including debt of the National Bank to the IMF). In addition to publicly guaranteed liabilities of some Ukraine's corporate borrowers, e.g. State guaranteed Eurobonds issued by Naftogaz, other external liabilities of Ukraine's corporates may have a systemic importance for the country. In particular, Naftogaz' debt (in arrears) for gas shipments from Russia's Gazprom has direct implications for the country's current account as Gazprom sets its price depending on Naftogaz' debt payment record.

Official reserves declined by 16% to USD 20.4 billion in the course of 2013, as a result of the large current account deficit, pressure on the hryvnia and significant debt repayments in 2013. This negative trend continued in January and February when reserves dropped a further 13% per month to USD 15.5 billion at end-February (2 months of 2014E import cover). This development clearly reflects an increased balance-of-payments vulnerability.

At 41% of GDP (end-2013), **public debt** is below the high-risk benchmark. At the same time, public debt servicing obligations, in particular on external debt or on foreign currency denominated domestic debt, weigh heavily on public finances and international reserves in the near future. Total debt service of the government and the NBU for the rest of 2014 amount to about USD 10 billion. Debt payments peak between June and September. In the period March-May debt service amounts to approximately USD 2 billion. In addition, the outstanding Naftogaz' debt to Gazprom amounts to another USD 2 billion. Debt payment obligations in 2015 are about USD 10 billion.

According to the NBU, there is sufficient liquidity in **the banking sector**, but no credits are extended to corporates since February. Deposit erosion amounted to some 2% in January and about 8% in February. Possible further currency devaluation would present problems for the banking sector and asset quality has the potential to fall quickly. The banking sector is in need of a thorough asset quality review. Beyond short-term risks, the banking sector in Ukraine presents some structural weaknesses that are likely to be a focus of a reform programme supported through the foreseen IMF arrangement. There are clear weaknesses in bank supervision and corporate governance in the banking sector and a lack of protection of creditor rights.

Reliable data on external financing needs are difficult to obtain at this point. Public F/X liabilities consist of debts to International Financial Institutions (IFIs – IMF, EBRD, WB, EIB), Eurobonds (issued by both the government and by Naftogaz and guaranteed by the government), F/X-denominated domestic treasuries (held by around 20 private companies) and a state-guaranteed loan to Naftogaz by Gazprombank. Total debt service of 2014 of the government and the NBU amount to between USD 9.7-13.8 billion, of which 1.6 billion appear to have been already paid in January-February, leaving USD 8.1-12.2 billion for the rest of 2014. Debt payments peak in June (total 1.3 billion of which 1 billion in Eurobonds maturing on 4 June), July (total 1.1 billion of which 0.7 billion to IMF) and September (total 2.1 billion of which 1.6 billion in Naftogaz-issued Eurobonds guaranteed by the State). In the next three months (March-May) debt service amounts to approximately USD 2 billion consisting mainly of payments to the IMF. In addition, the outstanding Naftogaz' debt to Gazprom for gas deliveries amounts to USD 1.9 billion (USD 1.3-1.47 billion for 2013 + USD 0.2-0.4 billion for February 2014), whereas the January debt was paid on 6 March. Gas imports in February should have been paid by 7 March.

1.3. Structural reform challenges

Despite an ambitious Programme for Economic Reforms for 2010-2014 (PER), implementation of key structural reforms were below expectations under the former government. Notwithstanding the declared policy goal of an improved business climate in Ukraine, there were a number of adverse trends, such as an increase of corruption, insufficient progress in public finance management reform, and increased pressure on business from tax and customs administrations.

Fiscal consolidation is a major challenge for the new government to deal with. The general government deficit equalled 6.5%-7.5% of GDP in 2013; it is largely due to energy price subsidies and to the quasi-fiscal deficit of the energy company Naftogaz (around 2% of GDP in 2013). Payment discipline in the **utilities sector** is an issue. Energy tariffs for households and district heating companies must be increased as soon as possible. Tariff increases should be complemented by a targeted social assistance programme to support the poorer parts of the population.

Corruption is widespread in Ukraine, especially in the area of taxation and customs where, until now, there is an almost complete lack of transparency. These challenges are reflected in Ukraine's low ratings, by regional standards, in a number of comparative studies. There is a clear need for an audit control system of tax and customs to get rid of this structure. The new government has made anti-corruption one of its top priorities leading up to the 25 May elections. The government has already announced it will return Tax Revenue and Customs to the Ministry of Finance after they were joined last year under former Minister Klymenko. The justice system is weak and unable to deal with the significant backlog of court cases on business malpractice. Tackling corruption should improve investor confidence and the overall business climate in the medium to long term.

The financial sector would benefit from a thorough asset quality review of individual banks to determine their vulnerability (especially systemically important banks) to further destabilisation of the economy, including further devaluation. The NBU should be strengthened in its role as bank supervisor. Regulatory forbearance is a major problem and enforcement of creditor rights is extremely weak, which has a significant impact on the business climate.

Over the short-to-medium term, Ukraine's government needs to deliver on key reforms, improve fiscal sustainability while addressing the investment climate, rein in corruption, and diversify the economy. In addition, the exchange rate policy should gradually move towards a free float in order to avoid a further widening of the current account deficit and a continued drain of the country's international reserves.

1.4. International support to Ukraine

In early March 2014 **the IMF** sent a fact finding mission to Ukraine to assess the latest economic developments and external financing needs and to establish initial contact with the new government. The mission started also preliminary discussions on the priority policy measures to be adopted by the authorities and on a possible financing arrangement with the IMF. It is expected that such an arrangement will be put in place in the near future, but at the time of the preparation of the proposal its main parameters, timeframe and the amount of IMF financing were still not determined.

The **World Bank** intends to provide to Ukraine support of up to USD 3 billion in 2014. Out of this amount, one-third would be in the form of budget support, under two Development Policy Loans (DPLs) of USD 500 million: a general DPL and a financial sector DPL. Further USD billion under the same operations would be available in 2015.

The **EBRD**'s active portfolio in Ukraine currently amounts to some €4.5bn and 183 projects. Ukraine is the EBRD’s second largest country of operations. In 2013, there were 31 signings to the value of €798m, all of them non-sovereign with the exception of the Nuclear Safety project (€300m). Indicative Annual Bank Investment (ABI) in 2014 has been structured at between €550-750m. As part of the international community’s help, the EBRD would have the capacity to invest around €800 million to a billion annually in Ukraine over the next few years.

A **EURATOM** Loan Facility and a Guarantee agreement of EUR 300 million was signed in July/August 2013, to be complemented with a EUR 300 million loan from the EBRD (referred to above).

In 2012 and 2013, the **US** provided over USD 200 million in foreign operations assistance to Ukraine. In 2014, a similar annual amount of cooperation assistance is foreseen; however the US has also announced it will support Ukraine through a USD 1 billion loan guarantee scheme.

In addition to the MFA, the EU assistance will be also provided through the European Neighbourhood Instrument (ENI).

The Commission is currently funding a number of on-going sector budget support and technical assistance programmes (approximately €400 million) which will provide input to the new Government in key areas such as economic development, public financial management and justice.

The Commission is currently preparing a €300 million Annual Action Programme 2014 including a State Building Contract to assist the Government of Ukraine in promoting sustainable and inclusive growth, and consolidating and improving democratic and economic governance. This will be complemented by actions in favour of civil society.

For the remaining period of 2015-2020, a yearly bilateral envelope of approximately €130 million is currently foreseen as part of the ENI with an additional €40-50 million per year from the afore-mentioned umbrella programme ("more-for-more") subject to proven progress in deepening democracy and respect of human rights and further significant funding from the Neighbourhood Investment Facility (NIF) described below.

The NIF will be mobilised in favour of bankable investment projects in Ukraine. Experience with the implementation of the NIF in the East over the past programming period has shown that, for an amount of €200-250 million of grants foreseen for Ukraine for blending, one could expect a leverage effect that would generate loans of up to €3.5 billion. The participation of IFIs will be crucial to allow this leveraging and to exploit its full potential.

The Instrument contributing to Stability and Peace (IcSP), formerly the Instrument for Stability, could be deployed to target urgent actions, for example, on police reform and electoral support. Up to €20 million could be mobilised quickly if appropriate actions are identified and a further €15 million could be added from the Common Foreign and Security Policy (CFSP) budget to support measures in relation to security sector reform.

Additional support to non-state actors will also be delivered through thematic programme such as the Civil Society Organisations and Local Actors and the European Instrument for Democracy and Human Rights (EIDHR).

Finally, Ukraine is the most important country for the EU for operations in the area of nuclear safety and security. Currently, projects are being implemented under the Instrument for Nuclear Safety Cooperation for a total amount of €50 million, in the field of nuclear waste management and social projects in the affected area around the Chernobyl exclusion zone. In addition, a further envelope of €36.5 million can be contracted in the short term for actions in this field. The programming period for the new financial

The **EIB** currently operates in Ukraine under the Eastern Partner Countries Mandate 2007-2013 which provides an EU guarantee to EIB lending (within a regional ceiling of EUR 4.05 bn for the Eastern Neighbourhood and Russia following the reallocation of additional EUR 200m, and a climate change mandate estimated at around EUR 300m for the region) and under the Eastern Partners Facility (EPF – facility at the own risk of the Bank) with EUR 1.5 bn (out of which up to EUR 500 m for Russia). Under the future External Mandate (2014-2020), the regional ceiling for the Eastern Countries amounts to EUR 4.83 bn.

In order to help ensure effective delivery and maximise the impact of the international economic and development assistance to Ukraine, the Commission is exploring avenues to enhance international donor coordination by setting up, together with the international community and IFIs, an ad hoc donor coordination mechanism. Such a mechanism could take work forward on the basis of a needs assessment and of the reform programme prepared by the Ukrainian authorities with the IMF support, and provide a sustainable way out of Ukraine’s difficult economic situation supporting economic and political transition.

In donor coordination mechanism proposed by the Commission would take the form of an **international platform** based in Kiev which would meet regularly to closely coordinate donor efforts to address the economic situation of the country. The political guidance will be provided by high level coordination meetings of the international platform. The Commission is willing to host the meetings in Brussels. This mechanism is open to the participation, namely, of EU Member States, IMF, World Bank, EBRD, EIB, and interested third countries.

1.5. Ukraine's external financing needs

Based on the available preliminary indications, in 2014 and 2015 Ukraine will be facing significant external financing needs reflecting in particular a still substantial current account deficit, large external debt payment obligations and the need to re-build a minimum buffer of foreign exchange reserves. Also, private capital inflows, in the form of foreign direct investments or private credits, will remain extremely low. It is expected that preliminary projections of Ukraine's residual external financing needs will become available in the coming weeks, in view of the results of the on-going technical discussions the Ukrainian authorities are conducting with the IMF. But already now it is anticipated that a wider international support will be required to cover these needs and create conditions for a successful implementation of the reforms in Ukraine. The proposed EU MFA would contribute to cover part of the residual financing gap for the 2014-2015 period.

2. OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1. Objectives

The objectives of the proposed MFA operation are to:

- Contribute to covering the external financing needs of Ukraine in the context of a significant deterioration of the country's external accounts brought about by the on-going political and economic transition.
- Alleviate Ukraine's budgetary financing needs.
- Support the fiscal consolidation effort and external stabilisation in the context of the foreseen IMF programme.
- Facilitate and encourage efforts of the authorities of Ukraine to implement measures identified under the EU-Ukraine Association Agenda, while reinforcing the EU's economic policy dialogue with the authorities.
- Support structural reforms aimed at improving the overall macroeconomic management, strenghening economic governance and transparency, and improving conditions for sustainable growth.

2.2. Conditionality

In view of the critical need for Ukraine to implement strong macroeconomic policies and ambitious reforms, it is not deemed appropriate to disburse the new programme without specific conditionality. The assistance will be conditional to an IMF arrangement being in place and to the implementation by Ukraine of specific structural reform measures that will be agreed by the Commission on behalf of the EU and Ukraine in a Memorandum of Understanding, to be negotiated between the Commission and the Ukrainian authorities. The preparation of the Memorandum of Understanding will start in the very near future, already before the adoption of the Decision on the assistance. It will be made in coordination with the IMF and the World Bank.

In the preparation of the list of conditions or prior actions for the release of the assistance, the Commission will target structural reforms aimed at improving the overall macroeconomic management and the conditions for sustainable growth (e.g. targeting the transparency and efficiency of public finance management; fiscal reforms; governance and supervision of the financial sector; reforms to strengthen the social safety net; and reforms to improve the regulatory framework for trade and investment).

2.3. Indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

- Progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF-supported programme.

- Progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which will be included in a Memorandum of Understanding.

2.4. Delivery mechanisms

The proposed new MFA would amount to up to EUR 1 billion. Regarding the form of the assistance, the Commission proposes to disburse the full amount in the form of medium-term loans, in one or two instalments. The decision on the number of instalemnts will be taken in view of a more complete information on Ukraine's financing needs and the timing of financial support reflecting the parameters of the future stabilisation and reform programme to be agreed with the IMF.

The preferred option is to disburse the assistance in two tranches, with the first tranche being conditional to the IMF arrangement being in place, and the second tranche – being also conditional to the implementation of the agreed conditions. There will be a delay of at least three months between the two tranches. The disbursement of the first instalment (possibly EUR 500 million) is expected to take place in June 2014, and the disbursement of the second instalment – in autumn of the current year. In case, however, the Commission decides that in view of the extreme urgency of the financing needs the disbursement of the assistance should be made in one tranche, the Commission would still condition it to the completion of some critical prior actions.

The proposal, which is consistent with the methodology for determining the use of grants and loans in EU MFA endorsed by the Economic and Financial Committee in January 2011[1], is based on the following considerations:

Firstly, Ukraine is a middle-income country with a **relatively high per capita income level**. Ukraine's per capita Gross National Income (GNI) of USD 3,500 (2012).[2] For comparison, in April 2014 the European Parliament and the Council is expected to approve an MFA loan of EUR 300 million to Tunisia (GNI per capita of USD 4,150), while an MFA grant of EUR 90 million was provided to Moldova (GNI per capita of USD 2,070) in 2010. An MFA loan of EUR 180 million to Jordan (with a GNI per capita of USD 4,670) is currently under approval process.

Secondly, Ukraine's **public debt ratio** remains at a manageable level (41% of GDP at the end of 2013). Moreover, under an adjustment scenario, the ratio is expected to decline from 2015 onwards. External debt, for its part, is expected to peak at 84.6% of GDP in 2014 and then gradually decline from 2015 onwards.

The proposal to provide the full MFA in the form of loans is also **consistent with the treatment granted by the World Bank and the IMF to Ukraine**. Indeed, Ukraine is not eligible for concessional financing from either the IDA or the IMF.

MFA is an untied and undesignated macroeconomic support instrument, which helps the beneficiary country meet its external financing needs, and may contribute to alleviating budgetary financing needs. The funds would be paid to the National Bank of Ukraine. Subject to provisions to be agreed in the Memorandum of Understanding, including a confirmation of residual budgetary financing needs, the funds may be transferred to the Ministry of Finance of Ukraine as the final beneficiary.

2.5. Risk assessment

There are fiduciary, policy and political risks related to the proposed MFA operation.

There is a risk that the macro-financial assistance, which is not dedicated to specific expenses (contrary to project financing, for example), could be used in a fraudulent way. In general terms, this risk is related to factors such as the quality of management systems in the central

[1] "Criteria for Determining the Use of Grants in EU Macro-Financial Assistance", note of the European Commission to the EFC, January 2011.

[2] World Bank's Atlas 2011 figures. GNI per capita is the gross national income, converted to US dollars using the World Bank Atlas method, divided by the midyear population.

bank and the Ministry of Finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriatedness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Memorandum of Understanding and the Loan Agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a dedicated account at the National Bank of Ukraine. Moreover, alongside reaching an agreement on the Memorandum of Understanding, the Commission services will conduct, with the support of external consultants, an Operational Assessment, in order to assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Ukraine. Ideally this Operational Assessment would be made before the Memorandum of Understanding is agreed, however, given the urgency of the MFA programme, the assessment can only be carried out in parallel with negotiations and recommendations can only be made at a later stage. In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission is also using budget support under the European Neighbourhood Instrument to help the Ukrainian authorities improve their public finance management systems and these efforts are strongly supported by other donors. Against this background, special conditionalities on improving public finance management will potentially be required. Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

Another key risk to the operation stems from the economic and political uncertainty, notably due to the unprovoked Russian violation of Ukrainian sovereignty and territorial integrity. On the domestic front, the main risk is instability related to difficulties in the political and economic reform process. The full implementation of the stabilisation and reform measures supported by the international community, including the proposed MFA operation, might be undermined by social dissatisfaction potentially leading to unrest. A derailment of the adjustment process could put the objectives of the IMF-supported programme in jeopardy, endanger macroeconomic stability and prevent the effective disbursement of the MFA.

Finally, there are risks stemming from a possible weakening of the European and global economic environment (taking into account Ukraine's high dependence on both the EU and Russian markets), which would have an important effect on Ukraine's fiscal consolidation efforts if the necessary reforms have not been put in place.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficiently strong grounds to proceed with the MFA to Ukraine.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

3. ADDED VALUE OF EU INVOLVEMENT

The European Union's financial support to Ukraine reflects the country's strategic importance to the EU in the context of the European Neighbourhood Policy. The instrument of macro-financial assistance is a policy-based instrument directed to alleviate short- and medium-term external financial needs. As a part of the overall EU package of assistance, it would contribute to support the European Union's objectives of economic stability and economic development in Ukraine. By helping the authorities' efforts to establish a stable macroeconomic framework, the proposed assistance would help improve the effectiveness of other EU financial assistance to the country, including budgetary support operations.

By helping the country overcome the economic difficulties caused by the political transition, the proposed MFA will contribute to promoting macroeconomic and political stability in the country. By complementing the resources made available by the international financial institutions, bilateral donors and other EU financial institutions, it contributes to the overall effectiveness of the financial support provided by the international community.

In addition to the financial impact of the MFA, the proposed programme will strengthen the government's reform commitment and its aspiration towards closer relations with the EU. This result will be achieved, inter alia, through appropriate conditionality for the disbursement of the assistance. In a larger context, the programme will signal to the other countries of the Eastern Partnership that the EU is ready to support countries like Ukraine, embarking on a clear path towards political reforms, in moments of economic difficulties.

4. PLANNING OF FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macroeconomic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures.

4.1. Monitoring

Monitoring will involve the review of reports and data provided by the authorities and by review missions to Ukraine by Commission staff. To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to the IMF-supported programme, including compliance with macroeconomic performance criteria and structural reform benchmarks identified under the future IMF programme, as reported by the IMF in the context of the regular review of the programme.

- Progress in the implementation of structural policy indicators, which are to be agreed with the Ukrainian authorities in a Memorandum of Understanding. It is foreseen that the

Commission will conduct the negotiations on the Memorandum of Understanding already before the formal adoption of the decision on the assistance. Ahead of the disbursements of the assistance, the authorities will be asked to submit a compliance statement in relation to the agreed policy conditionalities or prior actions. In addition, under the Memorandum of Understanding monitoring system, the authorities will be required to submit regular reports on certain economic and reform indicators.

Although this assistance is centrally managed, where appropriate, the EU Delegation in Ukraine will also be called to provide reporting. An annual report, as well as regular information on developments in the management of the assistance, to the European Parliament and to the Council are foreseen.

4.2. Evaluation

Ex-post evaluations of macro-financial assistance operations are foreseen in the Multi-Annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed macro-financial assistance to Ukraine will be launched within a period of two years after the completion of the operation. A provision for the ex-post evaluation is included in the proposed Decision for the assistance, and will also be included in the Memorandum of Understanding. Budget appropriations from the macroeconomic assistance budget line will be used for this evaluation.

5. ACHIEVING COST-EFFECTIVENESS

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

- First, since the assistance would be leveraged by the assistance provided by the international financial institutions, with which, as noted, it would be closely coordinated, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able to draw on the expertise of those institutions, including the International Monetary Fund and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

- Second, providing a coordinated macroeconomic support to Ukraine on behalf of the EU Member States, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

- Third, all of the assistance would be provided in the form of loans, the budgetary impact of which is more limited.

- In addition, the Commission will aim at achieving synergies with other EU policies and instruments used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management).

ANNEX

EUROPEAN EXTERNAL ACTION SERVICE

Brussels, 13 March 2014

EEAS.III.B.2/SP/gdg (2013)

ASSESSMENT ON UKRAINE'S POLITICAL REFORMS

1. The decision by the Cabinet of Ministers of Ukraine on 21 November to suspend the preparations for the signing of the Association Agreement, including a Deep and Comprehensive Free Trade Area, triggered a prolonged period of mass demonstrations in Kyiv and other Ukrainian cities. The situation saw a grave escalation in the beginning of 2014, including with the adoption of measures that significantly restricted the Ukrainian citizens' fundamental rights, violence against demonstrators with several casualties and injured, disappearances and reports of torture. On 20 February 2014, the worst violent events in Ukrainian modern history took place, resulting in more than 80 deaths.

On 21 February, then President Yanukovych and the leaders of the opposition signed an agreement to end the conflict, witnessed by the Foreign Ministers of Germany and Poland and a representative of the French MFA for the French Foreign Minister. However, President Yanukovych left Kyiv the following night and did not fulfil his commitments under the agreement.

In the aftermath, the Verkhovna Rada took a number of important decisions, by constitutional majority, including on the restoration of the 2004 Constitution pending a comprehensive constitutional reform, appointment of a new Government, and the calling of early presidential elections.

2. The new Government led by Prime Minister Yatseniuk adopted a governmental programme with the overall objective of integrating Ukraine into the European Union, notably through signing the Association Agreement/DCFTA and through the adoption and implementation of economic and financial reforms. The Government sent a formal request for assistance to the IMF and invited the EU to assess the needs, committing to respect the criteria set by the IMF related to exchange rate policy and the gas tariffs.

3. In its 3 March 2014 conclusions on Ukraine, the Foreign Affairs Council expressed the EU's support to the efforts of the new Ukrainian Government to stabilise the situation and pursue the course of reforms. The EU also reaffirmed the necessity of further constitutional reform in Ukraine and to hold free, fair and transparent Presidential elections. Furthermore, the Council conclusions stressed the utmost importance of ensuring inclusiveness at all levels of the government by the Ukrainian authorities, including through steps designed to reach out to all Ukrainian regions, population groups and to ensure full protection of national minorities in accordance with Ukraine's international commitments.

In their Statement of 6 March 2014, the EU Heads of States and Governments reiterated the EU's commitment to signing the Association Agreement/DCFTA, and decided to sign, as a matter of priority, very shortly all the political chapters of the agreement. The Heads of State and Government also committed to provide strong financial backing to Ukraine and welcomed the comprehensive assistance package presented by the European Commission, which foresees inter alia a new Macro Financial Assistance programme of up to €1 billion and the mobilisation of €610 million loans under the already approved MFA programme.

4. On this basis, the EEAS considers that macro financial assistance to Ukraine is in line with, and supportive of, the EU's overall political and economic engagement with Ukraine.