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COMMISSION STAFF WORKING DOCUMENT

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

Accompanying the document

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing further macro-financial assistance to Ukraine

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

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Introduction

In early 2014, Ukraine embarked on an ambitious macroeconomic adjustment and structural reform programme that aimed to overcome an acute balance-of-payments crisis and to lay the foundations of a new economic model and pave the way for long-term, sustainable growth. The reform programme was underpinned by a financial assistance programme by the International Monetary fund (IMF) and other international donors. As part of this assistance package, the EU initially committed to implementing two macro-financial assistance (MFA) programmes totalling EUR 1.61 billion to alleviate the short-term financing pressures Ukraine was facing, while supporting deep and comprehensive reforms.

In view of the deteriorating economic situation due to the confidence loss associated with the conflict in the East provoked by Russia's destabilising actions, the EU approved another MFA programme of up to EUR 1.8 billion in April 2015, of which EUR 1.2 billion was disbursed, bringing the total EU assistance to Ukraine under this instrument to EUR 2.81 billion.

The significant international financial support and prudent macroeconomic policies were instrumental in stabilising Ukraine's economy amid an unfavourable external environment such as a lingering territorial conflict and trade restrictions imposed by one of Ukraine's major export markets – Russia. After a cumulated GDP contraction of about 16% in 2014-2015, Ukraine returned to growth in 2016 as investment activity and household consumption started recovering. Inflation moderated significantly, despite remaining elevated. Prudent fiscal policies have significantly reduced fiscal risks. On the external front, the current account deficit was reduced from its pre-crisis levels, while international reserves have been gradually replenished after reaching a record low in early 2015.

Monetary policy and fiscal consolidation steps were accompanied by important structural reforms in energy, banking, public administration, among others. In addition, steps were taken to overhaul the public procurement system and to launch a judiciary reform. Progress with anti-corruption reforms has been uneven. While the establishment of institutions in charge of preventing, investigating and prosecuting corruption offences represents progress, some of these institutions have failed to deliver visible results and efforts from vested interests to delay or derail strong anti-corruption action have been apparent. The incomplete implementation of two anti-corruption measures, along with two other unmet conditions, was behind the cancellation in January 2018 of the third and final tranche from the aforementioned third MFA programme.

Ukraine's economy still faces significant risks. On the balance of payments, these stem from the uncertain geopolitical environment in the region (with associated risks for Ukraine), slower-than-expected recovery in private capital flows and heavy external debt repayments resuming in 2019.

Seeking support for the country's renewed balance of payments needs, including the replenishment of international reserves, the **Ukrainian authorities requested further MFA from the EU in November 2017**. Taking into consideration this request and following an in-depth assessment of the political and economic situation in Ukraine, **the European Commission is submitting to the European Parliament and the Council a proposal to provide MFA of EUR 1 billion to Ukraine in the form of loans**. In order to fit with the time frame of the IMF programme, which expires in March 2019, the operation should be limited to two instalments. The proposed MFA will cover part of Ukraine's residual external financing needs in 2018 and 2019 in the context of the on-going IMF programme. These needs are estimated at USD 4.5 billion, in addition to the USD 40 billion of financing needs that the

IMF estimated at the beginning of the programme in 2015 and which the EU helped cover through MFA I-III. The EU's renewed assistance would be expected to reduce the economy's short-term balance of payments and fiscal vulnerabilities, while supporting the government's adjustment and reform programmes through an appropriate package of accompanying policy measures to be agreed with the Ukrainian authorities in a Memorandum of Understanding.

1.2. Ukraine's macro-economic situation

Ukraine was affected by a particularly deep recession in 2014 and 2015, when real GDP contracted by 6.6% and 9.8%, respectively. While reflecting Ukraine's long-standing macroeconomic and structural weaknesses, the economic crisis was largely driven by the confidence loss and damage to production capacity resulting from the conflict provoked by Russia's destabilising actions in the East of the country. The combination of a strong policy response and a large-scale international support package helped the **economy return to growth in 2016** (2.3%). The recovery continued into 2017 despite the negative impact on the industrial sector of a cargo blockage introduced in March 2017 vis-à-vis the non-government-controlled areas. GDP growth amounted to estimated 2.2% year-on-year driven by robust investment and household consumption on the back of improving confidence and wage growth. On the supply side, double-digit growth in construction output was complemented by increasing retail and transport activity. At the same time, agricultural production contracted due to adverse weather conditions in the first half of the year.

Strong domestic investment and household demand are expected to remain the main drivers of Ukraine's economic growth. Both the authorities and international forecasters project an acceleration to around 3% in 2018 and further to nearly 4% by 2020. The speed of economic recovery, however, could be negatively affected by the recent tightening of the monetary policy that aimed to contain inflation. At the same time, the benign global economic environment could be conducive to growth, through growing demand from Ukraine's key export partners.

The **disinflation trend** that prevailed from spring 2015 to mid-2016 (consumer price inflation peaking at 60.9% year-on-year in April 2015 and reaching a low of 6.9% in June 2016) **has gradually reversed** over the course of 2017. This has been the result of higher food prices, partly due to the frost in early 2017 which damaged crops, increasing production costs and a pick-up in consumer demand, both fuelled by the sizable wage growth partly offsetting the sharp loss of purchasing power resulting from the 2014-2015 crisis. The depreciation of the local currency in the final months of 2017 also supported price growth. As a result, headline inflation reached 13.7% in December 2017, exceeding the 10% upper band of the central bank's inflation target.

In order to tame price increases, the **central bank reversed the monetary easing cycle** in place since March 2015. It raised its policy interest rate by a cumulative 4.5 percentage points since October 2017 to 17% as of 2 March 2018.

In spite of the economic crisis, **Ukraine has made significant progress in the consolidation of its public finances in the past three 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 2.4% in 2016 (compared with the 3.7% deficit target agreed for 2016 under the IMF programme). Budget execution continued to be strong in 2017 due to robust tax collection, rising dividend payments from state-owned enterprises and some one-off factors such as the confiscation of frozen assets of former President Yanukovich (totalling 1% of GDP). As a result, the consolidated state budget deficit in 2017 amounted to approximately 1.5% of GDP. Also importantly, **quasi-fiscal deficits have been considerably reduced** since 2014. Notably, the operating deficit of Naftogaz, previously a key drag on the public budget, was

eliminated in 2016. Yet, the state has had to recapitalise banks in the wake of stricter supervision of their capital buffers. Following the nationalisation of Privatbank, the country's largest bank, in December 2016, the total recapitalisation of banks by the state amounted to 2.4% of GDP in 2017. Despite this, and thanks to the overall policy of **fiscal consolidation** has also helped reduce **general government debt** to an estimated 76% of GDP at the end of 2017 (down from 81% at end-2016).

With respect to the external sector, Ukraine's **current account** deficit has gradually widened (3.5% of GDP in 2017) following the sharp downward adjustment induced by the economic crisis (from 9% of GDP in 2013 to 0.3% in 2015). This was mainly the result of the recovery in investment imports (reflecting growing business confidence) and of robust domestic consumption. A further widening of the current account deficit was contained by the strong rebound in exports (17% year-on-year in 2017) on the back of a growing global economy and favourable terms of trade. Private, non-FDI **capital flows** have also increased, notably as a result of a USD 3 billion Eurobond placement by the government in September 2017.¹ The support from Ukraine's multilateral and bilateral partners, coupled with a current account adjustment and a gradual return of private financial flows, helped Ukraine replenish its **international reserves** to USD 18.6 billion at the end of January 2018 despite weakness in FDI.

	2015	2016	2017*	2018*	2019*	2020*
GDP, real, % change	-9.8	2.3	2.2	3.0	3.6	4.0
GDP per capita, USD	2,135	2,199	2,459	2,597	2,818	3,050
Consumer price index, end-period, % change	43.3	12.4	13.7	8.9	5.8	5.0
Unemployment rate (survey-based, %)	9.1	9.3	9.3	9.1	8.9	8.5
Consolidated state government deficit/surplus, % of GDP**	-1.6	-2.3	-1.5	-2.4	-	-
General government debt, % of GDP	79.1	81.0	75.6	82.4	-	-
Current account, % of GDP	-0.3	-3.7	-3.5	-3.4	-3.6	-
Gross international reserves, end-period, in billion USD***	13.3	15.5	18.8	28.6	30.7	-
in months of next year's imports	3.1	3.5	3.6	-	-	-
Foreign direct investment, net	3.3	3.8	1.7	2.5	3.2	-
Nominal exchange rate, end-year, USD/UAH	24.0	27.2	28.1	-	-	-

Source: National authorities; IMF; Commission staff estimates; * - preliminary estimate; ** - deficit ceiling in 2018 in line with the Budget Law; *** - projected/programmed target for 2018 and 2019

Despite the improvement of Ukraine's economic situation since 2015, a number of external vulnerabilities remain, such as the overdependence on commodity exports, high external indebtedness and a level of reserves below IMF adequacy standards. Additionally, the unstable domestic political environment and possible intensification of tensions in the East are downside risks that could weigh on the still timid recovery.

Being a commodity exporter (agricultural products and metals accounted for approximately 70% of Ukraine's merchandise exports in 2017), Ukraine remains particularly vulnerable to **worsening terms of trade** and to the measures introduced by Russia to restrict transit from Ukraine. In fact, the global plunge of commodity prices was a key factor for the balance of payments crises which Ukraine went through in 2009 and 2014-2015.

Ukraine's **high external indebtedness** constitutes another source of vulnerability. Despite sharp deleveraging by the corporate and banking sectors since the 2014 crisis, gross external

¹ In September 2017, Ukraine placed USD 3 billion of 15-year Eurobonds with yield of 7.375%. The bulk of this amount, around USD 1.6 billion, was used to refinance bonds maturing in 2019 and 2020 and thus alleviate the country's high debt-servicing needs in that period.

debt amounted to USD 117.3 billion as of 1 October 2017 (111% of GDP), including USD 47.5 billion of short-term maturities (45% of GDP). While the short-term debt pertains predominantly to the private sector and does not represent as such a direct liability for the state, part of it is related to state-owned companies (sometimes guaranteed by the state) and thus amounts to a contingent liability for the authorities. The amount of direct state-owned external debt maturing in the following year has significantly declined with the crisis, as the authorities resorted to long-term lending from international financial institutions and rescheduled some USD 15 billion of bonded debt (both directly owned as well as guaranteed) with a debt operation of November 2015.² However, it remains relatively elevated and the repayment obligations in 2018-2019 are considerable.

While Ukraine has managed to replenish its gross **international reserves** over the last three years, the process has been slower than initially programmed by the IMF. With USD 18.6 billion at end-January 2018, reserves remain below their pre-crisis level and also below the level foreseen for end-2017 at the launch of the IMF programme in March 2015 (USD 22.3 billion). Reserves could come under renewed pressure in 2018-2019, when the country is expected to make more than USD 12 billion of payments (interest and principal) on sovereign and quasi-sovereign external debt.³ This peak in debt repayments comes at the time of the presidential and parliamentary elections in 2019. In this context, the further replenishment of Ukraine's international reserves seems necessary, and the EU's additional MFA could usefully support this effort, both directly (through its disbursements) and indirectly (as a catalyst for private capital inflows and instilling confidence in the local currency).

1.3. IMF and other donor support

In March 2015, the IMF approved a four-year Extended Fund Facility (EFF) programme for Ukraine of around USD 17.5 billion, which replaced the USD 17 billion Stand-By Arrangement that was initiated in April 2014 (under which USD 4.6 billion had already been disbursed). The necessity of this longer programme arose from the deteriorated balance of payments position and the emergence of new financing needs with the intensification of the conflict in the East in the course of 2014 and in early 2015. The main elements of the new arrangement were:

- *Restoring confidence and economic and financial stability through strong adjustment policies.* This is to be achieved via (i) a tight monetary policy and a sustainable exchange rate policy to allow Ukraine rebuilding its international reserves; (ii) bank recapitalisation to strengthen the soundness of the banking sector, including through introducing measures to reduce related-party lending; (iii) fiscal adjustment to ensure a sustainable public debt trajectory; (iv) measures to reduce the deficit of the oil and gas company Naftogaz.
- *Lifting medium-term growth through deep structural reforms.* These comprised (i) governance reforms, including anti-corruption and judicial reforms; (ii) deregulation and tax administration reforms to improve the business climate; (iii) a comprehensive reform of state-owned enterprises.

² While Ukraine managed to agree debt restructuring with private bondholders, it failed to reach an agreement with Russia over the repayment of a USD 3 billion Eurobond, which has been issued under former President Yanukovich. Ukraine defaulted on this liability upon its maturity in December 2015 after the unwillingness of Russia to negotiate a restructuring of this debt. The two sides are currently disputing this debt in a UK court.

³ Payment obligations on the post-restructuring bonds will resume in 2019. Moreover, the first of three USD 1 billion US-guaranteed bonds will mature in 2019 (the US guaranteed one five-year Ukrainian bond each in 2014, 2015 and 2016 as a contribution to the IMF-led international financial assistance package).

A total of USD 8.5 billion from the IMF programme has been disbursed, sometimes with significant delays due to uneven reform implementation.⁴ Following the disbursement of the first tranche of USD 4.9 billion in March 2015, the Fund provided three loan instalments – USD 1.7 billion in August 2015, USD 1 billion in September 2016 and USD 1 billion in April 2017.

For the conclusion of the ongoing fourth programme review, which would open the way to a disbursement of USD 1.9 billion, the adoption of laws on pension reform, on privatisation and on the establishment of an anti-corruption court is a prerequisite for an IMF staff-level agreement. The first two laws were adopted (in October 2017 and in January 2018, respectively), while a draft law on the anti-corruption court was introduced to Parliament in late December 2017 after some delay. However, the draft is not fully in line with IMF programme requirements, which means that it will need to be amended in the legislative process in order to unblock the review. Moreover, fiscal, energy and financial sector policies need to remain consistent with Ukraine's commitments under the IMF programme. The pending review is expected to be concluded in the first half of 2018, provided there has been sufficient progress on outstanding issues.

The IMF financial assistance has been complemented by substantial support from a number of bilateral partners (notably the EU and some of its Member States, the US, Japan, Canada, Switzerland and Norway).⁵ Other international financial institutions such as the World Bank, the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB) have also significantly scaled up their activity to support Ukraine's economic transition. Most of this financing was provided in 2015, when Ukraine's financing needs were the highest. In addition to the international financial support, the debt operation that Ukraine agreed with some of its private creditors also contributed to covering Ukraine's financing needs in 2015-2018, by rescheduling some USD 15 billion of Eurobonds and commercial loans to the period of 2019 and beyond and by decreasing Ukraine's nominal liabilities by USD 3 billion following a 20% debt reduction.

1.4. External financing needs

Despite the successful macroeconomic stabilisation, Ukraine continues to face considerable external vulnerabilities. While the country has managed to replenish its gross international reserves since 2015, the process has been slower than initially programmed by the IMF.⁶ As a result, foreign exchange reserves remain below their pre-crisis level and well below the IMF's reserve adequacy metric.⁷ They stood at only 54% of this composite indicator at the end of 2016 and at around 70% at end-2017. Thus, **further reserve build-up is needed to reduce**

⁴ According to the original schedule of the IMF, Ukraine should have received approximately USD 14.5 billion from the Fund by the end of 2017.

⁵ The EU and the US were the largest bilateral donors. The EU approved in April 2015 a third MFA programme of EUR 1.8 billion (out of which EUR 1.2 billion was eventually disbursed) that added on the two previous programmes of EUR 1.6 billion disbursed in May 2014 – April 2015. In addition, considerable grant assistance in the form of budget support and thematic programmes was extended to Ukraine. The US provided two bond guarantees to Ukraine, which enabled the country to borrow USD 1 billion in both 2015 and 2016. This came on top of a USD 1 billion guarantee extended in May 2014.

⁶ This, however, is partly due to the delay with the implementation of the IMF programme. In March 2015-December 2017, Ukraine received USD 8.5 billion, or some USD 6 billion less than what was initially envisaged.

⁷ This metric is composed of three indicators that measure reserves in relation to months of future imports, broad money and short-term external debt repayments. As a rule of thumb, reserves within 100-150 percent of the metric are considered adequate.

external liquidity risks, in particular in light of the repayment obligation of more than USD 12 billion of external debt (principal and interest) falling due almost equally in 2018 and 2019.⁸ This peak in debt repayments comes at the time of the presidential and parliamentary elections (respectively scheduled in March and October 2019).

According to an updated estimate of Ukraine's financing needs by the IMF of December 2017, **the country faces significant external financing requirements in 2018-2019**. The cumulative financing gap is estimated at USD 16.1 billion,⁹ with nearly two-thirds of it (USD 10.5 billion) falling into 2018. The bulk (USD 11.6 billion) of the country's external financing needs relates to the accumulation of international reserves required to reach 100% of the reserve adequacy metric of the IMF. The remainder (USD 4.5 billion) corresponds to the balance of payments deficit. This deficit is mostly driven by the financial account, where private capital inflows are recovering at a slower pace than initially expected, including due to stalled privatisation, which has impacted on the volume of foreign direct investments. At the same time, strong domestic demand is expected to keep the current account deficit relatively elevated over the medium term.

As far as financing is concerned, some USD 11.7 billion are available. The majority of it (USD 8.5 billion) would come from the undisbursed amounts envisaged in the IMF's EFF arrangement. Another USD 3.1 billion is attributed to the debt operation that Ukraine agreed earlier with bondholders and holders of commercial debt.

Overall, after IMF assistance, **Ukraine is estimated to face a financing gap of USD 4.5 billion, or EUR 3.8 billion,¹⁰ in 2018-2019** (see Table 2). Part of it should be financed by the World Bank, which considers providing a policy-based guarantee of USD 800 million in 2018. Taking this World Bank into account, Ukraine's residual external financing needs will still amount to USD 3.7 billion in 2018-2019, USD 2.5 billion in 2018 and USD 1.2 billion in 2019. The proposed EUR 1 billion MFA from the EU would thus cover 26.5% of the overall financing gap and 32% of the USD 3.7 billion gap once the potential contribution from the World Bank is taken into account.

⁸ Ukraine's debt repayments related to the bonds that were restructured under the debt operation of November 2015 will start in 2019, when some USD 400 million would have to be redeemed. From 2020 to 2027, the country faces annual debt repayments of USD 1.3-1.4 billion under the restructured bonds. In addition, the country could have to make disbursements to private creditors on the GDP warrants that were issued as part of the 2015 debt restructuring. The warrants, whose notional face value is USD 3.6 billion, are structured to pay out depending on economic performance in 2019-2038. The first reference year is 2019, which could potentially trigger a payout in 2021.

⁹ This estimate is based on the assumption that Ukraine would have access to the international debt markets in 2018 and 2019, borrowing USD 2 billion in each year.

¹⁰ All conversions in this document are based on a EUR/USD exchange rate of 1.19.

Table 2. Ukraine: Financing needs, USD billion						
	2015	2016	2017	2018	2019	Total
Financing gap*	15.6	6.3	6.8	10.5	5.6	44.8
Reserve accumulation	6.0	1.9	2.8	9.5	2.1	22.3
Underlying balance-of-payments gap**	9.6	4.4	4.1	1.1	3.4	22.5
Identified financing	15.6	6.3	6.9	7.2	4.4	40.3
Bilateral and multilateral	9.8	2.8	2.4	5.3	3.3	23.6
IMF	6.5	1.0	1.0	5.3	3.3	17.1
Other bilateral/multilateral	3.3	1.8	1.4	-	-	6.5
World Bank	1.0	0.3	0.7	-	-	1.9
European Union	0.9	0.1	0.6	-	-	1.7
United States	1.0	1.0	-	-	-	2.0
Other bilateral	0.4	0.3	0.1	-	-	0.9
Debt operation	5.7	3.5	4.4	2.0	1.1	16.7
Remaining gap, out of which	-	-	-	3.3	1.2	4.5
EU MFA				0.6	0.6	1.2
World Bank				0.8	-	0.8
Other sources, to be identified				1.9	0.6	2.5
Memorandum items						
Capital market access	-	-	1.5	2.0	2.0	5.5
Current account (% of GDP)	-0.3	-3.7	-3.5	-3.4	-3.6	-
Gross international reserves***	13.3	15.2	18.8	28.6	30.7	-
<i>Source: IMF</i>						
* - excludes the effect of spending reflected on the current account by project loans						
** - excludes project loans and currency swaps						
*** - gross international reserve target for 2018 and 2019						

1.5. Structural reforms

Selected reform achievements in 2014-2017, with uneven progress across sectors

With the political transition in 2014, **Ukraine embarked on an ambitious and wide-ranging reform programme**. This programme was supported by large-scale financial and technical assistance provided by multilateral and bilateral partners. Following the initial strong reform impulse, however, **progress has become uneven**, which impacted not only on the pace of economic recovery but also on the implementation of the financial support programmes for the country.¹¹ The main obstacles to faster reform implementation became the complex domestic political environment, the lack of political will among some of the decision-makers to implement ambitious reforms in certain sectors such as the fight against corruption, and the opposition by vested interests which continue to exert influence on policy-making in the country.

Despite these domestic challenges and the difficult security situation in the East, Ukraine managed to push through reforms in a variety of sectors, many of which were supported through conditionality under MFA I-III.

In the area of **public finance management**, the authorities – in line with MFA conditionality – strengthened the external audit function and improved transparency in public procurement, which has also resulted in considerable fiscal savings for the state. Fiscal governance was

¹¹ In the case of the EU's MFA, this effect was evidenced by the considerable delay with the disbursement of the second tranche from MFA III and the non-disbursement of the final loan instalment from this programme.

strengthened through the introduction of measures to improve tax compliance and through the launch of mid-term budgetary planning.

Governance reforms resulted in the set-up of new **anti-corruption** institutions, again in line with MFA conditionality, with one of them, the National Anti-Corruption Bureau, having acquired a critical role in investigating corruption offences. In addition, in September 2016, the authorities launched an electronic platform for submission of asset declarations by senior public officials. However, the National Agency for the Prevention of Corruption (NAPC), which is in charge of verifying these declarations to identify possible cases of corruption offences, currently remains unable to conduct this function in an efficient manner, as it has not yet introduced an automatic verification mechanism. This was one of the unmet conditions from the final tranche of MFA III, which remained undisbursed. An Action Plan was adopted in November 2017 outlining key steps to be taken by the NAPC and other responsible agencies to unlock the situation. However, these commitments remain to be implemented. Taking into account the delays already incurred with the deadlines initially set in the Action Plan, and assuming that implementation will swiftly resume, the automatic verification of electronic asset declarations could in principle start operating by summer 2018.

A **judicial reform** introduced in 2016 saw the election of a new Supreme Court in 2017 and the launch of competitive selection procedures for judges at lower-instance courts. As part of the 2016 reform, Ukraine committed to establishing a special anti-corruption court. Progress to this end, however, has been slow. The draft legislation on the anti-corruption court was submitted only in December 2017 and is still pending parliamentary approval. The adoption of the law is a key requirement for provision of financial assistance by the IMF and the World Bank.

In the area of **public administration**, as agreed in the policy programme for MFA III, a major reform was launched in mid-2016, which is expected to depoliticise and professionalise the civil service and to improve its effectiveness. While important measures were launched in order to improve **corporate governance and transparency of state-owned companies**, the government's **privatisation** efforts have not yielded significant results yet.¹²

The **energy sector** also witnessed comprehensive reforms, many of which featured in the policy programme of MFA III. The independence of the market regulator was strengthened, a new law on electricity was adopted with the objective to increase competition in the sector, major steps towards improving energy efficiency were also introduced. Strong progress was made in reforming the gas sector, although the strategy approved for the unbundling of Naftogaz has not been fully implemented yet. Household gas tariffs were increased to better reflect costs, while utility subsidies were raised to compensate poorer households for the tariff hike. However, utility pricing has not been depoliticised, as evidenced by a de facto suspension in 2017 of the supposedly automatic formula for household gas and heating price adjustments to import parity as laid down in the legislation and agreed with the IMF (on the occasion of what should have been its first application).

In the **banking sector**, the focus of recent reforms was on the improvement of regulation and supervision. The authorities have dedicated significant efforts to cleaning up the segment from unviable players and better capitalising the remaining banks in order to stabilise the system and pave the way for recovery in credit activity.¹³ An important step in this area was

¹² In January, the Ukrainian Parliament adopted a new privatisation law, which is expected to simplify and accelerate the sale of state-owned companies. The adoption of the law is one of the requirements for the release of the next tranche from the IMF programme for the country. However, no SOEs of a significant size has as yet been privatised.

¹³ The number of banks fell from 180 in 2014 to 82 at the end of 2017.

the nationalisation in December 2016 of Privatbank, a major systemic bank (the largest lender in the country), which was failing under the weight of non-performing related-party loans. The investigation and claw-back of collateral linked to these loans is still ongoing.

Other important reforms included deregulation, reinforcing the efficiency of the competition authority and decentralisation, which has already had positive fiscal implications. In the social sphere, the authorities launched major pension, education and healthcare reforms. The conditions attached to MFA III spurred progress in the government's response to the situation of internally displaced people in Ukraine, while also highlighting remaining concerns.

Main government reform priorities

In April 2017, the Ukrainian government approved a **mid-term priority action plan to 2020**, which outlines the main reform areas the authorities plan to pursue in the next few years. It consists of five pillars: (i) economic growth; (ii) effective governance; (iii) human capital development; (iv) rule of law and fight against corruption; (v) security and defence.

In order to promote **economic growth**, the authorities would seek to improve the business climate through deregulation, tax and customs reforms and further advancing the reform of the public administration. Moreover, privatisation would be stepped up, while public procurement would be further improved. An effective system to monitor and control state aid to business entities would be created. One of the key measures planned under this pillar is the launch of the land reform, which has been continuously delayed despite the significant economic benefits it is expected to bring to the country. Finally, the authorities plan to further reduce Ukraine's energy independence and improve its energy efficiency.

In **security and defence**, the key priorities are further developing the capability of Ukraine's armed forces, strengthening border security and guaranteeing the country's information sovereignty. In addition, the authorities would seek to restore the main infrastructure and key social services in the eastern parts of the country.

With regard to **governance**, the focus would be on advancing reforms of public administration, including by promoting e-government and decentralisation. These reforms are seen as critical for ensuring high-quality and accessible services for business and citizens. Furthermore, in order to ensure an efficient and transparent use of public finances, further steps would be taken towards implementing a full-scale medium-term budget planning.

When it comes to **human capital**, the key priorities would be the shift of the healthcare system to a policy based on health promotion and disease prevention from a treatment-based policy and modernising the educational system by improving the quality of secondary education and promoting vocational training. The reform of the pension system, which aims at improving its fairness and effectiveness, is also among the main elements in this pillar.

The authorities consider the **rule of law** critical to sustainable, inclusive growth and to social development. They therefore commit to strive to enforce legislation and ensure effective, coordinated and transparent operation of anti-corruption institutions, including by securing sufficient financial resources to this end. The objective of the anti-corruption activities by 2020 would be to strengthen the institutional infrastructure as well as the planning and policy-making capacity of the anti-corruption agencies responsible for corruption prevention, in particular, to enable corruption prevention bodies to operate effectively. The operation of the e-declaration system and system of government control over political parties' financing would be strengthened as a result. In order to assert the rule of law, the government plans to continue to reform the system of enforcement of judicial rulings, notably by recruiting private enforcement officers in addition to existing public officers.

While the government plans seem to go in the right direction, the implementation of anti-corruption reforms in recent years has been weak.¹⁴ Essential reforms such as strengthening the investigative powers of the National Anti-Corruption Bureau - notably by authorising it to wiretap -, or establishing an independent anti-corruption court, which are two structural benchmarks under the IMF programme, or the effective verification of asset declarations of public officials, which was among the conditions agreed under MFA III, do not feature among the government's priority actions described in the action plan. With regard to the establishment of an anti-corruption court, there has been progress since the adoption of the government's action plan in April 2017. The President submitted the relevant legislation to Parliament in December 2017, but the draft proposed was not in line with some important recommendations from the Venice Commission. Following calls by the IMF, the World Bank and the EU to follow these recommendations, the draft law is expected to be substantially amended in the parliamentary process.

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

2.1. Objectives

The objectives of the proposed MFA operation are to:

- (i) contribute to covering the external financing needs of Ukraine in the context of a sizeable external financing gap brought about by lower-than-expected private capital flows, significant external debt amortisation and the need to build up foreign exchange reserves;
- (ii) alleviating Ukraine's budgetary financing need;
- (iii) support the fiscal consolidation effort and external stabilisation efforts in the context of the IMF programme;
- (iv) support structural reform efforts aimed at improving the overall macroeconomic management, strengthening economic governance and transparency, and improving conditions for sustainable growth, including the fight against corruption;
- (v) facilitate and encourage efforts of the authorities of Ukraine to implement measures identified under the EU-Ukraine Association Agreement and in the context of the bilateral cooperation programmes, support regulatory convergence and economic integration with the EU and strengthen the EU's economic policy dialogue with the authorities.

2.2. Monitoring 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

¹⁴ While the confiscation of assets of nearly USD 1 billion believed to be related to former President Yanukovich can be considered an important step, it does not indicate that the anti-corruption set-up in Ukraine is generally working well.

Memorandum of Understanding to be negotiated between the Commission and the Ukrainian authorities.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

The proposed new MFA would amount to EUR 1 billion. Regarding the form of the assistance, the Commission proposes to disburse the full amount in the form of medium- to long-term loans. As usual, these loans will have favourable conditions in terms of long maturities (of up to 15 years) and a low interest rate (the rate at which the EU, benefiting from its AAA rating, borrows the funds in the international capital markets). This form of financial support is similar to the one provided under the previous three MFA programmes that were implemented in 2014-2017. It is consistent with the treatment granted by the World Bank and the IMF to Ukraine.

MFA provides untied and undesignated macroeconomic support, which helps the beneficiary country to 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.

3.2. Risk assessment

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

There is a risk that the MFA could be used in a *fraudulent way*. As MFA is not designated to specific expenses by Ukraine (contrary to project financing, for example), this risk is related to factors such as the general quality of management systems in the National Bank of Ukraine and the Ministry of Finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriateness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Loan Agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. It is further envisaged that a number of specific policy conditions will be attached to the assistance, including in the area of public finance management, with a view to strengthening efficiency, transparency and accountability. Also, the assistance will be paid to a specific account of the National Bank of Ukraine.

Moreover, in line with the requirements of the Financial Regulation, the Commission services will carry out an Operational Assessment of the financial and administrative circuits of Ukraine to ascertain that the procedures in place for the management of programme assistance, including MFA, provide adequate guarantees. The assessment will cover areas such as budget preparation and execution, public internal financial control, internal and external audit, public procurement, cash and public debt management, as well as the independence of the central bank. The preliminary findings of the consultancy company engaged with this Operational Assessment are to be received in the second quarter of 2018. Developments in that area will be further closely monitored by the EU Delegation in Kyiv. The Commission is also using budget support assistance to help the Ukrainian authorities improve their PFM systems, and these efforts are strongly supported by other donors.

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.

A second risk stems from the possibility that Ukraine will fail to service the financial liabilities towards the EU stemming from the proposed MFA loans (default or credit risk), which could be caused for example by a significant additional deterioration of the balance of payments and fiscal position of the country. This risk is mitigated, however, by the fact that the EU's MFA is part of an international package of official assistance led by the IMF that is supporting an adjustment and reform programme aimed at restoring fiscal and balance of payments sustainability through the implementation of a series of policy measures, included those to be agreed in the Memorandum of Understanding between the EU and the Ukrainian authorities. Moreover, the risks for the EU budget are cushioned by the EU's Guarantee Fund for external actions.

Another key risk to the operation stems from the regional geopolitical situation, in particular the lingering conflict in the eastern part of the country, which acts as an important deterrent to private capital inflows. A worsening of the regional geopolitical situation could have a negative impact on Ukraine's macroeconomic stability, affecting the performance of the IMF programme and the disbursement and/or repayment of the proposed MFA. Ukraine's still difficult relations with Russia, one of its key export markets, is also negatively impacting on the economic recovery of the country. Diplomatic efforts for conflict management and resolution continue, including with the support of the EU.

On the domestic front, the main risks stem from the complex political environment and the existence of strong vested interests against reforms. This could result in insufficient reform implementation, in particular ahead of national elections in 2019, and therefore hamper the implementation of the proposed MFA, including through impacting on progress with the IMF programme. However, despite the difficult political environment, Ukrainian authorities have requested further MFA, knowing that disbursements will be conditional on the implementation of reforms to be agreed. This conditionality provides a tool to support reform-oriented forces in the country and in particular within the authorities (government and Parliament). Moreover, politically Ukraine remains highly committed to its comprehensive commitments under the Association Agreement with the EU, including in the part on the establishment of a Deep and Comprehensive Free Trade Area, which is also reflected in the government's action plan of April 2017.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficient grounds and guarantees to proceed with the proposed MFA to Ukraine. The Commission services will maintain close contacts with the Ukrainian authorities during the implementation of the MFA in order to address quickly any concerns that may arise.

4. ADDED VALUE OF EU INVOLVEMENT

The Union's financial support to Ukraine reflects the country's strategic importance to the EU in the context of the European Neighbourhood Policy (ENP). The MFA instrument is a policy-based instrument that aims to alleviate short- and medium-term external financial needs. As a part of the overall EU package of assistance, it would contribute to supporting the Union's objectives of economic stability, economic development and resilience in Ukraine and, more broadly, in the eastern European neighbourhood.

The EU's MFA would also complement the standard EU aid packages mobilised under the European Neighbourhood Instrument (ENI). By supporting the authorities' efforts to establish

a stable macroeconomic framework, the EU's MFA would enhance the added value and effectiveness of the EU's involvement through other financial instruments.

In addition to the financial impact of the MFA, the proposed programme will strengthen the government's reform commitment and further foster its aspiration towards closer relations with the EU, as reflected by the Association Agreement that entered into force in September 2017. 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 in the region that the EU is ready to support countries implementing ambitious economic and structural reforms.

5. CHARACTERISTICS OF MACRO-FINANCIAL ASSISTANCE

5.1. Exceptional Character and Limited Timeframe

The proposed MFA operation would be exceptional, aiming to support the restoration of a sustainable external finance situation of Ukraine. It would have an availability period of 2.5 years from the entry into force of a Memorandum of Understanding, as part of conditionality requirements described below. However, the operation is expected to run along with the current IMF EFF arrangement for Ukraine that is set to expire in the spring of 2019. Against this background and given the time required for the legislative process in the European Parliament and the Council, the EU's assistance is expected to be implemented in 2018 and the first half of 2019. Subject to the implementation of the policy measures to be agreed, the disbursement of the first tranche could take place in the second half of 2018, while the second instalment could be made available in the spring of 2019.

5.2. Political preconditions and EU-Ukraine relations

MFA is available to third countries that are politically, economically and geographically close to the EU. Countries that are covered by the ENP, like Ukraine, are in principle eligible for MFA. In order to receive MFA, the beneficiary country needs to respect effective democratic mechanisms (including a multi-party parliamentary system) and the rule of law and guarantee the respect for human rights.

Political preconditions: The political preconditions for receiving MFA may be considered to be fulfilled in the case of Ukraine. 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. Ukraine is an open society, where elections are held freely and largely in line with international standards, although Ukrainian authorities should proceed with the reform of the electoral legislation. Media freedom has improved, but further work is needed to strengthen the pluralistic media environment. The most severe human rights violations take place in the areas not under the control of the government, following the illegal annexation of the Crimean peninsula and the conflict in the east provoked by Russia's destabilising actions. Ukraine has made considerable reforms in the justice and anti-corruption sectors, but immediate actions are needed to ensure their completion, full implementation and irreversibility.¹⁵

EU-Ukraine relations: The EU and Ukraine have developed close political and economic relations over the years, leading to the signature of an Association Agreement, including a Deep and Comprehensive Free Trade Area (DCFTA), on 21 March and on 27 June 2014. The Association Agreement which is the main tool for bringing Ukraine and the EU closer

¹⁵ A more detailed assessment of the compliance with this criterion, provided by the European External Action Service (EEAS), is reproduced in the Annex of this Staff Working Document.

together, replaces earlier frameworks for cooperation. It promotes deeper political ties, stronger economic links and the respect for common values.

Parts of the Association Agreement have been provisionally applied since 1 November 2014. This has enhanced EU-Ukraine cooperation on human rights, fundamental freedoms and the rule of law, political dialogue and reforms, movement of persons. It has also strengthened cooperation in a number of sectors such as energy, environment and climate action, transport, financial services, public finances, agriculture, consumer protection and civil society. The provisions concerning the DCFTA had been provisionally applied since 1 January 2016, when the EU and Ukraine started to mutually open their markets for goods and services. The Association Agreement, including its trade part, entered into force on 1 September 2017, following the conclusion of the ratification process.

The EU is Ukraine's first trading partner, accounting for 40.6% (in value terms) of Ukraine's total trade in 2016. Bilateral trade increased further in 2017. Ukrainian exports to the EU grew by 27.3% year-on-year, while imports from the EU rose by 22.1% (in value terms).

The EU is also an important source of assistance to the reform process in Ukraine. In March 2014, the Commission adopted an unprecedented financial support package to Ukraine worth over EUR 11 billion for the next few years. This was augmented in early 2015 by another EUR 1.8 billion through the approval of a third MFA programme for the country. Out of the total pledge of nearly EUR 13 billion, the EU has so far mobilised more than EUR 10 billion to stabilise Ukraine's economy and support structural reforms. This includes EUR 3.4 billion in macro-financial assistance (out of which EUR 2.8 billion has been disbursed) as well as nearly EUR 1 billion in grants. In addition, the EIB and the EBRD have each signed project investment contracts for more than EUR 3 billion to support infrastructure development and private sector activity, among others.

5.3. Complementarity

The proposed MFA would complement assistance provided by other multilateral donors in the context of the IMF-led economic programme. The EU's MFA would also complement other EU aid packages mobilised under the ENI. By supporting the adoption by the Ukrainian authorities of an appropriate framework for macroeconomic policy and structural reforms, the EU's MFA would enhance the added value of the overall EU involvement, increasing the effectiveness of the EU's intervention including through other financial instruments. The proposed MFA would also contribute to the EU's leverage on policy making in Ukraine by helping the country reduce economic vulnerabilities and promote higher and more inclusive economic growth.

5.4. Conditionality

Disbursements under the proposed MFA operation would be conditional on successful reviews under the **IMF programme** and on the effective drawing by Ukraine on IMF funds, as well as on the fulfilment of the political pre-conditions. In addition, the Commission – on behalf of the EU – and the Ukrainian authorities would agree on a **specific set of structural reform measures, to be defined in a Memorandum of Understanding**. These reform measures would support the authorities' reform agenda and complement the programmes agreed with the IMF, the World Bank and other donors, as well as the policy programmes associated with the EU's budget support operations. They would be consistent with the main economic reform priorities agreed between the EU and Ukraine in the context of the Association Agreement, including the DCFTA and the Association Agenda.

The Commission would seek a broad consensus with the Ukrainian authorities, so as to ensure ownership and hence increase the likelihood of smooth implementation of the agreed

conditionality. The policy conditions should address key weaknesses of the Ukrainian economy and economic governance system. In particular, delivering on key anti-corruption and governance reforms will be indispensable if the MFA operation is to be successfully completed.

In light of the incomplete implementation by Ukraine of the policy programme linked to MFA III, which led to the cancellation of the final tranche by the Commission in January 2018, it is appropriate to include specific conditions for each of the two tranches of this assistance. More specifically, **it is planned to reflect the four measures that were not implemented under the previous programme in the following way:**

- On the **verification of asset declarations** of public officials, the Commission would insist on the establishment of an effective verification system, including through automatic verification software with direct and automatic access to state databases and registers. In the Memorandum to be agreed with Ukraine under the proposed new MFA operation, the Commission would therefore require the aforementioned automated verification system to be in place and operating, with a significant number of declarations verified through the automated system, giving priority to high-level officials.
- On the **verification of data to be provided by companies on their beneficial owners and the enforcement of companies' reporting obligation**, it has to be recognised that this is still in its infancy internationally, including in the EU. Expert exchanges between Ukraine and the EU will be organised, on a Ukrainian request, with a view to defining feasible steps for Ukraine to operationalise a verification mechanism. On this basis, the Memorandum could specify tangible benchmarks for a verification mechanism as a condition under the MFA programme.
- The **wood export ban**, which is not compatible with refraining from trade-restricting measures, remains in place, and a law repealing it is yet to be considered by the responsible parliamentary committee in Ukraine. The Commission will engage with the Ukrainian authorities with a view to finding a solution to this irritant through the use of dedicated trade instruments, possibly including the bilateral dispute settlement.
- As to the law **establishing a central credit registry**, it was adopted on 6 February 2018 by the Ukrainian parliament and entered into force on 4 March 2018. This measure can thus be assessed as implemented and does not need to be reflected in the new Memorandum.

In addition, **the Memorandum for the new programme will also include other measures to be implemented by Ukraine in order to receive the first and second disbursement.** These will comprise actions in the area of public finance management, which is part of all MFA-related policy programmes. More generally, the conditionality will focus on a select number of key sectors that are relevant to Ukraine's macroeconomic stabilisation.

5.5. Financial Discipline

The planned assistance would be provided in the form of a loan and should be financed through a borrowing operation that the Commission will conduct on behalf of the EU. The budgetary costs of the assistance will correspond to the provisioning, at a rate of 9%, of the amounts disbursed in the guarantee fund for external lending of the EU, from budget line 01 03 06 (“Provisioning of the Guarantee Fund”). Assuming that the first loan disbursements will be made in 2018 and the second one in 2019 for a total amount of EUR 1 billion, and according to the rules governing the guarantee fund mechanism, the **provisioning will take place in the budgets for 2020 (for EUR 45 million) and 2021 (EUR 45 million).**

Based on current projections on the utilisation of the budget line 01 03 06, the Commission assesses that the budgetary impact of the proposed MFA operation for Ukraine can be accommodated.

In line with the requirements of the Financial Regulation, the European Commission services would carry out in the second quarter of 2018, as noted, an Operational Assessment of the financial and administrative circuits of Ukraine. Developments in this area will continue to be closely monitored also through the regular assessment of PFM reforms by the EU Delegation in Kyiv.

6. EVALUATION AND COST-EFFECTIVENESS

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

6.1. Evaluation

Ex-post evaluations of MFA 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 MFA 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 MFA budget line will be used for this evaluation.

6.2. Achieving cost-effectiveness

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

- (i) First, since the assistance would be leveraged by that 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 IMF and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.
- (ii) Second, providing a coordinated macroeconomic support to Ukraine on behalf of the EU countries, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.
- (iii) Third, all of the assistance would be provided in the form of loans, through which scarce budgetary funds are effectively leveraged, thus enhancing the impact of the EU budget.
- (iv) In addition, the Commission will aim to achieve 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



Head of Division

Eastern Partnership Bilateral

Brussels, 9 March 2018

EURCA EAST 2 (2018)

ASSESSMENT OF DEMOCRACY, HUMAN RIGHTS, RULE OF LAW AND REFORMS IN UKRAINE

***Political preconditions:** Countries which are covered by the ENP are eligible for MFA. A pre-condition for granting MFA should be that the eligible country respects effective democratic mechanisms, including a multi-party parliamentary system and the rule of law and guarantees respect for human rights.*

Ukraine's Constitution envisages a parliamentary-presidential democracy which is based on the rule of law, division of powers, and guarantees for local self-government. The Constitution protects human dignity, equality, rights and freedoms such as freedom of media, speech, religion, association and assembly as well as broad social and economic rights. It also guarantees the free functioning of political parties. Cabinet of Ministers is accountable both to the Parliament and the President who holds important powers and who has also legislative initiative and veto rights.

Following a major political crisis in 2013-2014, Ukraine has embarked on an ambitious reform path, supported by its international partners. The reform agenda is rooted in the EU-Ukraine Association Agreement, including its Deep and Comprehensive Free Trade Area (AA/DCFTA), the Association Agenda and various Government strategies and action plans.

The AA/DCFTA was signed in 2014, has been partly provisionally applied since November 2014 (the DCFTA since January 2016), and entered into force on 1 September 2017. The Association Agenda, facilitating its implementation, was most recently updated in March 2015. The constitutional, electoral and judicial reforms and preventing and combatting corruption are among its priorities for action.

Ukraine has pursued the implementation of structural reforms, generating positive trends in the governance, economic and social spheres despite the internal and external challenges, including the illegal annexation of the Crimean peninsula by Russia and the conflict in the east of the country provoked by Russia's destabilising actions. Ukraine has continued to advance measures to tackle corruption, but the sustainability of reforms remains a challenge and immediate actions need to be taken in order to ensure the full implementation and sustainability of these reforms.

Recent developments

The last presidential, parliamentary and (nation-wide) local **elections** took place in spring 2014, autumn 2014 and autumn 2015 respectively and were assessed by the Office for Democratic Institutions and Human Rights of the Organization for Security and Co-operation in Europe (OSCE/ODIHR) as "competitive, well organized overall and the campaign generally showed respect for the democratic process". Nonetheless, criticism was expressed in relation to the over-complicated legal framework, the dominance of powerful economic groups, and the influence of political and business interests of media owners on media reporting.

Since 2015, local elections have been held in over 400 newly amalgamated communities as part of the ongoing decentralisation. Ukrainian independent civil society election observation organisations have characterised the electoral process as competitive, with a broad choice of candidates. They have assessed the conduct of elections positively, noting some irregularities which, however, did not have a significant impact on the overall outcome.

Ukrainian **electoral legislation** for all types of elections remains to be harmonised and consolidated. Currently it is dispersed in multiple legislative acts, does not address sufficiently a number of important issues and contains contradictory or unclear provisions. The OSCE/ODIHR, the Venice Commission and the Ukrainian civil society have been advocating for the adoption of a single Electoral Code, which the EU has also supported. A draft electoral code passed the first reading in the Parliament on 7 November 2017, but with minimum required votes; substantive efforts are required from the Government to ensure its final adoption.

In addition, the appointment of 13 new members of the Central Election Commission, to replace those whose mandate has expired, is still pending. Positive steps have been taken in the field of party financing, where tightened transparency rules entered into force in 2016.

Next presidential and parliamentary elections are scheduled in spring and autumn 2019 respectively. The discussions about the local elections in the territories not under the control of government in eastern Ukraine are ongoing within the Trilateral Contact Group. Gender quota has been introduced to the local elections; at national level only 12 % of Members of Parliament are women.

The current government coalition is formally composed of two party factions (Bloc Petro Poroshenko and Popular Front). It falls short of a proper majority in the parliament and must systematically resort to situational alliances with other parties. Strong vested interests are still represented in the Parliament, as well as among institutions and authorities.

The **constitutional system** in Ukraine has been subject to several changes during the past years, often through controversial procedures. The current reform process which was launched in 2015 is generally perceived as more transparent, participatory and in line with international standards. Constitutional amendments on the judiciary entered into force in September 2016, strengthening judicial independence and reorganising the court system. Constitutional amendments related to decentralisation have been adopted by the parliament in the first reading, with the second reading still pending. Draft amendments aiming to modernise the chapter on human rights were discussed in 2015, but so far no draft has been submitted to the parliament.

Since 2014 Ukraine has been implementing a **decentralisation** reform at the basic (community) level. Overall, it has led to significant increases in tax revenues, notably in the voluntary amalgamated communities, increased trust among the population towards the local

authorities and new opportunities for socio-economic development. The **public administration reform** is being implemented steadily, albeit in some areas at a slow pace.

In terms of **media freedom**, Freedom House ranked Ukraine as "partly free country" in 2017. Its report highlights that Ukraine's media environment has significantly improved since 2014, as ongoing reforms continue to strengthen the legislative environment for journalists and outlets, although several challenges remain. Although declining overall, instances of physical attacks against journalists have persisted, along with impunity for those who committed such crimes.

Ukraine has adopted one of the most progressive and far-reaching legal frameworks in Europe on the transparency of media ownership, although the influence of private interest on editorial lines remains an issue. A law on public broadcasting was adopted in April 2015, creating a single public company providing public service broadcasting on both TV and radio, and enshrining the editorial independence of the new broadcaster. An urgent and key challenge is the persisting and significant shortfall in funding to the broadcaster out of the state budget, as stipulated in the law.

A number of ambitious reforms have been initiated in Ukraine's **justice** sector, in particular the creation of a new Supreme Court which started operating in December 2017. There has also been progress in the implementation of **anti-corruption** reforms, but immediate actions are needed to ensure completions, full implementation and sustainability of these reforms. The independence and capacity of National Anti-Corruption Bureau, the Specialised Anti-Corruption Prosecution and the National Agency for the Prevention of Corruption (NAPC) must be ensured and reinforced, reversing the current trends undermining their work. Effective verification of e-declarations was one of the unmet policy conditions of the third macro-financial assistance programme, due to which it was not possible to disburse its third tranche. It remains a key issue for the credibility of anti-corruption reforms.

The continued lack of convictions in high-level anti-corruption cases is of serious concern. These shortcomings are expected to be remedied by the envisaged establishment of a specialised High Anti-Corruption Court as recommended by the Council of Europe's Venice Commission. Ukrainian authorities have to reinforce their efforts to ensure the independence, operation capacity and full effectiveness of the anti-corruption institutions. Full investigation of the large-scale fraud at Privatbank prior to its nationalisation, eventual prosecution and conviction of those responsible, along with the recovery of misappropriated funds, are still to be conducted.

Ukraine has a vibrant **civil society** that plays an active role in promoting, design and oversight of reforms, especially in the area of anti-corruption, judiciary, decentralisation, human rights, media, health and energy. However, some civil society actors have also denounced increased pressure on their activity, undermining their work and credibility.

In the territory under the control of Ukrainian authorities, **human rights** are generally respected and fundamental freedoms upheld. Still, a number of concerns persist, relating to discrimination on various grounds, cases of torture and ill-treatment, and the lack of protection of vulnerable groups.

The ongoing conflict in the east of the country and the illegal annexation of the Crimean peninsula by Russia continue to take a heavy toll on the human rights situation, resulting in grave violations of human rights and international humanitarian law. Referring to the impact of the ongoing conflict, Ukraine has notified of derogations from some of its obligations under the International Covenant on Civil and Political Rights and the European Convention

of Human Rights. A mechanism of periodic independent review of these derogations has been established, but no review has been conducted.

As a result of the conflict, there are approximately 1.6 million internally displaced persons (IDPs), who continue to suffer from socio-economic difficulties and lack of access to certain political and social rights. The EU has called on the Ukrainian government to resume social assistance and pension payments. In 2017, the authorities adopted a long-term integration strategy for IDPs.

The Government has adopted an ambitious and comprehensive National Human Rights Strategy and Action Plan in 2015. It has clear timelines and definition of responsibilities, but its implementation continues to proceed slowly, with only a quarter of the actions implemented within the envisaged timeline. Adequate resources and political will are needed to ensure its implementation.

The investigations into the killings at Maidan and the violent events in Odesa on 2 May 2014 have proceeded very slowly and culprits have still not been brought to justice. The Council of Europe's International Advisory Panel has identified a number of shortcomings in these investigations, which need to be addressed.

Minority rights remain overall protected. The adoption in September 2017 of a framework law on education has sparked concerns by some minorities and their kin-states. These remain to be addressed by taking into account fully the Venice Commission recommendations, in dialogue with representatives of the minorities.

Legislative changes still to be made include a ban on all forms of discrimination, including discrimination based on the grounds of sexual orientation and gender identity, as well as the development of the new Labour Code, keeping the anti-discrimination provisions of the current Labour Code in the new one when adopted, and the new anti-discrimination law.

Gender-based discrimination and domestic violence remain a challenge. The ratification of the Istanbul Convention remains pending. In March 2017, the Vice Prime Minister for European and Euro-Atlantic Integration has been appointed to coordinate the Government's gender equality policies and a post of gender policy commissioner has been created.

EU-Ukraine relations

After almost three years of provisional application of different parts of the AA/DCFTA, it entered into force on 1 September 2017. Effective and swift implementation of the AA/DCFTA provides a clear path for Ukraine's political association and economic integration with the EU.

On 11 June 2017, a visa free regime for short term stays in Europe for Ukrainian citizens holding biometric passports came into force. The First Report under the Visa Suspension Mechanism concluded on Ukraine that overall, the visa liberalisation benchmarks continue to be fulfilled. However, immediate actions need to be taken in order to ensure full implementation and sustainability of past reforms, in particular as regards the anti-corruption benchmark.

Conclusions

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. Ukraine is an open society, where elections are held freely and largely in line with international standards, although Ukrainian authorities should proceed with the reform of the electoral legislation. Media freedom has improved, but further work is needed to strengthen the pluralistic media environment. The most severe human rights violations take place in the

areas not under the control of the Government, following the illegal annexation of the Crimean peninsula and the conflict in the east provoked by Russia's destabilising actions. Ukraine has made considerable reforms of the judiciary and the fight against corruption, but immediate actions are needed to ensure completion, full implementation and irreversibility of these reforms.

The EU remains fully committed to supporting Ukraine in its reform efforts together with other international donors. The envisaged financial assistance should help keep the current reform momentum to the extent that its effective disbursement will be conditional on continued progress with key reforms. In this context, the European External Action Service and the Commission stand ready to provide a further detailed assessment of the situation of democracy, human rights, rule of law and reform in Ukraine throughout the lifecycle of the proposed Macro-Financial Assistance operation, whose political preconditions may be considered as being fulfilled. Delivering on key anti-corruption and governance reforms will be indispensable if the Macro-Financial Assistance operation is to be successfully completed.