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COMMISSION STAFF WORKING DOCUMENT

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

Accompanying the document

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing macro-financial assistance to Ukraine

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

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1.1. Introduction

Following public mass protests, former President Viktor Yanukovych left power and a **reform-minded government was appointed in Ukraine in February 2014**. It embarked on an ambitious macroeconomic adjustment and structural reform programme that aimed to change the country's unviable economic model and pave the way for long-term, sustainable growth. The reform programme was underpinned by a USD 17 billion financial assistance programme by the IMF and significant support from other international donors. On its side, the EU committed to implementing two macro-financial assistance (MFA) programmes of a combined amount of EUR 1.61 billion to alleviate the short-term financing pressures Ukraine was facing, while supporting the reform programme of the authorities in the areas of public finance management and anti-corruption, trade and taxation, energy and financial sector restructuring. In addition to the MFA assistance, the EU put in place a EUR 355 million programme in the form of grants for institution building.

Despite the volatile political calendar in Ukraine, which included the holding of presidential and parliamentary elections within less than six months from each other, **the authorities made significant progress with advancing their reform programme**. Monetary policy and fiscal consolidation steps were accompanied by important structural reforms in the energy and banking sectors. In addition, steps were taken to fight corruption by the introduction of an anti-corruption legislative package and significant amendments to the public procurement legislation.

Following a stalling of reform progress in the period around the parliamentary election in October 2014, the government that took office in December 2014 has committed itself to further resolute reforms, both in the macroeconomic and structural areas. Encouragingly, it has a strong parliamentary majority, which is required for pushing such reforms through. In December 2014, the newly formed government presented an ambitious Action Plan outlining the reform agenda of the coalition government. It is envisaged to be followed up in early 2015 by a comprehensive National Reform Strategy setting out structural reform measures for 2015-17 that are necessary to ensure the medium-term macroeconomic stability of Ukraine and the implementation of the EU-Ukraine Association Agreement. It is expected that this document will cover areas including public finance management and the transparency of the budgetary process; tax administration; management of state-owned enterprises; reform of the judiciary, rule of law and anti-corruption; public administration reform; reforms in the energy and financial sectors; and measures to improve the business and investment environment.

The **reform efforts of the authorities have been seriously complicated, however, due to the eruption of an armed conflict in the East** that took a heavy toll on the domestic economy by destroying part of the country's productive capacity and leading to a confidence crisis. The situation was aggravated by growing trade restriction from Russia, one of the key export markets for Ukraine, and the escalation of a natural gas dispute between the two countries. As a result, the economic recession in Ukraine has become more severe than initially expected by international donors. The crisis is expected to be prolonged, as Ukraine is heading for another year of a contraction in 2015. The loss of export proceeds due to the conflict in the east and the confidence crisis led to a sharp depreciation of the local currency and a depletion of international reserves. In the current situation, Ukraine does not have access to international debt markets and is not expected to regain it in the short term. A significant additional external financing gap has therefore emerged.

Against this background, **additional official financial assistance is required** to address Ukraine's short-term balance of payments needs, including the replenishment of international reserves, and to support the reform programme of the authorities, in particular the restructuring of the energy and banking sectors. Last but not least, this support is required to shore up investor confidence, which is essential for bringing Ukraine's economy eventually back to a sustainable growth path.

In this context, the **Ukrainian authorities requested Macro-Financial Assistance (MFA) from the EU of EUR 2 billion** on 9 September 2014. The request for MFA was reiterated in a further letter of 15 December 2014. Taking into consideration these requests, the economic situation in Ukraine and discussions among Ukraine's major donors about possible additional external financing, **the European Commission is submitting to the European Parliament and the Council a proposal to grant Ukraine MFA of EUR 1.8 billion in the form of medium-term loans to be disbursed in three instalments**. The proposed MFA will help Ukraine cover part of its residual additional external financing needs in 2015 and early 2016 in the context of the on-going IMF programme. These additional needs are estimated at USD 15 billion. The EU's assistance will also 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 (MoU).

1.2. Ukraine's macro-economic situation

Ukraine is experiencing a deep recession that is the result of long-standing economic and structural problems. The situation is aggravated by the armed conflict in the eastern part of the country that not only destroyed part of Ukraine's productive capacity but also had significant confidence impact for households and businesses. In recent months, the implementation of much-needed stabilisation policies, aimed at reducing imbalances and safeguarding fiscal and external sustainability, have further weighed on short-term economic prospects. As a result, **GDP is expected to contract by 7% in real terms in 2014**.

The drop of the real GDP in 2014 is the result of a significant decline in investment activity and reduced household expenditure. Household consumption, which was still expanding in the first quarter of 2014 as a result of the delayed impact from the expansionary income policies implemented by former President Yanukovych, started gradually contracting with the steep weakening of the hryvnia and the negative spillover effects from the uncertain geopolitical situation. At the same time, export performance, despite benefiting from the weaker currency and the trade preference provided by the EU, was hurt by disruptions of the production chain and growing trade tensions with Russia. On the supply side, there was a broad-based decline in 2014, with the exception of agriculture, which benefited from yet another strong harvest. The biggest slump was recorded in industry and construction, which were the worst-performing sectors in 2013 as well. The ongoing weakening of industrial activity reflects primarily the impact for the economy of the armed conflict in the East, the major industrial hub of the country that accounted for nearly a quarter of industrial production in 2013.

Looking ahead, **Ukraine's economy seems to be heading for another year of recession in 2015** due to depressed household consumption (reflecting low confidence, erosion of purchasing power owing to currency depreciation and concomitant inflation, and weak credit activity), tight fiscal and monetary policies (required to address the on-going macroeconomic imbalances) and weak investment activity (due to the unstable geopolitical situation). Export performance, although benefiting from the depreciation of the hryvnia, is likely to be constrained by the on-going trade tensions with Russia and the serious damage to industrial exports as a result of the armed conflict in the East. In view of the above-mentioned factors, the Ministry of Finance and the National Bank of Ukraine revealed in November 2014 their forecast for GDP contraction of 4.3-4.5% in 2015.

The **economic outlook is clouded by downside risks** reflecting a possible intensification of armed activities in the East and uncertainty over natural gas deliveries by Russia[1] and over the extent of restrictive trade measures by Russia following the signature of the Association Agreement (AA) and the Deep and Comprehensive Free Trade Area (DCFTA) agreement with the EU in March and June.[2] An additional risk could arise from an unfavourable judgement of the international arbitration court in Stockholm on Russia's claim for gas arrears by Ukraine.[3] The sharp contraction of the Russian economy including as a result of the fall in oil prices in the final months of 2014 and the economic sanctions by the EU and the US against the country, as well as the still weak economic activity in the EU pose additional challenges to the possible economic recovery of Ukraine in view of the country's strong exposure to these neighbours via trade and financial channels.

Despite the strong economic contraction and the conservative central bank policies, **inflationary pressures remain high**, reflecting the currency weakening and an adjustment of administered prices (in particular of utility tariffs). CPI inflation accelerated to 21.8% year-on-year in November and is expected to pick up further in the near future as the effect of the currency depreciation fully kicks in. The **hryvnia has lost close to 50% of its value against the USD** since its floatation in February, well above initial expectations. The weakening was particularly strong in August and September, forcing the central bank to introduce a number of administrative measures and currency controls, in addition to undertaking some foreign exchange market interventions, which succeeded in bringing temporary stability to the exchange rate ahead of the October parliamentary elections. At the same time, these measures negatively impacted business activity and led to a fast depletion of the already low international reserves. Following a slight relaxation of the administrative controls, the currency has depreciated strongly as from November.

Weak economic activity, coupled with higher interest outlays on foreign currency denominated debt in light of strong currency depreciation, as well as and sizable losses of tax collection in the eastern parts of the country, led to **widening of the budget deficit** in 2014 despite a number of austerity measures introduced by the authorities.[4] The fiscal deficit rose by 31% on the year in January-October to UAH 54 billion, or 3.5% of the projected GDP for the year. On the revenue side, a sharp decline in corporate tax revenues was offset by tax

1 A short-term gas deal, until March 2015, was reached by Russia and Ukraine on 30 October. A longer-term solution has yet to be negotiated.

2 Russia has introduced a number of barriers to Ukraine's imports and pledged to abolish the preferential CIS FTA regime for the country if the DCFTA enters into force. Due to the tense trade relations between the two countries, Ukraine's exports to Russia dropped to 19% of the total in Q1-Q3 2014 from 24% in 2013.

3 Russia has demanded USD 4.5 billion from Ukraine for unsettled gas deliveries implemented until mid-2014. Ukraine contests the price and evaluated its liabilities at USD 3.1 billion. As part of the October deal, Ukraine committed to clear USD 3.1 billion of gas arrears to Russia.

4 The authorities have twice revised the budget (in March and in July) in an attempt to rein in the high fiscal deficit.

increases, in particular excise duties and fees for extraction of mineral resources. Furthermore, an additional 1.5% tax on personal income was introduced as of September to finance security spending. In the meantime, expenditure growth was driven by higher interest outlays on foreign liabilities due to currency weakening and increased transfers to local authorities for repayments of their arrears. Security spending also rose sharply, by 60% year-on-year in January-October, and thus contributed to the widening fiscal deficit. In order to rein in expenditure, the authorities implemented significant cuts in other main expenditure items such as public administration, education and healthcare. According to recent forecasts of the Ministry of Finance, the government fiscal deficit will rise to 5.3% of GDP for 2014 as a whole.

A major additional drag on public finances in 2014 came from the ailing oil and gas company **Naftogaz**. This company traditionally runs sizable operational deficits due to the administrative cap on natural gas prices for households and municipal utility companies, which forces Naftogaz to sell at below-cost rates, and general operational inefficiency. In 2014, the company's activities were negatively affected by the strong depreciation of the hryvnia and the need to cover gas arrears to Russia (including ones accumulated in 2013). As a result, the state had to inject UAH 103bn into Naftogaz by November, an amount representing 6.8% of projected GDP. Thus, **the overall fiscal deficit run by Ukraine in 2014, which includes the deficit of Naftogaz, is projected at nearly 12% of GDP**, up from 6.7% in 2013 and compared to 8.5% forecast by the IMF in April 2014.

The widening budget deficit and the sharp depreciation of the local currency, coupled with a significant economic contraction, led to a **sharp deterioration of Ukraine's public debt metrics**. The general government public debt increased by 62% (in nominal local currency terms) in the first ten months of the year to UAH 945 billion (USD 73 billion) at the end of October. The figure corresponds to 63% of the projected GDP for 2014 and represents an increase of almost 23 percentage points from the end-2013 debt of 40.2% of GDP. In view of the sharp depreciation of the local currency in November and disbursements of EUR 760 million in financial support loans under the EU MFA programme in November and December 2014, as well as capital injections in state-owned enterprises, Ukraine's public debt is likely to near 70% of GDP at the end of 2014. A further increase must be expected in 2015 on the back of continued economic contraction and significant official external financing expected in the year, which comes almost entirely in the forms of loans. The planned recapitalisation of state-owned financial institutions will also contribute to the increase of the public debt in 2015.

On the external side, the depreciation of the hryvnia, coupled with weak domestic demand, has contributed to a **significant adjustment of the current account**. The deficit is expected to narrow to around 4% of the GDP in 2014 from 9.0% in 2013, although this is primarily due to strong import compression.[5] However, this was accompanied by **sizeable private-sector financial outflows due to dwindling confidence** in an environment of high geopolitical uncertainty.[6] The official financing extended as from May 2014 was insufficient to offset the capital flight. Overall, Ukraine received around USD 9 billion in gross official financing in May-December, a large part of which was used to cover maturing debt (see IMF support and other donor assistance up to 2014).

[5] In January-October, imports of goods plummeted by 26.2% year-on-year, well outpacing the 10.8% decline of exports.

[6] The net outflow from the financial account amounted to USD 4.8 billion in January-October 2014. Withdrawals of bank deposits by non-residents were the main factor behind the capital outflow. Both FDI and portfolio investments also recorded outflows in the period, although of a smaller size.

In the context of a deepening economic recession and a confidence crisis, the **substantial official financial assistance provided to Ukraine in 2014 was insufficient to stop the continuous drain on reserves**. In the first eleven months of the year, reserves halved from their end-2013 level to only USD 10 billion. A further significant drop is expected in December as a result of payments for gas (including arrears to Russia). As a result, Ukraine's gross international reserves are now expected to drop to USD 7 billion at the end of 2014, or around one month of 2015 projected imports of goods and services.

1.3. IMF and other donor support

The government's ambitious economic adjustment and structural reform programme has been supported by the IMF and other IFIs (namely the World Bank and the EBRD), as well as the EU and other bilateral partners. On 30 April 2014, the Executive Board of the IMF approved a two-year Stand-By Arrangement (SBA) for Ukraine amounting to SDR 10.976 (USD 17 billion, or 800% of the country's quota).

The IMF programme is focused on reforms in the following key areas: monetary and exchange rate policies; financial sector; fiscal policies; energy sector; and governance, transparency, and the business climate. In the area of monetary policy, the focus is on ensuring price stability while maintaining a flexible exchange rate regime. Financial sector reforms aim at maintaining confidence in the system and strengthening financial regulation and supervision. This is ensured by the implementation of diagnostic tests to assess the strength of the major domestic lenders and their recapitalisation needs. The main objective of the policy measures in the area of fiscal policy is the gradual reduction of the budget deficit, in particular by streamlining public expenditures.[7] Fiscal sustainability should also be ensured by comprehensive reforms of the energy sector, in particular restructuring Naftogaz and gradually raising energy tariffs to cost-recovery levels. Finally, reforms to strengthen governance and transparency in order to improve the business climate consist of capacity building to reform public procurement and tax administration, measures to strengthen anti-money laundering activities and to fight corruption.

Along with the approval of the SBA in April, the IMF made a **first disbursement of USD 3.2 billion**. On 29 August, the Board approved the first mission review and made available almost **USD 1.4 billion**. The completion of the first review was delayed (originally approval was planned for July) due to a longer-than-planned review mission and the summer recess. Out of the USD 4.6 billion provided by the IMF, USD 3 billion were directed to the budget.

In order to accommodate the delay in its programme schedule, and following a request by the Ukrainian authorities, the Fund decided to re-phase the SBA. Thus, the second and the third programme reviews, initially planned for end-August and end-October 2014, were merged into one single programme review to be conducted in November, with a view to combining the two subsequent tranches (USD 2.7bn in total) in one single payment, in principle in December. However, in view of the early parliamentary elections on 26 October, the IMF's second review was postponed to December and has since been extended to January, meaning that the possible approval of the **disbursement of the next tranche could be expected in late January 2015 at the earliest**.

The IMF's USD 17 billion financial support has been complemented by significant support from other official and bilateral assistance (EU, US, Japan, Canada). Other international

[7] The aim of the Ukrainian authorities is to reduce the fiscal deficit to 3% of GDP in 2016.

financial institutions such as the World Bank, the EBRD and the EIB have also significantly scaled up their activity to support Ukraine's economic transition.

The EU provided EUR 1.6 billion (USD 2.1 billion) in emergency support to Ukraine in 2014, becoming the biggest net contributor in the year.[8] The majority of this financing, EUR 1.36 billion, was disbursed from the Macro-Financial Assistance (MFA) facility in the form of long-term loans (with maturity of 10 or 15 years) on very favourable terms. Another EUR 250 million was provided in the form of grants for budget support under the State Building Contract that aims to strengthen the institutions in Ukraine.

The **World Bank provided USD 1.25 billion** under two policy loans – a USD 750 million Development Policy Loan (DPL) that focuses on implementing reforms in the public sector, the business environment and the subsidy system and a USD 500 million Financial Sector DPL that aims at supporting the restructuring of the banking sector. The World Bank is expected soon to approve a second DPL in the amount of USD 500 million. The approval of the loan was initially expected by the end of 2014 but was delayed due to the unforeseen parliamentary elections and the slow formation of a new government. Finally, the World Bank has committed to more than USD 1 billion in project financing, namely under three projects that aim to improve energy efficiency, support infrastructure and modernise the social safety net. However, being project-related, this financing will likely take longer to be disbursed.

The **US provided a bond guarantee to Ukraine**, which enabled the authorities to raise USD 1 billion from external debt markets in May. Bilateral assistance, although of a much smaller scale, was provided by Canada (USD 180 million) and Japan (USD 100 million).

Finally, as part of the international support for the economic recovery of Ukraine, there was a **substantial increase in project financing provided by the EBRD and EIB**. This increase relates mainly to commitments for projects, though the growth of actual disbursements was limited due to the medium to long-term nature of such financing as well as the relatively slow and not sufficiently efficient administrative process, including parliamentary ratification, on the Ukrainian side. Specifically, the EBRD and the EIB signed new projects of approximately EUR 1 billion each in the course of 2014. This represents a substantial increase from the traditional business volume of the two lenders to the country.

1.4. Ukraine's external financing needs

At the time of the launch of its programme, the **IMF estimated Ukraine's gross external financing needs at almost USD 27 billion over the course of the SBA** (Q2 2014–Q1 2016). They were attributed to still substantial current account deficits, large external debt obligations of both public and private sector and the need to replenish reserves. The Fund's committed net financing (i.e. taking into account Ukraine's repayments to the IMF of debts stemming from an earlier IMF programme) over the course of the programme amounted to USD 11.9bn, or 44% of the identified external financing needs. Other IFIs and bilaterals contributed to filling the residual financing gap.[9]

[8] Even though the IMF was the principal provider of financial assistance in gross terms, a large part of this support was directed to repayment of loans previously extended by the Fund. These repayments amounted to USD 3.7 billion in 2014, meaning that the net inflow was USD 0.9 billion in the year.

[9] The bilateral contributions include Ukraine's borrowing from international debt markets using official bilateral guarantees (such as the US guarantee provided to Ukraine in May 2014); while appearing as normal portfolio investment in the balance of payments, this borrowing effectively contributes to satisfying the identified residual financing need.

In August, with the approval of its first programme review, the IMF stated that the programme was adequately financed. It also identified a shortfall of USD 3.5 billion (USD 1.1 billion on 2014 and USD 2.5 billion in 2015) resulting from revisions in projections for the speed of project implementation and accompanying financing. However, the IMF expected at the time that USD 2 billion in bond issues would cover a large part of this gap, while official donors would come up with an additional USD 0.9bn of support. At that time, the **IMF also presented a negative scenario for Ukraine's economy** that envisaged a prolonged armed conflict in the East and an associated confidence crisis. Under this scenario, Ukraine's GDP was projected to contract by 7.3% in 2014 and another 4.2% in 2015, while the additional external financing needs would reach USD 19 billion.

This negative scenario has now largely materialised. In the absence of a sustainable resolution to the conflict in the East, and in view of Russia's obstructive trade policy,[10] Ukraine has witnessed a confidence crisis. This crisis has resulted in a higher capital outflow[11] than initially projected and a much sharper currency depreciation, which prompted foreign exchange market interventions by the central bank despite a low level of international reserves. Private investments plummeted from already low levels, while the limited fiscal space of the government meant no state response was possible to offset the negative trends in the real sector. In view of the above-mentioned developments, Ukraine's gross international reserves are expected to drop to only USD 7 billion at the end of 2014 (from USD 20.6 billion a year earlier), which translates into one month of imports.

The urgent need to rebuild reserves to viable levels that would instil enough credibility in the local currency and thus in Ukraine's ability to service its debt has resulted in a significant increase of the external financing needs in the short-term. According to **preliminary estimates, these extra needs total USD 15 billion until Q1 2016** (see table below). Apart from the need to replenish reserves, ongoing capital outflows reflecting weak confidence also contribute to the additional financing gap. The current account adjustment, while significant, is also now believed to be somewhat slower than initially expected. This is primarily due to the strong reduction of export proceeds following the loss of productive capacity in the East and the imposition of trade barriers by Russia. These two factors counteract the positive impact for exporters from the weaker currency and the trade preferences provided to Ukraine by the EU.

This estimated USD 15 billion of additional financing needed by Q1 2016 comes on top of the financing gap initially estimated by the IMF. **The fresh financial assistance needed to fill the additional financing gap would ensure primarily a significant build-up of reserves**, while indirectly also enabling continued imports of essential goods, notably purchases of gas from Russia and EU Member States. This would act as a catalyst for the return of private inflows and thus supporting the uninterrupted servicing by Ukraine of its international liabilities. Indeed, in 2015, the sovereign will face another year of sizable foreign exchange debt repayments of close to USD 10 billion. The biggest part of these repayments falls into Q4 2015, when Ukraine has to redeem a USD 3 billion Eurobond held by Russia. It should be noted that a possible rollover of this bond could provide an important short-term relief to Ukraine's balance of payments.

[10] In 2014, Russia occasionally imposed bans on various imports from Ukraine, claiming that Ukrainian products did not meet Russia's technical and phyto-sanitary norms.

[11] Capital outflows reached USD 4.4 billion in January-October 2014 compared to inflows of USD 14.7 billion in the same period in the previous year. As a result, the balance of payments recorded a deficit of USD 8.5 billion in the 10 months compared to a USD 1.1 billion surplus in the corresponding period a year earlier.

The proposed MFA programme of EUR 1.8 billion would cover around 15% of the estimated total additional external financing needs faced by Ukraine in 2015–Q1 2016. This proposal is exceptionally large not only in nominal terms (it would be the largest-ever MFA operation by a wide margin) but also in terms of coverage.[12] However, this exceptionally high coverage can be justified by: the political importance of Ukraine for the stability in the European Neighbourhood; the political integration of the country with the EU as reflected by the Association Agreement between the two sides that provisionally entered into force on 1 November 2014; as well as the exceptionally challenging situation and correspondingly large financing needs that this EU neighbour is currently facing.

1.5. Ukraine's structural reform challenges

Ukraine has been lagging significantly behind its regional peers with the implementation of structural reforms. Slow progress on this front was a major factor for the absence of growth in 2012 and 2013. After former President Yanukovych left power, **the newly appointed government announced a very ambitious and comprehensive structural reform agenda**. This programme was supported by the IMF through its two-year SBA and other multilateral and bilateral partners. The core of the structural reform agenda were the energy and banking sectors, areas that have been important contributors for the accumulation of imbalances over the preceding years and in particular for the overall weak fiscal position of the state. The authorities also committed to undertake measures to address long-standing problems to the business climate in the country such as widespread corruption, a high regulatory burden and an inefficient public administration.

With the macroeconomic crisis turning deeper than expected and the conflict in the East, **the authorities did not manage to push through their entire structural reform agenda in 2014**. The political calendar, which included presidential elections in May and early parliamentary elections in October, also impacted negatively on the progress with the policy reform programme.

Despite these impediments, important steps were made in addressing long-standing problems in the areas of energy, banking sector restructuring, public finance management and the fight against corruption. These reforms were underpinned by the financial support programmes Ukraine entered with the IMF, the World Bank and the EU.

In the **energy sector**, the authorities started to gradually increase gas tariffs with the objective to bring prices closer to cost-recovery levels[13] and thus gradually scale down the generous subsidies the state provides through the state-owned company Naftogaz. The heavily subsidised gas prices for households and municipal heating utilities not only result in a sizable fiscal drag for the budget but also give a rise to numerous corruption practices.[14] Along with the price adjustment, the authorities strengthened the social safety net in order to cushion the

[12] For comparison, recent MFA operations for ENP countries have covered on average 6.6% of the total financing gap (unweighted average of nine MFA decisions over the period 2009-2014).

[13] In line with the IMF programme, the Ukrainian authorities raised retail gas tariffs by 56% on average from 1 May 2014 and increased retail heating tariffs by 40% from 1 July 2014. However, the impact of these increases was eroded by the stronger-than-expected depreciation of the local currency in 2014. Thus, a more ambitious price adjustment programme than the one agreed with the IMF in the spring of 2014 may be needed in the future to bring residential gas prices closer to their cost-levels and thus reduce the deficit that Naftogaz is running.

[14] In 2009-2013, the operating deficit of Naftogaz amounted to 1.7% annually on average. In 2014, it is estimated to have worsened to more than 6% of GDP and thus becoming the main factor behind Ukraine's double-digit overall fiscal deficit in that year.

most vulnerable households at least partially against retail energy price increases. Notably, on 1 July 2014, a new targeted social security scheme became operational. Important measures were also introduced to improve collection rates of Naftogaz - special purpose accounts were introduced in July 2014 for the centralised collection of gas settlements from municipal utilities. These mandatory accounts will distribute the proceeds from the gas settlements between the entities producing, transporting and supplying the gas, which should ensure that Naftogaz automatically receives its dues. In another step to improve collection of current and past bills, the government decided in August 2014 to establish an interagency working group for the collection of debts of natural gas consumers and the improvement of the financial state of Naftogaz. Last but not least, the authorities had launched the process of restructuring the state-owned gas conglomerate, in particular by allowing for the unbundling of the company by the establishment of two separate entities to deal with storage and transit of natural gas.

The **banking sector** is undergoing a comprehensive restructuring whose main objective is to streamline the system by eliminating unviable banks from the market and set a stronger regulatory framework for banking activity. The reforms that were implemented by the central bank in 2014 included, among others, steps to clean-up the banking sector from insolvent, measures for recapitalisation of the banking sector, strengthening of the operational and financial capacity of the Deposit Guarantee Fund (DGF), and disclosure of the banks' ultimate beneficial owners. As a result of these measures, the National Bank of Ukraine put more than 30 commercial banks into receivership in 2014 (out of 180 operational at the end of 2013). It also carried out stress tests to identify the recapitalisation needs of the 35 biggest lenders accounting for 82% of total assets. Furthermore, bank resolution practices were improved with the technical assistance provided by the IMF, the World Bank, the EBRD and the US Treasury. In order to improve transparency in the sector, measures were launched to introduce strict requirements of ultimate beneficial owners' disclosure for the 26 banks with the least transparent ownership structure.

The ambitious reform agenda in the energy and banking sectors has been important for an improvement in Ukraine’s medium- to long-term prospects. However, the reforms have so far failed to yield the hoped-for positive results in the short term, given a much worse macroeconomic environment than initially expected. For example, the sharp depreciation of the local currency more than offset the impact from the increases of energy tariffs on Naftogaz’ operating deficit, which widened further in 2014. Furthermore, collection rates were negatively impacted by the weakening economic activity and the armed conflict in the eastern parts, where Naftogaz retained its operations but could not collect its receivables.[15] The weakening of the currency also resulted in a rapid deterioration of the banks’ credit portfolio. Moreover, banks were affected by the forced suspension of their activities in the separatist-controlled areas and the inability to collect their claims in these parts.

Reform drive was more limited in the area of public finance management (PFM), where the biggest achievement was the amendment to the procurement legislation in April 2014, which led to a reduction of the procedures that are exempted from competitive bidding and an extension of the definition of procuring entities that allowed for a wider coverage of state-owned enterprises. Furthermore, publication requirements regarding public procurements had been substantially widened and improved, thus increasing transparency.

[15] In order to address the dire financial situation at Naftogaz, in November 2014 the government obliged almost 170 of the biggest industrial consumers to purchase natural gas from the state-owned company. This, de-facto monopolisation of the market was strongly criticised by the private gas companies operating in Ukraine. Following their appeal, the Kyiv Administrative Court overturned the relevant government resolution.

Among the challenges in the area of PFM that have yet to be tackled by the authorities are low budget transparency, weak forecasting and budgetary planning, high tax evasion and corruption in the area of tax administration. The country lacks a public debt management strategy and has to strengthen significantly the institutional and analytical framework for quasi-fiscal operations in order to improve transparency and reduce corruption in state-owned enterprises. Even though the institutional set-up for internal auditing is gradually being strengthened, constraints are arising due to budgetary limitations. The institute of external auditing remains underdeveloped due to the lack of a proper legislative framework.[16]

In the area of **tax administration**, partial progress was achieved in the settlement of VAT refund claims as the share of automatic refunds increased considerably over the course of 2014. However, accumulation of arrears continued, in part as a result of the difficult fiscal situation, negatively impacting on the business climate. Legislative changes that envisage the introduction of electronic VAT accounts as of January 2015 have been strongly contested by businesses, which is likely to lead to a postponement of their introduction. The government that took office in early December 2014 pledged a major overhaul of the tax system to improve the competitiveness of the economy. As a result, the number of taxes will be reduced to 9 from 22 at present. However, details about the fiscal impact of these cuts and the overall reform of the tax system have so far remained insufficient.

The tax reform is an important element of the **government reform programme that was approved by parliament on 11 December** and is underpinned by the coalition agreement among the ruling parties finalised in November. The programme also aims at streamlining the state sector by significantly reducing public spending; reducing the shadow economy; improving public finance management and encouraging competition. If implemented, these measures could be expected to lead to a significant improvement in the business environment in the country, which at the current stage is not propitious for investment activity.[17] In a context of high security concerns and domestic political volatility, privatisation came to a halt in 2014.

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, heightened security risks, and the economic and political developments in the region.

- Alleviating Ukraine's budgetary financing needs.

[16] The activities of the Accounting Chamber of Ukraine (ACU) are regulated by legislation introduced in 1996. In line with the MFA-related programme policy agreed with the EU, the government submitted a draft proposal to parliament in October 2014 that should have updated and improved the framework for the ACU, including by extending its remit to cover state-owned enterprises. However, this proposal was withdrawn from the parliamentary agenda as the new parliament convened after the election.

[17] According to the most recent global report of the World Bank on the ease of doing business, Ukraine ranks 96th, well behind its regional peers from the Eastern neighbourhood. Ukraine scores particularly poorly in access to electricity (185th out of 189); trade across borders (154th) and resolving insolvency (142nd).

- Support the fiscal consolidation effort and external stabilisation in the context of the IMF programme.

- Facilitate and encourage efforts of the authorities of Ukraine to implement measures identified under the EU-Ukraine Association Agreement, while reinforcing the EU's economic policy dialogue with the authorities.

- Support structural reform efforts aimed at improving the overall macroeconomic management, strenghening economic governance and transparency, and improving conditions for sustainable growth.

2.2. 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 to be negotiated between the Commission and the Ukrainian authorities. Conditions will include structural measures relevant for ensuring macroeconomic stability, e.g. in the areas of public finance management and anti-corruption; tax administration; reforms in the energy sector, including strengthening the social safety net to ensure targeted cushioning of the ongoing withdrawal of retail energy price subsidies; financial sector reforms; and measures to improve the business environment.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

The proposed new MFA would amount to EUR 1.8 billion. Regarding the form of the assistance, the Commission proposes to disburse the full amount in the form of medium-term loans. This 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 3,960 in 2013[18] is the third highest among the six countries of the Eastern Partnership, behind Azerbaijan and Belarus. For comparison, Tunisia, a country for which the Parliament and the Council adopted an MFA operation of up to EUR 300 million in loans in May 2014, had a GNI per capita of USD 4,360 in 2013. An MFA loan of EUR 180 million to Jordan (with a GNI per capita of USD 4,380) was approved in December 2013. 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**.

[18] 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 mid-year population.

MFA is an untied and undesignated macroeconomic support instrument, 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 macro-financial assistance, which is not dedicated to specific expenses, 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 bank and the Ministry of Finance and the appropriateness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures have been and will be taken. First, the Commission services, with the support of duly mandated external experts, carried out an Operational Assessment of the financial circuits and administrative procedures at the Ministry of Finance and the National Bank of Ukraine in April 2014, in order to fulfil the requirements of the Financial Regulation applicable to the General Budget of the European Communities. This review covered 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. It determined that the framework for sound financial management of macro-financial assistance is sufficiently effective in Ukraine for the EU to provide this support. Also, the assistance will be paid to a dedicated account at the National Bank of Ukraine. Second, the proposed legal basis for macro-financial assistance to Ukraine includes a provision on fraud prevention measures. These measures will be elaborated further in the Memorandum of Understanding and the Loan Agreement, envisaging 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. Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including 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.

Finally, there are risks stemming from a possible weakening of the European and global economic environment.

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.

4. ADDED VALUE OF EU INVOLVEMENT

The Community 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 European Commission's package of assistance for the economic transformation of Ukraine, it will contribute to support the European Union's objectives of economic stability and economic development in Ukraine and, more broadly, in the eastern European neighbourhood.

By helping the authorities' efforts to establish a stable macroeconomic framework and implement an ambitious structural reform programme, the proposed assistance will help improve the effectiveness of other EU financial assistance to the country, including budgetary support operations such as the State Building Contract.

By helping the country overcome the economic difficulties caused by the economic transition and the deteriorating security situation in the eastern parts of the country that had a strong negative impact on confidence, the proposed MFA will contribute to promoting macroeconomic stability and political progress in the country.

By complementing the resources made available by the international financial institutions, bilateral donors and other EU financial institutions, it will contribute to the overall effectiveness of the package of financial support agreed by the international donor community in the spring of 2014.

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 recently signed Association Agreement and Deep and Comprehensive Free Trade Area agreement. 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 like Ukraine, embarking on a clear path towards economic and political reforms, in moments of economic difficulties.

5. CHARACTERISTICS OF MACRO-FINANCIAL ASSISTANCE

5.1. Exceptional Character and Limited Timeframe

The MFA proposal will be exceptional, aiming to support the restoration of a sustainable external finance situation of Ukraine. It will be linked to an IMF arrangement (currently the SBA from April 2014) and, in principle, should not exceed the timeframe of this arrangement. Against this background and given the expected time of approval of the programme by the co-legislators, the assistance is expected to be implemented in 2015–Q1 2016. The disbursement of the first tranche could take place in the middle of 2015 provided that the IMF programme remains on track and provided a swift ratification of the MoU by the Ukrainian side. The second instalment, conditional on a number of policy measures, could be disbursed in the fourth quarter of 2015. The third and last instalment could be made available, provided the policy measures are met, towards the end of the first quarter of 2016. While in the short term the country faces substantial balance of payments financing needs, the macroeconomic and structural adjustment programme agreed with the IMF and supported by the proposed MFA is expected to produce a gradual strengthening of the balance of payments and fiscal positions.

5.2. Political preconditions and EU-Ukraine relations

As a country covered by the European Neighbourhood Policy (ENP), Ukraine is eligible for MFA. It is a pre-condition for granting MFA that the country respects effective democratic mechanisms, including a multi-party parliamentary system and the rule of law and guarantees respect for human rights.

Following mass public protests, former President Viktor Yanukovych left power in February 2014 and Ukraine held democratic presidential and parliamentary elections (on 25 May and 26 October, respectively), which were largely in compliance with its international commitments according to the OSCE ODIHR. The reinstatement of the 2004 has improved checks and balances among the branches of power.

Since the spring of 2014 Ukraine has shown engagement in improving the independence and the functioning of its justice system by taking some of the long-awaited steps such as the adoption of the law on the Prosecutor General's Office, now awaiting implementation. The reform of the security sector is also high on the agenda and is supported by the EU Advisory Mission to Ukraine. Important legislative amendments were adopted to combat corruption, proving Ukraine's commitment to strengthen the rule of law.

While the human rights situation has deteriorated gravely in the territories under the control of the separatists in Donbas and in the illegally annexed Crimea as per reports of the Office of the High Commissioner for Human Rights of the United Nations, human rights in the rest of Ukraine have largely been respected since spring 2014. In addition, a comprehensive legislative framework in the human rights field is expected to be developed, with notably a human rights strategy listing necessary legislative amendments to be submitted by the Cabinet of Ministers. Investigations into the human rights abuses at Maidan and into the tragic events in Odesa on 2 May are assisted by the Council of Europe's Investigation Advisory Panel.

EU-Ukraine relations: Since 1991, when Ukraine gained independence, the EU and Ukraine have developed an increasingly dynamic relationship. Ukraine is a priority partner country within the European Neighbourhood Policy and the Eastern Partnership. The ambitions of both the EU and Ukraine to enhance their relationship created an opportunity to move beyond cooperation towards gradual economic integration and deepening political association.

As a result, the two sides signed an Association Agreement on 21 March 2014, which includes an agreement for the establishment of a so-called Deep and Comprehensive Free Trade Area (DCFTA), signed on 27 June 2014. After the 12 September trilateral meeting on the Association Agreement, at the request of Ukraine, the European Union agreed to delay the provisional application of the DCFTA until 31 December 2015. Provisional application of remaining relevant parts of the AA started on 1 November following ratification by the Ukrainian Parliament and the consent given by the European Parliament on 16 September 2014.

In the meantime, Ukrainian exporters can benefit from autonomous trade preferences that were first granted by the EU in April 2014 until end-October 2014 and later extended until the end of 2015. In view of these measures, and as a result of a decrease in trade between Ukraine and the Russian Federation, the EU has become Ukraine's major trade partner in 2014. On 15 December, the European Union and Ukraine held the first meeting of the Association Council, which launched the institutional framework of enhanced cooperation.

The EU is also an important source of assistance to the reform process in Ukraine, including through the Support Group for Ukraine. On 11 March, the Commission adopted an unprecedented support package to Ukraine worth EUR 11 billion for the next few years. With the help of the newly created Support Group for Ukraine, the implementation of this support package is under way. As of 15 December, the European Union has disbursed more than EUR 1.6 billion in loans and grants to the state budget to support the financial, economic and political stabilisation of the country.

In sum, Ukraine is facing a dramatic situation with the illegal annexation of Crimea/Sevastopol and the conflict in Eastern Ukraine due to the activities by illegal armed groups. In the meantime, the internal political situation is stabilising and Ukraine has taken first steps in the reform process. Ukraine conducted largely free and fair presidential and parliamentary elections, took steps to improve the rule of law and largely respected human rights. Further improvements of the situation are expected to happen in the following months in view of the declared political engagement of Ukraine's authorities in continuing the reform process (Association Agreement, coalition agreement, Government Action Plan). In this context, the political preconditions for macro-financial assistance may be considered to be sufficiently fulfilled at this stage, while a continued monitoring of the situation will have to take place. 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.

5.3. Complementarity

The proposed MFA would complement the assistance provided by other multilateral and bilateral donors in the context of the IMF-sponsored economic programme. The EU's MFA would also complement other EU aid packages mobilised under the European Neighbourhood Instrument, and in particular the policy measures envisaged under the State Building Contract for Ukraine, which was signed in May 2014. 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 overall intervention including through other financial instruments.

5.4. Conditionality

As it is normally the case with MFA, the disbursements would be conditional on successful reviews under the IMF programme and the continued drawing by Ukraine on IMF funds. In addition, the Commission and the Ukrainian authorities would agree on a specific set of structural reform measures, to be defined in a Memorandum of Understanding. These measures will support the authorities' reform agenda and implementation of the EU-Ukraine Association Agreement, as well as complementing the programmes agreed with the IMF, the World Bank and other multilateral and bilateral donors.

The European Commission will seek a broad consensus with the Ukrainian authorities, so as to ensure a smooth implementation of the agreed conditionality. These policy conditions should address some of the fundamental weaknesses accumulated over the years by the Ukrainian economy. Possible areas of conditionality could in principle include: public finance management and anti-corruption; tax administration; reforms in the energy sector, including strengthening the social safety net to ensure targeted cushioning of the ongoing withdrawal of retail energy price subsidies; financial sector reforms; and measures to improve the business environment.

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 ("the provisioning of the Guarantee Fund"). Assuming that the first and second loan disbursements will be made in 2015 for a total amount of EUR 1,200 million and the third loan disbursement in 2016 for the amount of EUR 600 million, and according to the rules governing the guarantee fund mechanism, the provisioning will take place in the budgets for 2017 (for EUR 108 million) and 2018 (EUR 54 million). On the basis of the currently available information on the expected overall provisioning needs of the Guarantee Fund, the additional budgetary impact will be partly financed by a reallocation in the indicative financial programming for 2017 and 2018 from macro-financial assistance grants (budget line 01 03 02) and partly by using the unallocated margin for commitments under Heading 4 in the Multi-Annual Financial Framework.

To ascertain that the beneficiary has sound financial management in place, in line with the requirements of the Financial Regulation, the European Commission services undertook an Operational Assessment (OA) of the reliability of the financial circuits and administrative controls at the Ministry of Finance and the National Bank of Ukraine. This OA, prepared by a team of international experts, was finalised in August 2014.

6. 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.

6.1. 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 SBA, 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. In this process, the Commission services will monitor key areas of the public finance management system, including the ones identified in the Operational Assessment from August 2014, so as to have the relevant information on any changes in the control environment. Ahead of the disbursement of the second and third instalments, the authorities will be asked to submit a compliance statement in relation to the policy conditionalities. In addition, under the Memorandum of Understanding monitoring system, the authorities will be required to submit quarterly reports of 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.

6.2. 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.

7. 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 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 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 countries, 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, 19 December 2014

ASSESSMENT OF THE POLITICAL SITUATION 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.*

Mass public protests following which former President Viktor Yanukovych left power in February 2014 led the Parliament to reinstate the 2004 Constitution, which improved checks and balances among the branches of power. Further improvements of the constitution should be developed in an inclusive manner to allow decentralisation, judiciary reform and to clarify the balance of powers between the President and the Government. Ukraine conducted successfully presidential and parliamentary elections (on 25 May and 26 October, respectively), which were largely in compliance with its international commitments according to the OSCE ODIHR. The legislative framework was improved for the Presidential and Parliamentary elections and Ukraine has proven its ability to develop a multi-party democracy, while a comprehensive reform of the electoral legislative framework is still pending. In parallel, the process of decentralisation was launched with the presentation of the "Concept on Local Self-Governance and Territorial Organisation of Power in Ukraine" in April 2014 and of a legislative package to the Parliament. So far, only the law on cooperation of territorial communities received in June 2014 the necessary support of the Parliament.

Since the spring of 2014 Ukraine has demonstrated engagement in improving the independence and the functioning of its judiciary by taking some long-awaited steps, such as the final adoption of the law on the Prosecutor General's Office in October 2014, largely taking into account recommendations of the Venice Commission of the Council of Europe. To eliminate the risk of selective justice, a law on "The restoration of Trust in the Judiciary" was adopted by the Parliament in April 2014, changing the undue administrative subordination of judges to court presidents and making court presidents and judges independent from the political authorities. Laws on the role of the High Council of Justice, the judicial system and the status of judges are awaited as well as constitutional amendments enabling the independence of judges. While the implementation of the new Criminal Procedure Code continued to improve the treatment of detainees and prisoners, the establishment of a State Bureau of Investigations is still awaited. The reform of the civilian security sector is also high on the political agenda and concrete proposals (strategy, amending laws) are under consideration with the support of the EU Advisory Mission to Ukraine (a CSDP mission officially launched on 1 December 2014). Extraordinary powers were given to law-enforcement bodies by the Parliament in connection with the anti-terrorist operation in the East, including provisions regarding the investigation of crimes committed in the area of the anti-terrorist operation. The fight against corruption also intensified, and two anti-corruption legislative packages were adopted in May and October 2014 as well as a new law on public procurement. As a consequence, the ranking of Ukraine in the Transparency International Corruption Perception Index 2014 improved (142 compared to 175 in 2013). Progress is expected in 2015 with the implementation of these laws and notably with the establishment of the National Agency for Preventing Corruption and the National Anti-Corruption Bureau. Important steps were taken by Ukrainian authorities in 2014 to strengthen the rule of law, which should be continued in 2015.

The respect for human rights and fundamental freedoms in the parts of Ukraine under the control of the Government has improved since February 2014 compared to 2013. A comprehensive legislative framework in the human rights field is expected to be developed. Investigations into the human rights abuses at Maidan and into the tragic events in Odesa on 2 May are carried out with the support of the Council of Europe's Investigation Advisory Panel. Freedom of Assembly was well respected since the cancellation of the restrictive legislation introduced mid-January 2014. Freedom of expression and media has substantially improved since February 2014, notably with the adoption of the law on Public Broadcasting aiming at transforming the state broadcasting service into an independent public service. Amendments were made to the anti-discrimination law in May 2014 and a ruling of the Highest Specialised Court on Civil and Criminal Cases was issued in May confirming that sexual orientation is implicitly considered in the existing legislation, and discrimination on grounds of sexual orientation therefore prohibited. The President vetoed the revocation of the 2012 language law. Since 2014, human rights in Ukraine have largely been respected notably compared with 2013. Further progress is still awaited, notably of Internally Displaced Persons.

In 2014, Ukraine faced a dramatic situation with the illegal annexation of Crimea/Sebastopol by the Russian Federation and the conflict in Eastern Ukraine due to the activities of illegal armed groups. Ukraine has been active in seeking a sustainable political solution to the conflict on its territory with the support of the European Union. Rule of law and respect for democracy and human rights in the illegally annexed Crimea and the territories in Eastern Ukraine under the control of the separatists have dramatically deteriorated as reported by the Office of the High Commission for Human Rights of the United Nations. The Crimean Tatar Community is particularly affected in the Crimean peninsula. In Eastern Ukraine, numerous cases of intimidation, threat, "expropriation" of private property, arbitrary detention, torture, forced disappearance and violence against the civilian population, including by indiscriminate use of weapons are reported notably by the Office of the High Commission for Human Rights of the United Nations.

EU-Ukraine relations: Since 1991, when Ukraine gained independence, the EU and Ukraine have developed an increasingly dynamic relationship. Ukraine is a priority partner country within the European Neighbourhood Policy and the Eastern Partnership. The ambitions of both the EU and Ukraine to enhance their relationship created an opportunity to move beyond cooperation towards gradual economic integration and deepening political association.

As a result, the two sides signed an Association Agreement on 21 March 2014, which includes an agreement for the establishment of a so-called Deep and Comprehensive Free Trade Area (DCFTA), signed on 27 June 2014. After the 12 September trilateral meeting on the Association Agreement, at the request of Ukraine, the European Union agreed to delay the provisional application of the DCFTA until 31 December 2015. Provisional application of remaining relevant parts of the AA started on 1 November following ratification by the Ukrainian Parliament and the consent given by the European Parliament on 16 September

2014. The Association Agreement is currently under ratification by Member States. The Association Agreement is currently under ratification by Member States.

In the meantime, Ukrainian exporters can benefit from autonomous trade preferences that were first granted by the EU in April 2014 until end-October 2014 and later extended until the end of 2015. In view of these measures, and as a result of a decrease in trade between Ukraine and the Russian Federation, the EU has become Ukraine’s major trade partner in 2014 and is expected to further strengthen its position in the future. To conclude an intense series of high level meetings in 2014, on 15 December, the European Union and Ukraine held the first meeting of the Association Council, which launched the institutional framework of enhanced cooperation.

The EU is also an important source of assistance to the reform process in Ukraine, including through the Support Group for Ukraine. On 11 March, in response to the economic and political crisis in Ukraine, the Commission adopted an unprecedented support package to Ukraine worth EUR 11 billion for the next few years. The implementation of this support package is under way. A Support Group for Ukraine was created to support the implementation of the support package and the reform process in Ukraine. The EU disbursed EUR 1.36 billion out of its EUR 1.61 billion macro-financial assistance package to Ukraine, following the continued implementation of the IMF Stand-By Agreement and policy conditions attached to the programmes by Ukrainian Government. In 2014, the European Commission provided EUR 250 million out of EUR 355 million in grants (State Building Contract) to support the reform process in Ukraine. Subsequently, a programme of EUR 55 million aiming at supporting regional development and decentralisation was signed in November.

The EU is strongly committed to support the territorial integrity, sovereignty and independence of Ukraine. The EU is engaged in diplomatic talks to facilitate the finding of a sustainable political solution to the conflict and decided to take restrictive measures against those responsible for the illegal annexation of Crimea and Sevastopol and the destabilisation in Eastern Ukraine (and the entities associated with them), as well as restrictive measures against the Russian Federation. The European Union stands ready to review its sanctions regime according to developments on the ground.

In sum, Ukraine is facing a dramatic situation with the illegal annexation of Crimea/Sevastopol and the conflict in Eastern Ukraine due to the activities by illegal armed groups. In the meantime, the internal political situation is stabilising and Ukraine has taken first steps in the reform process. Ukraine conducted largely free and fair presidential and parliamentary elections, took steps to improve the rule of law and largely respected human rights. Further improvements of the situation are expected to happen in the following months in view of the declared political engagement of Ukraine's authorities in continuing the reform process (Association Agreement, coalition agreement, Government Action Plan). In this context, the political preconditions for macro-financial assistance may be considered to be sufficiently fulfilled at this stage, while a continued monitoring of the situation will have to take place.