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COMMISSION STAFF WORKING DOCUMENT

Ex ante evaluation statement Macro-financial assistance to Ukraine

Accompanying document to the

Proposal for a Council decision providing macro-financial assistance to Ukraine

(COM(2009)580 final)

Ex ante evaluation statement

Macro-financial assistance to Ukraine

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Background

Ukraine's transition from state planned to market economy was comparatively difficult: in 2008 Ukraine's real GDP still represented only 74% of its 1990 level[1]. In 2000, after a prolonged contraction, growth resumed; Ukraine registered an average growth rate of 6.9% during 2000-2008.

The on-going global economic and financial crisis had a very significant impact on Ukraine, probably the strongest in the European Union's eastern neighbourhood. To counter the effects of the crisis, the authorities have put in place a strong programme of economic adjustment, and secured a large financing from the IMF. Also, the Ukrainian authorities have approached a large number of bilateral donors and creditors, including the European Union, for financial support.

In this context, the Commission proposes to the Council to provide to Ukraine a macro-financial assistance (MFA) package amounting to EUR 610 million. The EU support would consist of the activation of a EUR 110 million loan from a previous MFA operation agreed by the Council in 2002 (Council Decision 2002/639/EC on 12 July 2002) but not implemented and of a new operation amounting to EUR 500 million. The 2002 MFA can be activated without requiring a new Council decision, already before the formal adoption of the decision on the new amount. The reactivation of the assistance decided back in 2002 would require the preparation of a new set of contractual documents, including the Memorandum of Understanding setting forth the economic and financial conditions of the operation, and the loan agreement (see below).

1.2. Recent economic developments and economic outlook

Until mid-2008, Ukraine's economic performance was quite positive, and the country was successfully catching up after the initial hardship of transition to market economy. However, since the onset of the global crisis, the economic situation of the country has deteriorated dramatically (see Table 1, on next page). In 2009, Ukraine's real GDP growth decelerated to 2.5%, and in the first quarter of 2009, GDP is estimated to have contracted by around 20% year-on-year. For the period January–June 2009, industrial output decreased by 27.5% year-on-year, while manufacturing industry contracted by 31.4%. The latest IMF projections for the current year point to a drop of real GDP by as much as 14%.

The transmission mechanisms through which the global economic and financial crisis impacted on Ukraine's economy are broadly the same as for other countries of the region: firstly, an abrupt halt in access to international finance for the domestic financial system, leading to the reduction of domestic credit growth (Ukraine relied on external financing for credit growth much more than its neighbours, which partially explains why it was hit harder); secondly, a trade shock resulting from the fall in commodity prices (steel prices dropped between July 2008 and early 2009 by 65%) and from the fall in demand from Ukraine's main trading partners. Thirdly, the fact that imports became more expensive, led by the increase in natural gas prices charged by Russia, which is phasing out its remaining gas subsidies.

[1] On a per capita basis this figure is 85%, reflecting Ukraine's significant population loss

Table 1: Ukraine - Selected economic and social indicators

	2006	2007	2008	2009	2009	2010
			Est.	1st Review	Proj. 1/	
Real economy (percent change, unless otherwise indicated)						
Nominal GDP (billions of hryvnias)	544	721	950	990	916	1,056
Real GDP	7.3	7.9	2.1	-8.0	-14.0	2.7
Contributions:						
Domestic demand	13.1	17.2	9.1	-22.5	-29.7	4.2
Net exports	-5.8	-9.3	-7.0	14.5	15.7	-1.5
Unemployment rate (ILO definition; percent)	6.8	6.4	6.4	9.9	10.7	10.0
Consumer prices (period average)	9.1	12.8	25.2	17.2	16.3	10.3
Consumer prices (end of period)	11.6	16.6	22.3	16.0	14.0	9.0
Nominal monthly wages (average)	29.2	29.7	33.7	4.0	3.5	9.0
Real monthly wages (average)	18.4	15.0	6.8	-11.2	-11.0	-1.2
Public finance (percent of GDP) 2/						
General government balance 3/	-1.4	-2.0	-3.2	-4.0	-6.0	-3.0
Overall balance (including Naftogaz and bank recapitalization costs)	-1.4	-2.0	-3.2	-10.8	-11.4	-6.4
Overall balance (including Naftogaz operational deficit) 4/	-1.4	-2.0	-3.2	-5.9	-8.6	-4.0
Privatization proceeds	0.4	0.6	0.3	0.3	0.3	0.4
Net domestic financing	-0.3	0.4	2.5	2.5	5.8	2.8
Net external financing	1.3	1.0	0.4	3.2	2.6	0.8
Public debt (end of period) 5/	15.7	12.9	19.9	32.5	35.4	38.6
Of which: external debt (foreign currency denominated)	12.5	10.1	15.0	23.1	25.0	23.8
Money and credit (end of period, percent change)						
Base money	17.5	46.0	31.6	6.6	10.1	9.6
Broad money	34.5	51.7	30.2	3.8	1.5	14.4
Credit to nongovernment	70.6	74.0	72.1	7.8	3.1	2.5
Velocity	2.08	1.80	1.84	1.85	1.75	1.76
Interbank overnight rate (annual average, percent)	3.6	2.3	13.7	…	…	…
Balance of payments (percent of GDP)						
Current account balance	-1.5	-3.7	-7.2	0.5	0.6	0.1
Foreign direct investment	5.3	6.4	5.5	4.6	3.4	3.8
Gross reserves (end of period, billions of U.S. dollars)	22.3	32.4	31.5	29.3	30.0	31.0
Months of next year's imports of goods and services	3.7	3.9	6.4	5.3	5.5	5.2
Debt service (percent of exports of goods and services)	5.1	4.0	2.7	5.6	7.1	4.0
Goods exports (annual volume change in percent)	2.7	3.2	-1.9	-8.8	-13.6	6.1
Goods imports (annual volume change in percent)	12.5	20.3	16.8	-31.8	-36.4	6.6
Goods exports	36.1	34.8	37.7	42.2	38.9	41.0
Goods imports	40.9	42.2	47.1	45.1	41.3	44.6
Share of metals in merchandise exports (percent)	42.2	41.7	40.8	35.5	35.3	34.5
Net imports of energy (billions of U.S. dollars)	8.1	11.5	16.7	13.0	11.5	16.1
Goods terms of trade (percent change)	-0.3	9.0	8.0	-13.6	-13.6	-2.1
Goods and services terms of trade (percent change)	1.5	7.4	8.8	-9.2	-9.1	2.2
Exchange rate						
Exchange rate regime	de facto peg		managed float			
Hryvnia per U.S. dollar, end of period	5.0	5.0	5.4	…	…	…
Hryvnia per U.S. dollar, period average	5.1	5.0	5.3	…	…	…
Real effective rate (CPI, percent change)	4.8	2.6	12.6	…	…	…
Social indicators						
Per capita GDP: US$ 2,282 (2006); Poverty (percent of population): 8.0 (2006; World Bank estimate);						
Life expectancy at birth: 68.2 years (2006); Infant mortality (per 1,000): 16.0 (2005); Gross primary enrollment (percent net): 84 (2005)						

Sources: Ukrainian authorities; and IMF staff estimates and projections.

1/ Policies assumed here include: (i) exchange rate flexibility as from 2008; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2010; (iii) public-financed recapitalization of banks for a total amount of Hrv 24 bln.

2/ The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are adjusted to ensure consistency with international accounting rules. The 2010 projection includes the measures and structural reforms agreed under the program.

3/ The fiscal target under the original program (excludes the operational balance of Naftogaz).

4/ Starting with the second review, a new fiscal target was added under the program that ncludes the operational balance of Naftogaz.

5/ Government and government-guaranteed debt, and National bank of Ukraine debt. Excludes debt by state-owned enterprises.

Source: IMF

Since the agreement between the Ukrainian authorities and the IMF on a crisis-related financial package, Ukraine's current account has substantially improved, from a deficit of 7.2% of GDP in 2008 to an expected surplus of 0.5% of GDP in 2009 – this on the back of the narrowing trade deficit. Trade deficit was reduced as imports have been falling faster than exports. In the first six months of 2009, exports in goods and services decreased by 42.3%, while imports decreased by 49.8%. The narrowing of the trade deficit reflects a stronger than anticipated recession, and at the same time the improvement Ukraine's competitiveness following the devaluation of the domestic currency by 35% since September 2008.

Yet, while the current account balance is projected to achieve a small surplus in 2009, Ukraine has been suffering a capital account deficit: loss of confidence meant capital flight, reversal of capital inflows and a reduction in foreign direct investment. Strong pressures on the capital account produced strong pressures on international reserves that could only be kept at an appropriate level due to the financing provided by the IMF under a Stand-by Arrangement (SBA - see below). The international reserves of the National Bank of Ukraine (NBU) increased from USD 24.5 billion in April to USD 27.3 billion in end-June 2009, after the disbursement of the second tranche of the IMF's SBA (and they will increase again with the disbursement of the third tranche of the loan in late July 2009). Yet, the country's reserve position remains fragile: although its exchange rate regime is now more flexible, Ukraine still might need to use its reserves for the interventions on the foreign exchange markets.

Also, the lower economic activity is resulting in a significant shortfall in fiscal revenue leading to the widening budget deficit. The latest projections made in the context of the second SBA programme review (see below) point to a budget deficit target of 8.6% of GDP in 2009. This figure included for the first time the operating loss of the state owned energy utility Naftogaz.

After the very strong economic contraction of the first quarter of 2009, there have been some signs of a modest economic stabilisation. Since May 2009, industrial production indices show positive, albeit limited, month-on-month growth. Furthermore, some signs of stabilisation can be found in the hryvnia exchange rates: interbank market rates appreciated by around 5% since May 2009, after an almost 50% depreciation in 2008.

The inflation outlook has also been improving with consumer price inflation going down: while year-on-year CPI was 22.3% in January 2009, it decelerated to 15% in June 2009. For 2009 average, inflation is expected to be 16.3%. Also, for the first time since September 2008, real deposits into the Ukrainian banking system have increased (albeit by only 0.6% m-o-m), leading to a suspension of restrictions on the withdrawal of term deposits. Net FDI inflows also increased, reaching an estimated USD 2.1 billion up to June 2009, largely as a result of significant recapitalisation effort by foreign banks with operations in Ukraine.

1.3. Macroeconomic policy framework

The request from the Ukrainian authorities led to an agreement with the IMF on a 24-month stand-by arrangement for USD 16.5 billion which was approved in early November 2008. The exceptional access to IMF resources (the amount made available by the Fund represents 802% of Ukraine's quota) was justified by a severe current account and capital account crisis that Ukraine was facing in late 2008. The adverse terms-of-trade shock related to the falling demand for such Ukrainian products such as steel coincided with the shortfalls in financing related to the banking crisis and reduced depositor confidence. Further factors that made this exceptional access to IMF financing possible included (i) a sustainable position as far as external and public debt is concerned, (ii) good future prospects of Ukraine to regain access to private capital markets, and (iii) the domestic commitment to policy reforms.

The conditionalities of the original IMF SBA programme have focussed on three policy fields: (i) monetary and exchange rate policy, (ii) banking sector, and (iii) fiscal policies. In the first field, IMF programme demanded a more flexible exchange rate regime, abolishing foreign exchange tax, and making the Central Bank sufficiently independent by reforming its Council. In the second field, bank resolution and financial support to systemic banks was required, while in the third field, fiscal target of zero general government deficit was set out as a programme condition.

The two-year IMF programme is considerably frontloaded. The first tranche of a USD 4.5 billion loan was disbursed directly after the IMF Board decision. However, the second disbursement was delayed due to disagreements between the government of Ukraine and the IMF on issues concerning the benchmark of budgetary deficit, exchange rate regime and the degree of the independence of the Central Bank. An agreement could only be reached in April 2009; it led to the disbursement of the second tranche of USD 2.8 billion in May 2009. The second review of the SBA was completed on 28 July 2009 unlocking the disbursement of the third loan tranche of USD 3.3 billion.

A large part of the second tranche under the SBA (USD 1.9 billion) and the full amount of the third tranche were channelled directly to the budget in order to help Ukraine meet the general government's external payment obligations. In particular, a part of the third SBA instalment is expected to be used to cover sovereign bonds as well as Eurobond obligations of Naftogaz maturing in August and September 2009.

The IMF's Board had conditioned the completion of the second programme review and the release of the third instalment under the programme to, inter alia, the adoption by the parliament of a number of amendments to banking laws and the law on the NBU that would increase the transparency and regulation of the banking sector, as well as to several energy sector reforms, in particular to the increases in gas tariffs of Naftogaz for households and utilities (by 20% in autumn 2009, in January 2010 and quarterly increases hereafter during 2010). The gas sector reform is aimed at creating conditions for a development of a sustainable gas sector, capable of ensuring a sound functioning of Ukraine's gas pipeline network.[2]

1.4. Ukraine's external financing needs

The current IMF's projections of Ukraine's residual financing external needs in 2009 (see Table 2 on next page) point to a financing gap of about USD 2.8 billion not covered by already existing financing commitments from the IFIs (the IMF, the World Bank and the EBRD) and existing budget support (from the EU, under the ENPI). Out of these needs, some USD 560 million are expected to be covered by official debt restructuring and other sources, while the financing sources for the remaining USD 2.25 billion were still not identified by the time of the second programme review. The external financing needs for 2010 are expected to be lower than those for 2009.

The European Commission is requested to provide MFA to cover part of these financing needs. The EU MFA would cover external financing needs either of Ukraine's state budget, along with financing forthcoming from the World Bank (DPL - Development Programme

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2 The Euopean Commission has organised several meetings between the IFIs (the IMF, the World Bank, the EBRD and the EIB), the European gas industry, Ukraine's government and Naftogaz and Russia's government and Gazprom on possible financing of the rehabilitation of the gas transportation network in Ukraine and possible support to Ukraine and/or Naftogaz for purchase of gas to ensure a smooth transit of natural gas from Russia to the EU.

Loan) and the IMF, or balance-of-payments needs of Ukraine's banking and corporate sector, through reserve build-up.

Indeed, Ukraine's external financing needs reflect the financing needs of both the general government and the economy (enterprises and households). The bulk of the external financing needs of the non-government sector (including state-owned corporate entities) are the refinancing needs of the banking sector. In late 2008, the financial account experienced large outflows of short-term capital and a large drop of foreign direct investment. The deterioration of the financial account would have been even stronger if the roll-over rates on private sector debt had not held well since the beginning of 2009, in particular for corporations. The banking sector remains under great strain: depositor confidence is low and 20% of all bank deposits were withdrawn between October 2008 and March 2009. Repayment of loans by households and corporates deteriorated significantly as a large share of loans has been denominated in the foreign currency while hryvnia experienced a strong depreciation. A certain stabilisation was achieved in April 2009 as banks started restructuring their debt denominated in foreign currency. However, bank credits are still expected to contract in real terms in 2009, as banks still prefer to hoard liquidity.

Table 2: Ukraine – external financing needs

(Millions of U.S. dollars, unless otherwise indicated)

	2009
Total financing sources	31,114
Net FDI (including capital transfers)	4,070
Portfolio, net	-80
Debt financing, total	26,465
Private	21,905
Official	4,560
Of which:	
World Bank	1,250
Project financing	500
Unidentified multilateral and bilateral	2,250
Other 1/	560
Reserve accumulation (-denotes increase)	659
Total financing requirements	41,191
Current account deficit	-710
Total amortization (includes short-term debt, trade credit, and medium- and long-term amortization)	35,250
Amortization of private debt	32,262
Amortization of government debt	2,988
Other capital outflows	6,651
Financing need	10,077
Fund credit (net)	10,077
Gross reserves	30,000
Gross reserves (percent of short-term debt at remaining maturity in 2010)	90
Gross reserves (months of next year's imports)	5.5

Sources: Ukrainian authorities; IMF staff estimates and projections.

1/ Includes official debt restructuring.

Source: IMF

The external financing needs of the government sector are also substantial given that the overall financial requirements of the general government are not matched by the domestic financial resources. The general government deficit is expected to reach 6% of GDP in 2009 and 4.5% in 2010. Also, in 2009, the government will need to spend 2.6% of GDP to cover the operational losses of Naftogaz, the state owned major utility company. For 2010, additional budgetary costs related to Naftogaz recapitalisation are estimated at 1.0% of GDP. The fiscal deficit including the costs related to the Naftogaz operations is thus estimated to 8.6% of GDP in 2009 and 5.5% in 2010.[3] Two thirds of the government expenditure goes into public wages and social transfers, which implies that if external financing were not forthcoming, further cuts in social spending and in capital investment would be needed. Also, the necessary reforms in the energy sector – in particular reforms related to the functioning of Naftogaz – are expected to lead to high social costs for the Ukrainian population. These reforms need to be accompanied by important reforms in the social safety net.

Finally, in line with the Memorandum of Understanding on co-operation in the field of energy between Ukraine and the European Union signed on 1 December 2005, the Ukrainian authorities are also planning the safety upgrade of all nuclear units in the country to internationally recognised nuclear standards. In this context, the Ukrainian state owned nuclear utility Energoatom has indicated its intention to apply for a Euratom loan from the Community.

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

2.1. Objectives

The ***general objectives*** of the proposed macro-financial assistance operation are to:

- Contribute to covering Ukraine's external financing needs, including the needs of the banking and corporate sectors and the State budget;
- Help Ukraine alleviate the financial constraints on the implementation of the reform programme especially in the energy sector supported by the stand-by arrangement with the IMF;
- Facilitate and encourage efforts of the authorities of Ukraine to implement measures identified under the EU-Ukraine Action Plan and the Eastern Partnership;
- Reinforce the EU role in the economic policy dialogue with the Ukrainian authorities.

Linked to these general objectives of the programme, ***specific objectives*** in terms of financial and structural reforms will be detailed during the implementation of the programme and will be laid down in the Memorandum of Understanding that the Commission will negotiate with the authorities of Ukraine.

3 The fiscal needs in 2009 comprise also the cost of the recapitalisation of banks, estimated to 2.8% of GDP. However, the bulk of these costs (2.6% of GDP) are expected to be covered by the issuance of domestic bonds. The net fiscal cost of the bank recapitalisation in 2010 is projected to reach 0.5% of GDP.

2.2. Indicators

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, it will be a sine qua non for the implementation of the assistance;

- Progress in the implementation of specific actions that will be part of the conditions for disbursement. Those actions will be specified in the aforementioned Memorandum of Understanding. They will be consistent with the policy lines anchored in the IMF programme, as well as with the priorities of the European Neighbourhood Policy and those of Eastern Partnership.

3. ALTERNATIVE DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

Macro-financial assistance is an untied and undedicated macro-economic support instrument, which helps the beneficiary country meet its external financing needs, including through a reinforcement of gross international reserves. Macro-financial assistance can be provided either in the form of a loan, a grant or a combination of the two. Considering that Ukraine is a middle-income country, the Commission considers appropriate to provide the total of this assistance in the form of a loan. The euro-denominated loan will be paid to the National Bank of Ukraine and may be transferred to a Treasury account to cover external financing needs of the budget.

3.2. Risk assessment

There is a risk that the macro-financial assistance which is not dedicated to specific expenses (contrary to project financing, for example), could be used in a fraudulent way. In general terms, this risk is related to factors such as Central Bank independence, quality of management systems and administrative procedures, control and oversight functions in the financial circuits, security of IT systems, and adequate internal and external audit capabilities.

To mitigate the risks of fraudulent use, several measures will be taken. The Memorandum of Understanding and the Loan agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to clearly identified accounts at the Central Bank of Ukraine. Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Ukraine. In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission may also use other assistance instruments at its disposal to help the beneficiary authorities improve their public finance management systems if this area is not sufficiently covered 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.

While seriously taking into account this risk, the Commission services consider that there are sufficiently strong grounds to proceed with the MFA to Ukraine. The high financing needs faced by Ukraine plead in favour of an urgent action.

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 COMMUNITY INVOLVEMENT

The Community financial support to Ukraine's economic recovery reflects the country's strategic importance to the EU in the context of the European Neighbourhood Policy and of the newly established Eastern Partnership. The main financial support instrument to Ukraine is the European Neighbourhood Partnership Instrument that has three priority objectives: democratic development, administrative capacity building and infrastructure development. 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 EC package of assistance, it would contribute to support the European Union's objectives of economic stability and economic development in Ukraine.

5. GENVAL CRITERIA ON MACRO-FINANCIAL ASSISTANCE

On 8th of October 2002 the Council reconfirmed a set of principles for the use of the Community's macro-financial assistance (so called Genval criteria). The five criteria are: (i) the exceptional character of the assistance, (ii) its complementarity to financing of the International Financial Institutions (IFIs), (iii) the existence of policy conditionality attached to the assistance, (iv) the existence of political pre-conditions and, finally (v) strong financial discipline that needs to accompany the MFA.

5.1. Exceptional Character and Limited Timeframe

Ukraine's financing requirements in 2009-2010 result from the country's high external and fiscal imbalances that are closely related to the global economic crisis. The on-going economic adjustment and the conditionality of the IMF programme will contribute to reducing these imbalances over the medium term.

The exceptional character of the foreseen MFA is further stressed by the limited timeframe of the programme. The current MFA proposal is only valid for 2009-2010 for the duration of the IMF SBA arrangement.

5.2. Political pre-conditions

MFA is reserved to the third countries that are geographically close to the EU territory, that respect democracy and human rights and with which the EU has important political, economic and commercial ties. Ukraine fulfils these criteria. First, it has direct borders with the EU. Second, its economic and political relations with the EU are strong: it is an active EU partner in the European Neighbourhood Policy as well as in the recently established Eastern Partnership. Since March 2007, Ukraine negotiates an Association Agreement with the EU that would replace the existing Partnership and Cooperation Agreement and that includes a deep and comprehensive free trade area. Third, Ukraine has demonstrated a good record of macroeconomic management and economic reforms in the recent past and it respects democracy and human rights.

5.3. Complementarity

The proposed macro-financial assistance will be complementary to the existing EU financing, to the IMF financing and to the financial support of other international donors.

The MFA programme is complementary to other EC financing, in particular to medium-term ENPI budget support implemented within the framework of the EU Country Strategy for cooperation. Thus, it can help increase the EU's leverage on Ukraine's policy making as well as help Ukraine to overcome the current deep economic crisis.

The complementarity with the IMF programme is also assured. An MFA can only take place when a residual external financing gap is identified over and above the IMF resources and under the condition of a fair burden sharing. A residual external financing gap has been identified by the IMF, this assessment constitutes the basis for Commission's MFA programme proposal that would cover roughly one third of the external financing gap remaining after the IMF intervention.

The MFA programme is also complementary to the external financing coming from the IFIs more generally. In particular, the MFA is provided in the moment when the EU is also helping to mobilise financing to support the reform of the Ukraine energy sector. The Commission, together with the World Bank, the EBRD and the EIB, intends, subject to the individual rules, capacities and conditions of the IFIs, to work together in the development of a support package to the Ukrainian authorities designed to assist in developing a sustainable solution to Ukraine’s medium-term gas transit and gas payment obligations. The MFA under consideration is not intended to be directly linked to that package. However, it would support Ukraine’s economic stabilization and reform, including reform of the gas sector and accompanying reform of the social safety net.

5.4. Conditionality

The disbursement of MFA assistance will be conditional on the IMF Board decisions to approve programme reviews under the SBA and on Ukraine's subsequent decisions to draw funds from the IMF financial facility. In addition, a Memorandum of Understanding (MoU) will be negotiated between the Commission and the Ukrainian authorities. The MoU will contain specific structural reform measures related to the fields of cooperation between the EU and Ukraine. For example, in the field of public finance management the Commission plans to build on the results of policy dialogue conducted in the framework of implementation of the EU-Ukraine ENP Action Plan. Furthermore, the conditionality should include the improvement of social safety net to offset the social consequences of the energy sector reforms.

5.5. Financial discipline

The planned assistance would be provided in the form of a loan and should be financed through the 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 04 01 14 ("the provisioning of the Guarantee Fund"). Assuming that the loan disbursements will be made in 2009 for the amount of EUR 100 million and in 2010 for the amount of EUR 510 million and according to the rules governing the guarantee fund mechanism, the provisioning will take place in the 2011-2012 budget. Due to the constraints on the loan capacity at the time of the preparation of the relevant annual budget, the Commission may use additional commitment appropriations under the Heading 4 in 2012.

To ascertain that the beneficiary has in place a sound financial management in line with the requirements of the Financial regulation, the Commission services continue regular monitoring and intend – with the help of an external consultant - to carry out an Operational Assessment of the reliability of financial circuits and administrative controls of the different entities involved in the management of the EU funds, especially at the Ministry of Finance and at the Central Bank of Ukraine.

6. PLANNING OF FUTURE MONITORING AND EVALUATION

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

6.1. Monitoring

The monitoring system will be ensured by the provision of reports and data by the authorities and by the organisation of review missions to Ukraine by Commission staff. Although this assistance is centrally managed, where appropriate, the EC Delegation in Kyiv will also be called to provide additional reporting. The monitoring of the action by the Commission services will take place on the basis of macro-economic and structural policy indicators which are to be agreed with the Ukrainian authorities in a Memorandum of Understanding. In this process, the Commission services may also monitor key areas of the public finance management system, to be identified in the update of the Operational Assessment so as to have the relevant information on any changes in the control environment.

An annual report to the European Parliament and to the Council on the implementation of macro-financial assistance is foreseen in the proposed text of the Council Decision.

6.2. Evaluation

Two to three ex-post evaluations of macro-financial assistance operations are planned per year in the Multi-annual Evaluation Programme of the Economic and Financial Affairs Directorate-General. An ex-post evaluation of the proposed macro-financial assistance to Ukraine will be launched upon the completion of the operation. A provision foreseeing the ex-post evaluation will be included in the

Memorandum of Understanding. Financial resources for this evaluation will be drawn from the macro-economic assistance budget line.

7. ACHIEVING COST-EFFECTIVENESS

In implementing the programme, the Commission will be guided by the following principles:

- As soon as the Council has adopted the proposal, the Commission will negotiate with the Ukrainian authorities a Memorandum of Understanding laying out the conditions for the release of the EU assistance, as well as a loan agreement. Each tranche of the proposed assistance will be made available by the Commission to Ukraine on the basis of a satisfactory track record of the implementation of the IMF programme and the economic policy and financial conditions attached to the assistance.

- In negotiating specific policy conditions, the Commission will draw on all the expertise, including of the International Monetary Fund and the World Bank and of bilateral and multilateral aid agencies active in Ukraine. In addition, the Commission will aim at synergies with other Community policies and instruments (notably ENPI as indicated above) that could be used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management). Where appropriate, links to any related action under the European Neighbourhood Policy or Eastern Partnership or findings of the Progress Reports would be established.