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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

SUPPLEMENTAL FINANCING DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF EUR 437.05 MILLION
(US$489.45 MILLION EQUIVALENT)

TO

UKRAINE

FOR THE

FINANCING OF RECOVERY FROM ECONOMIC EMERGENCY
UKRAINE

(Supplemental Loan for Second Economic Recovery Development Policy Loan)

March 4, 2022

Macroeconomics, Trade and Investment Global Practice
Europe and Central Asia Region

Public Disclosure Authorized

UKRAINE

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of February 28)

Currency Unit: Ukrainian Hryvnia (UAH)

US$1.00 = UAH 29.67

ABBREVIATIONS AND ACRONYMS

CMU	Cabinet of Ministers of Ukraine
CPF	Country Partnership Framework
DPF	Development Policy Financing
DPL	Development Policy Loan
DPO	Development Policy Operation
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign Exchange
GDP	Gross Domestic Product
GNP	Gross National Product
GoU	Government of Ukraine
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
MDTF	Multi-Donor Trust Fund
MFA	Macro-Financial Assistance
MTEF	Medium-Term Expenditure Framework
MOF	Ministry of Finance
NBU	National Bank of Ukraine
PCG	Partial Credit Guarantee
PDO	Program Development Objectives
SBA	Stand-By Arrangement
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
TSO	Transmission System Operator
UN	United Nations
WBG	World Bank Group

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UKRAINE

**FINANCING OF RECOVERY FROM ECONOMIC EMERGENCY
UKRAINE**

(Supplemental Loan for Second Economic Recovery Development Policy Loan)

TABLE OF CONTENTS

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Parent Project
P178794	P177931

Proposed Development Objective(s)

The proposed program development objectives are to: (i) foster de-monopolization and anticorruption institutions; (ii) strengthen land and credit markets; and (iii) bolster the social safety net.

Organizations

Borrower:	UKRAINE
Implementing Agency:	MINISTRY OF FINANCE

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**489.45**

DETAILS

International Bank for Reconstruction and Development (IBRD)	489.45

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

High

Results

Indicator Name	Baseline	Target
Results Indicator #1: The share of gas transit revenues flowing in a transparent manner from Naftogaz to the new independent Gas TSO, based on the tariff set by the NEURC.	Baseline (2019): 0 percent	Target (2022): 100 percent
Results Indicator #2: Number of port concession projects signed with private investment mobilized through project financing by lenders.	Baseline (2019): 0	Target (2021): 2
Results Indicator #3: Number of voyages by ships (including cargo) on Dnipro River increases by about 20 percent.	Baseline (2019): 11,938	Target (2021): 14,300
Results Indicator #4: Number of full verifications of high-risk declarations selected using prioritization criteria, assigned automatically to staff, and implemented using an improved methodology.	Baseline (2019): 0	Target (2022): 1,500
Results Indicator #5: Area of agricultural land previously under moratorium sold/purchased by eligible individuals.	Baseline (2019): 0 hectares	Target (2022): 150,000 hectares
Results Indicator #6: Loans are issued to small farmers and backed by Partial Credit Guarantee (PCG) facility.	Baseline (2019): No	Target (2022): Yes
Results Indicator #7: Gross Pre-2020 NPL Portfolio of State-Owned Banks.	Baseline (2019): UAH 397 billion	Target (2021): Under UAH 300 billion
Results Indicator #8: NBU and NSSMC adopt action plan on reshuffling supervisory regimes for insurance, credit unions, pension funds, and other NBFIs.	Baseline (2019): No	Target (2021): Yes
Results Indicator #9: Pension benefits increase in line with the indexation formula within the first half of each calendar year, allowing adequate support for pensioners, of which at least 65 percent are women.	Baseline (2019): No	Target (2022): Yes

IBRD SUPPLEMENTAL FINANCING DOCUMENT FOR A PROPOSED LOAN TO UKRAINE

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation provides €437.05 million (US$489.45 million equivalent) in supplemental financing for the Second Economic Recovery Development Policy Loan (DPL-2) to help the Government of Ukraine (GoU) cover an unanticipated financing gap related to a severe escalation of geopolitical tensions and outbreak of war**. On December 17, 2021, the World Bank Executive Board approved the €300 million DPL-2[1] which had the following program development objectives (PDO) to: (i) foster de-monopolization and anticorruption institutions; (ii) strengthen land and credit markets; and (iii) bolster the social safety net. The proposed supplemental financing is consistent with the World Bank's policy on Development Policy Financing (DPF). First, the program is being implemented in compliance with the provisions of the legal agreement with the Bank. Second, given the ongoing war, Ukraine is unable to obtain sufficient funds from other lenders on reasonable terms and has effectively lost access to markets. Third, while the Bank has been discussing a new DPL to support critical reforms, the time available is too short for the government to complete identified reform actions under the current circumstances. Fourth, Ukraine remains committed to the program and the implementing agencies have demonstrated competence in carrying it out.

2. **Rising geopolitical tensions and the Russian invasion on February 23, 2022, have led to a severe deterioration of the macroeconomic, social and poverty situation in Ukraine.** The economy had weathered the COVID-19 pandemic better than initially anticipated thanks to earlier reforms that strengthened macro-fiscal and financial fundamentals. Although fiscal financing needs were still substantial, fiscal space needed to finance the deficit and rollover debt was sufficient given the anchor to the International Monetary Fund (IMF) Stand-By Arrangement (SBA) program, and continued access to external markets. However, a material deterioration in risk sentiment began in mid-November as geopolitical tensions rose, reflected in Eurobond yields doubling to nearly 10 percent in January. In addition, by mid-February, non-resident investors withdrew US$650 million from the domestic bond market. The Hryvnia fell by 8.4 percent versus the US Dollar, despite net FX sales of US$2.3 billion by the central bank. New spending pressures emerged such as fiscal support worth US$592 million announced on February 13 to insure and guarantee the continuation of flights to and from the country in the absence of commercial insurance. In recent days, conditions worsened further with the outbreak of intense war with bond yields rising to 35 percent on February 28. Trade, especially in the Black Sea through which half of Ukraine's trade (and 90 percent of its grain trade) flows, has been disrupted. The banking sector remains stable so far but is exposed to liquidity and ultimately solvency risks. With the declaration of a state of emergency on February 24, currency restrictions have been introduced by the National Bank of Ukraine (NBU). As of March 3, an estimated 1 million people have fled their homes to neighboring countries, and many more have been displaced internally.[2] Substantial damage to infrastructure (especially roads, bridges and power plants) including in key cities has been reported but it is difficult to quantify the damage.

[1] DPL-2 was the second operation in a series of two. The first operation (First Economic Recovery Development Policy Loan (DPL-1) was approved in June 2020 and disbursed in June 2021).

[2] https://www.reuters.com/world/over-660000-people-flee-ukraine-un-agency-says-2022-03-01/

3. **The GoU initially sought to manage macroeconomic risks from rising geopolitical tensions; however, with the start of war, the resulting macroeconomic and financing pressures have intensified.** As tensions rose at the turn of the year, the GoU tried to mitigate some fiscal risks, including by using IMF SDR allocations provided earlier in 2021 to buy back a portion of a Eurobond due for repayment in September 2022. With the outbreak of war, spending needs have risen while revenues are anticipated to drop sharply against the backdrop of diminished market access. Preliminary estimates indicate an unanticipated fiscal financing gap of US$11.6 billion or 5.7 percent of Gross Domestic Product (GDP) due to a higher fiscal deficit and reduced access to external and domestic financing sources. The gap could be larger if conditions worsen, and a more significant shortfall occurs in domestic capital markets.[3] In addition, quasi-fiscal liquidity pressures of about US$5.5 billion emanate from the energy sector, mainly from Naftogaz to restock gas reserves for the next heating season and to fund gas subsidies under a public service obligation. These challenges underscore the critical need for multilateral financing, to prevent a disorderly macro-fiscal adjustment that would compound already severe social and economic impacts.

4. **Development partners have already pledged significant support of US$5.1 billion as of March 3, 2022 to help Ukraine meet the unanticipated fiscal financing gap; this proposed operation is an important part of that effort.** The proposed package is a vehicle for bilateral partners seeking to provide immediate budget support alongside the World Bank program (as preparation of a new Development Policy Operation (DPO) would take some time). This additional support includes bilateral guarantees that allows additional IBRD financing, and linked parallel financing, as well as a standalone Multi-Donor Trust Fund (MDTF) to channel donor grant financing to support the operation. Guarantees mobilized as of March 4, 2022 amount to €79.75 million and US$50 million from the Netherlands and Sweden respectively, with linked parallel financing of US$100 million from Japan. The proposed MDTF co-financing would contribute to filling part of this unanticipated gap in financing. As of March 4, 2002, committed pledges approach US$134 million, including from Iceland (US$0.5 million), Latvia (US$5.5 million), Lithuania (US$5.5 million), Denmark (US$22 million) and the UK (US$100 million). Expressions of interest from other development partners could raise this amount significantly. The operation is complementary to other International Financial Institution (IFI) and bilateral financing, including US$2.2 billion in remaining IMF SBA disbursements, and additional budget financing announced from the European Union, United States, Canada, Poland, Italy, France and other bilaterals. As of March 3, total potential additional financing by international partners amounts to some US$5.1 billion, with the World Bank contributing 6.8 percent (9.5 percent including guaranteed amounts). The overall package will provide the liquidity needed by the GoU to avoid a disruptive macroeconomic adjustment, and to support continued social expenditures and other critical public services at a time of acute social and financing stress. That said, there remains a financing gap of U$6.7 billion that will need to be covered later during the year through official financing flows, to further ease liquidity pressures on the GoU.

5. **The program supported by the parent DPO (DPL-2) has been under implementation in compliance with the provisions of the legal agreement.** Following the approval of DPL-2 in December 2021 and through the period of rising geopolitical tensions, the authorities continued to implement reforms despite a more challenging operating environment. First, following the passage of legislation for creating a Partial Credit Guarantee (PCG) Fund in agriculture (a critical pillar of land reforms to ensure access to finance for small farmers), the GoU operationalized this in mid-February with the Cabinet of

[3] Indications are that, amid the crisis, appetite for domestic bonds (particularly longer tenor) has decreased.

Ministers of Ukraine (CMU) resolution establishing the fund with an authorized capital of UAH 200 million provided through the budget. Second, restrictions on the movement of foreign vessels were lifted on January 1, 2022, in keeping with the provision for non-discriminatory access to inland waterways for both local and foreign vessels. Third, the government adhered to its commitment to timely indexation of pensions, with the announcement of a 14 percent increase to take effect during March 2022. Progress was also made vis-a-vis implementation of Ukraine's historic land reform prior actions.

6. **Risks to the achievement of DPL-2 program development objectives have been raised to "high" across all risk categories.** The onset of war has created significant uncertainty and very large risks to the reforms supported by DPL-2, across all relevant dimensions. First, the ongoing war poses large macroeconomic and social risks. Second, in a fast-moving situation of conflict, political, governance, and fiduciary risks are especially heightened. These risks are partly mitigated through close engagement between the GoU and bilateral and multilateral partners. The government has sizeable eligible budgetary expenditures that the Supplementary DPF funds are expected to finance shortly after disbursement. However, additional fiduciary arrangements will be put in place for this operation, given the current conflict situation which could affect Public Financial Management (PFM) institutions and processes. Third, program implementation, technical design, sector policies and stakeholder risks have also increased due to the ongoing war, that could undermine the achievement of reforms supported by DPL. These risks are partially mitigated by the GoU's strong implementation record on DPL-2 supported reforms before the war. The GoU has reaffirmed commitments to resume these reforms once the war ceases, as it views them as an essential component of any recovery and reconstruction going forward. That said, the results indicators of the operation will likely be achieved later than the targeted dates. Fourth, all the above-mentioned risks would be exacerbated in the absence of additional and sizeable bilateral and multilateral financing assistance. The financing package, of which the proposed Supplemental DPF forms a part, partially mitigates this risk; the significant unidentified fiscal financing needs of some US$6.7 billion (which could potentially increase, depending on the duration of the ongoing war) remain a source of vulnerability that can only be mitigated by the provision of a substantial and rapid, emergency financing package by the IMF as well as financing from other development partners (e.g., through transfer of reserve SDR assets).

7. **Across all dimensions, there are residual downside risks related to the ongoing war that cannot be mitigated; there are also risks from delayed action.** There are substantial downside risks, stemming from the externally driven nature of the conflict, its duration and severity, that cannot be mitigated by the GoU. That said, there are also risks associated with not proceeding with the proposed Supplemental DPF. Delayed action (or inaction) could undermine the timely mobilization of a broader financial package from development partners and thus add to macroeconomic risks and make worse an already challenging social and economic situation.

2. THE IMPACT OF CRISIS, ECONOMIC DEVELOPMENTS AND OUTLOOK

8. **Ukraine's recovery from the COVID-19 shock has been materially disrupted by a severe escalation in geopolitical tensions, and the outbreak of war**. Ukraine was coming through the COVID pandemic in a stronger position than had been anticipated thanks to much improved macro-fiscal and financial policy fundamentals established over the past five years. Following a 3.8 percent contraction in 2020, the economy grew by 3.2 percent in 2021 as COVID restrictions eased and helped by a bumper

harvest that lifted growth in Q4 2021 to 5.9 percent y/y. Fiscal financing needs were substantial but were assessed to be manageable given steady progress on structural reforms and continued market access. However, beginning in mid-November of 2021, a sustained escalation in geopolitical tensions led to a substantial reassessment of risk, with economic stress being propagated to the broader economy and public finances through confidence, trade and financing channels. The impacts of the crisis are still unfolding, with fast-moving developments and extreme uncertainty. There has been a severe deterioration in recent days, with the outbreak of war which led to the declaration of an emergency in Ukraine on February 23, 2022.

9. **Economic activity is being severely impacted by the current war; a humanitarian crisis is unfolding**. Business confidence had already dropped sharply in January 2022 across all major sectors of the economy and declining availability of insurance had begun to impact business activity and trade. With the current war, trade has been disrupted, especially in the Black Sea. About half of Ukraine's exports are maritime, and 90 percent of grain trade passes through the Black Sea and these are expected to be severely impacted (as are imports). A humanitarian crisis is also unfolding: as of March 4, more than 1 million people are estimated to have fled to other countries, with the EU expecting another 4 million refugees to arrive in coming days; the UN allocated US$20 million on February 24 from the Central Emergency Response Fund to immediately scale up life-saving humanitarian assistance and protection to civilians. Other development partners are also mobilizing to provide humanitarian relief.

10. **The economic impacts of the crisis are most clearly visible in financing costs and currency pressures.** Sovereign bond yields have risen sharply since mid-November, rising to nearly 35 percent as of February 28, comparable to countries facing considerable crisis risks and with the previous crisis in 2014/15. Such high external funding costs have effectively eroded market access for Ukraine. Raising financing on the domestic market has also become difficult. As of February 18, non-resident investors had pulled out nearly UAH18 billion from domestic bond markets (US$650 million) since tensions began to rise in mid-November. Although the central bank had spent some US$2.3 billion in foreign exchange reserves to stem currency depreciation pressures between mid-November and mid-February, the Hryvnia still lost about 8.4 percent of its value relative to the US Dollar. With the declaration of a state of emergency, the NBU has imposed restrictions on currency and banking transactions.

11. **The ongoing war and limited market access, coupled with mounting fiscal financing needs, are a major pressure point.** Prior to the increase in tensions, Ukraine's fiscal financing needs for 2022 were estimated at 11.8 percent of GDP, including a 3.5 percent fiscal deficit. Just over two-thirds were expected to be met through domestic sources, and the remainder through IFI and external commercial borrowing. These were manageable given market access and affordable funding costs, as well as ample domestic liquidity in the banking sector. However, access to Eurobond markets is now closed, although on March 1 Ukraine was able to successfully raise US$277 million in "war bonds."[4] Additional financing needs due to the crisis are difficult to assess, but in a new baseline scenario (discussed below) the economy is expected to contract by 7.1 percent during the year, and the fiscal deficit to widen to 8.0 percent of GDP due to revenue pressures and additional spending needs. Known additional spending includes a 30 percent wage increase for military personnel, and the provision of US$592 million to ensure flight safety for insurance and leasing companies to guarantee continuation of flights through Ukraine's airspace. But additional

[4] https://www.bloomberg.com/news/articles/2022-03-01/ukraine-sale-of-war-bonds-raises-more-than-8-billion-hryvnia

unexpected needs are likely to materialize during the ongoing war; once conditions normalize, reconstruction and recovery will also add to spending needs.

12. **Additional quasi-fiscal liquidity pressures emanate from the energy sector.** In September 2021, Naftogaz received a US$1.2 billion transfer to cover the gap between regulated and international gas prices from the gas transmission system operator (TSO); the cost of covering the subsidy in Q1 2022 is estimated at about US$0.6 billion. Additional liquidity needs for replenishing the gas storage ahead of the next heating season are estimated at US$5 billion. However, financing in external capital markets for Naftogaz (which would have helped ease liquidity and cash flow pressures) is just as constrained as for the sovereign.

13. **Inflation has remained persistently high, in part due to currency pressures**. Inflation pressures rose significantly last year, reflecting high global energy and food prices, and global supply chain disruptions. Price pressures have remained strong in recent months, in part reflecting currency pressures since November, prompting the NBU to raise rates by 100bp to 10 percent in January (following 300bp of hikes in 2021).

14. **Compared to the 2014/15 crisis the banking system today is in much better shape; still, it faces heightened risks.** Following a rigorous clean-up as a result of the introduction of more stringent regulatory and supervisory measures, system-wide capital adequacy was estimated at 18 percent and NPL ratios at 30 percent at end-2021 (down 11 percentage points versus a year earlier). Although bank liquidity is high, the onset of the war is posing risks. Retail and corporate Hryvnia deposits have been gradually decreasing since the beginning of 2022. About a third of the loan portfolio and deposit liabilities are denominated in FX, a key source of vulnerability in case of sustained currency depreciation and/or economic contraction. Another pressure point is cyberattacks.[5] On February 24, 2022, the NBU adopted a resolution aimed at ensuring reliability and stability of the banking system, which included imposing several temporary restrictions such as cash withdrawal limits, suspension of foreign exchange market operations as well as fixing of the official exchange rate.

MACROECONOMIC OUTLOOK

15. **The macroeconomic outlook has deteriorated significantly since the start of the year.** Projections, given the fluid situation on the ground, are extremely difficult and subject to great uncertainty. The baseline accounts for the start of the war on February 24, which led to an emergency being declared in the country, and should be viewed as preliminary. The inherent uncertainty makes it necessary that projections be anchored to assumptions about the duration and nature of war; for the purposes of projections it is assumed that economic activity is severely impacted by war through end-April, with moderate or localized impacts for several months more. In this scenario, a 30 percent contraction in private investment and 4.5 percent drop in consumption is anticipated for 2022 as a whole. Despite a large drop in exports (resulting from trade disruption that also lasts until the end of April), the

[5] This is evidenced by a recent attack targeting operations of a number of banks including the two largest (state-owned) banks on February 15th. Oshchadbank's front service system stopped functioning (including ATMs, bank app, webservice and the POS terminal network). Privatbank also experienced troubles with bank app, webservice and some POS terminals and ATMs in select areas (most Kyiv ATMs worked). A few smaller banks' systems were also attacked. Stable functionality of web services and apps was restored in about 12-15 hours and caused only minor problems to the banking system.

drag from net exports is moderate, due to a similarly large drop in imports and because trade disruptions are expected to be temporary. Overall, GDP for 2022 is expected to contract by 7.1 percent (Table 1). This is a 10.9 ppt decline relative to pre-crisis projections in DPL-2 and larger than in 2014 (a 6.6 ppt drop); this larger impact takes into account the greater geographical area impacted by the conflict, and the destruction of infrastructure and displacement of people, which affects activity and spending. A gradual recovery in economic activity is projected for 2023 including reconstruction helping to lift investment spending - the latter is correspondingly reflected in an increase in Foreign Direct Investment (FDI) in the outer years of the projection period. Still, only a partial rebound in investment and consumption spending is anticipated, due to economic scarring (the loss of livelihoods, jobs and businesses, permanent loss of some infrastructure and connectivity assets and a delayed return of refugees to their homes) and only a gradual improvement in business confidence. As a result, growth is projected to remain negative in 2023 and return to positive (but modest) growth in 2024. The cumulative GDP loss (relative to the DPL-2 baseline) amounts to 15.3 percent of 2021 GDP.

Table 1: Key Macroeconomic Indicators

	Actual			DPL-2 Projections			Supplemental DPF projections		
	2019	**2020**	**2021e**	**2022p**	**2023p**	**2024p**	**2022p**	**2023p**	**2024p**
Nominal GDP, UAH *billion*	**3977**	**4222**	**5396**	**5599**	**6086**	**6621**	**6166**	**6537**	**6944**
GDP per capita, US$	3672	3766	4799	4937	5367	5839	4082	4367	4682
Real GDP, *percent change*	**3.2**	**-3.8**	**3.2**	**3.2**	**3.5**	**3.8**	**-7.1**	**-0.2**	**1.2**
Consumption, *percent change*	5.3	0.5	5.3	3.4	2.9	2.2	-4.5	0.1	2.2
Investment, *percent change*	11.7	-24.4	10.4	8.1	7.7	9.6	-30.0	12.0	12.0
Exports, *percent change*	7.3	-5.6	-2.4	2.0	4.4	5.0	-30.2	3.0	3.5
Imports, *percent change*	5.7	-9.5	9.2	5.7	4.8	4.1	-30.0	5.0	7.0
Monetary and External									
GDP deflator, *percent change*	8.2	10.3	24.6	7.3	5.2	5.0	21.4	6.2	5.0
CPI (eop), *percent change*	4.1	5.0	10.0	6.0	5.0	4.0	22.0	9.8	5.6
Current Account Balance, *percent GDP*	**-2.7**	**3.4**	**-1.1**	**0.3**	**-0.4**	**-1.0**	**-4.2**	**-2.4**	**-2.0**
Exports of G&S, *percent GDP*	41.3	38.8	41.2	41.3	40.7	40.0	34.2	33.9	34.1
Imports of G&S, *percent GDP*	49.4	40.3	42.7	44.4	44.1	43.8	38.0	40.2	39.7
Foreign Direct Investment, *percent GDP*	3.8	0.2	3.4	1.0	1.3	1.6	0.9	1.4	1.6
Gross Reserves, *billion US$, eop*	25.3	29.1	30.9	…	…	…	…	…	…
External Debt, *percent GDP*	79.1	80.8	64.0	63.2	57.4	52.1	75.2	73.1	67.0
Fiscal									
Revenues, *percent GDP*	39.5	39.7	41.0	40.6	40.7	40.3	32.8	32.5	32.2
Expenditures, *percent GDP*	41.6	45.3	44.7	45.1	43.2	42.5	40.8	39.4	38.4
GG Fiscal Balance, *percent GDP*	-2.1	-5.6	-4.0	-4.5	-2.5	-2.2	-8.0	-6.9	-6.3
PPG debt (eop), *percent GDP*	50.2	60.4	51.3	53.4	52.7	50.5	65.2	67.0	62.6

Source: World Bank Staff Estimates.

16. **Despite some fiscal compression, the deficit is expected to double in 2022 from 2021 levels.** Fiscal revenues are projected to drop by 10 percent in 2022 in line with the economic contraction across all major categories of revenues; on the spending side, it is assumed that the government maintains spending on key social programs, notably pensions. Growing crisis-related spending needs are met through substantial cuts in capital expenditures, including in the roads sector, and through a decline in subsidies to SOEs. Even so, the deficit rises to 8 percent of GDP in 2022 as new spending needs materialize due to the outbreak of war (Table 2). In the remaining years of the projection period, it is assumed that

current expenditures are fixed in nominal terms, in order to generate fiscal space for rising reconstruction and social expenditures. As a result, the fiscal deficit is expected to narrow at a moderate pace and to be financed through a gradual return to Eurobond markets and continued financing from development partners to support reconstruction spending. Inflation is expected to double in 2022, reflecting a combination of war-related goods shortages and some pass-through from exchange rate depreciation. The central bank remains committed to a prudent monetary policy over the medium to long term, and inflation is expected to gradually return towards the target rate over the medium term.

Table 2: Key Fiscal Indicators, percent of GDP

				DPL-2 Projections			Supplemental DPF projections		
	2019	2020	2021e	2022p	2023p	2024p	2022p	2023p	2024p
Revenues	39.7	41.0	41.0	40.6	40.7	40.3	32.8	32.5	32.2
Tax revenues	34.4	35.3	35.7	35.6	35.7	35.8	28.5	28.5	28.3
Personal Income tax	7.0	7.2	7.4	7.3	7.4	7.4	6.0	5.6	5.3
Corporate profit tax	3.0	2.9	3.0	3.3	3.4	3.5	2.4	2.3	2.2
Payroll tax	7.1	7.3	7.6	7.7	7.7	7.8	6.1	5.8	5.5
Property tax	1.0	0.9	0.9	1.0	1.1	1.1	0.7	0.7	0.6
VAT	9.6	9.8	9.9	9.9	10.0	10.0	7.8	9.1	9.8
Excise tax	3.5	3.8	3.7	3.4	3.4	3.3	2.9	2.7	2.6
Taxes on international trade	1.0	0.7	0.8	0.8	0.7	0.7	0.6	0.6	0.6
Other taxes	2.3	2.6	2.4	2.2	2.0	2.0	1.9	1.8	1.7
Non-tax revenues	5.3	5.7	5.3	5.0	5.0	4.5	4.3	4.0	3.8
Expenditures	**41.8**	**47.0**	**45.0**	**45.1**	**43.2**	**42.5**	**40.8**	**39.4**	**38.4**
Current expenditures	**37.7**	**42.9**	**41.0**	**41.1**	**38.2**	**37.0**	**39.6**	**37.2**	**35.3**
Wages and compensation	11.0	11.0	10.5	11.0	10.8	10.5	9.3	8.8	8.3
Goods and services	7.1	9.4	8.2	7.0	6.2	6.0	8.8	8.2	7.8
Interest payments	3.2	3.0	3.5	3.8	3.6	3.3	3.5	3.3	3.1
Subsidies to corporations	1.2	3.3	2.3	3.0	1.5	1.5	1.7	1.0	0.6
Social benefits	15.3	16.2	16.5	16.3	16.1	15.7	15.7	15.8	15.5
Pensions	10.7	11.9	12.0	12.0	11.9	11.5	11.1	11.5	11.4
Unemployment, disability and accident insurance	1.0	1.1	1.2	1.2	1.2	1.2	1.2	1.1	1.0
Social programs	3.6	3.2	3.3	3.1	3.0	3.0	3.5	3.3	3.1
Other expenditures	0.1	0.1	0.0	0.0	0.0	0.0	0.7	0.0	0.0
Capital expenditures	**4.1**	**4.1**	**4.0**	**4.0**	**5.0**	**5.5**	**1.2**	**2.2**	**3.1**
Primary Balance	**1.1**	**-3.2**	**-0.5**	**-0.7**	**1.1**	**1.1**	**-4.6**	**-3.5**	**-3.1**
Gen. Govt Balance	**-2.1**	**-6.0**	**-4.0**	**-4.5**	**-2.5**	**-2.2**	**-8.0**	**-6.9**	**-6.3**

Source: World Bank Staff Estimates.

17. **The higher fiscal deficit in 2022, coupled with constrained market access implies an unanticipated fiscal financing gap of US$11.6 billion (5.7 percent of GDP); shifting the additional financing needs towards domestic sources is expected to be difficult.** These estimates are preliminary but indicate a large financing gap resulting from a higher deficit and reduced access to capital markets. It is assumed that during the acute phase of the war the government is unable to tap financing in external capital markets, and only partially in domestic debt markets. The eventual size of the gap depends on how quickly the crisis is resolved, hostilities cease and access to markets is restored. Compared to the DPL-2 baseline, where it was assumed that excess domestic liquidity in the banking sector (about US$5.5 billion) would be sufficient to absorb nearly two-thirds of financing needs and external capital markets would absorb US$4.5 billion in Eurobond issuance, it is now assumed that Ukraine is unable to issue in external markets throughout the year and that domestic capital markets are able to absorb a smaller share of domestic debt issuance as banks conserve liquidity.

18. **The US$11.6 billion financing gap will need to be met through financing support from partners; current donor commitments amount to about US$5.1 billion, although more is anticipated**. Ukraine has requested an IMF Rapid Financing Instrument (RFI) and is also in discussions with G-7 governments about the transfer of reserve SDR assets.[6] Additional commitments by bilateral donors and development partners to cover emergency financing needs currently amount to about US$5.1 billion, with more funding anticipated during the year.

Table 3: Balance of Payment Financing Requirements and Sources, US$bn

	Actual			DPL-2 Projections			Supplemental DPF projections		
	2019	2020	2021e	2022p	2023p	2024p	2022p	2023p	2024p
Financing requirements (US$ Bn)	**32.3**	**21.3**	**29.4**	**28.7**	**28.2**	**36.9**	**30.0**	**22.3**	**31.4**
Current account deficit	4.1	-5.3	2.1	-0.1	1.4	2.9	7.0	4.2	3.8
Public redemptions (incl. IMF)	5.7	6.0	4.8	4.6	4.7	6.3	4.4	5.3	6.6
Govt redemptions	4.1	4.9	3.5	2.5	2.5	4.8	2.0	2.5	4.1
IMF repayment	1.6	1.1	1.3	2.1	2.2	1.5	2.4	2.8	2.5
LT private debt amortization (incl. portfolio)	5.4	8.5	9.2	6.8	7.4	11.3	6.8	7.4	8.0
ST private debt and trade credit	17.1	12.0	13.3	17.4	14.7	16.4	11.8	5.4	13.0
Financing Sources (US$ Bn)	**32.3**	**21.3**	**29.4**	**28.7**	**28.2**	**36.9**	**30.0**	**22.3**	**31.4**
FDI and portfolio investment	11.3	-0.4	7.8	2.0	3.0	5.0	1.5	3.5	4.0
Public borrowing (incl. IMF)	8.9	9.9	7.1	7.2	6.0	7.0	15.0	5.3	5.8
Eurobond issuance	2.4	4.0	3.0	4.5	3.3	4.3	0.0	0.5	1.0
Official commitments	8.9	7.8	4.4	1.2	1.2	1.2	6.1	1.2	1.2
IMF disbursement	0.0	2.1	2.7	1.5	1.5	1.5	2.2	1.4	1.4
Additional emergency assistance	-	-	-	-	-	-	6.7	2.2	2.2
LT private debt disbursement (incl. portfolio)	4.5	2.3	4.5	5.8	4.8	4.8	1.1	1.5	2.0
ST private debt disbursements	12.0	13.3	11.8	14.7	16.4	21.6	5.4	13.0	21.1
Drawdown in reserves	-4.5	-3.8	-1.8	-1.0	-2.0	-1.5	6.9	-1.0	-1.5

Source: World Bank Staff Estimates.

19. **The current account (CA) deficit is expected to widen in 2022; however sustained remittance inflows are expected to partially offset a widening trade balance.** Remittance from overseas Ukrainians, which amounted to 7.5 percent of GDP in 2021, are expected to remain high, especially once conflict ceases, reflecting increased assistance to families left behind; this helps to mitigate a widening of the trade deficit as export revenues decline more than import revenues. Overall, the CA deficit increases to US$7 billion (4.2 percent of GDP) in 2022. This will increase external financing needs given the substantial debt repayments coming due, including to the IMF. On the financing side, FDI is expected to drop sharply alongside portfolio inflows. Accordingly, the bulk of financing is expected to be met through official financing from multilateral partners and donors; in Table 3, the closure of external financing gaps is contingent on additional emergency assistance of US$6.7 billion in 2022. It is further assumed that Ukraine, as it recovers and reconstructs, will continue to receive additional official assistance (programmed at US$2.2 bn per year in Table 3) in coming years. External financing risks are partly mitigated by the remaining US$2.2 billion in available IMF disbursements this year under its SBA program, the mobilization of external support by bilateral partners (see discussion below) and still substantial external FX buffers. Furthermore, as a gradual recovery takes hold, and reconstruction begins, FDI is

[6] Reuters report dated February 17, 2022: “Ukraine bids for SDR transfers in funding push, new IMF deal” https://www.msn.com/en-us/money/markets/exclusive-ukraine-bids-for-sdr-transfers-in-funding-push-new-imf-deal-finance-minister/ar-AAU05ax

expected to slowly rise, followed by a return to portfolio investment flows and improving access to Eurobond markets.

20. **The Debt Sustainability Analysis (DSA) shows that public and external debt sustainability is contingent on mobilization of substantial official financing during 2022 and is highly vulnerable to shocks.**

21. **Public Sector DSA.** Under the baseline scenario, which assumes that Ukraine receives exceptional emergency financing in 2022, the public debt to GDP ratio is expected to increase to close to 65 percent of GDP in 2022 and then gradually decline to 60 percent. With growth recovering slowly and fiscal policy shifting towards supporting investments for reconstruction and recovery, debt is expected to remain at these levels. Risks to the baseline scenario case are high. Exchange rate risks are particularly critical given the large share of FX denominated debt (about 65 percent of total public and publicly-guaranteed (PPG) debt in 2021). A real exchange rate shock could push the PPG debt level to almost 90 percent of GDP in 2022-2024 (Figure 1), while a combined macro-fiscal shock would increase PPG debt to above 110 percent of GDP in the medium term.

Figure 1: Public and Publicly Guaranteed Debt (percent of GDP)

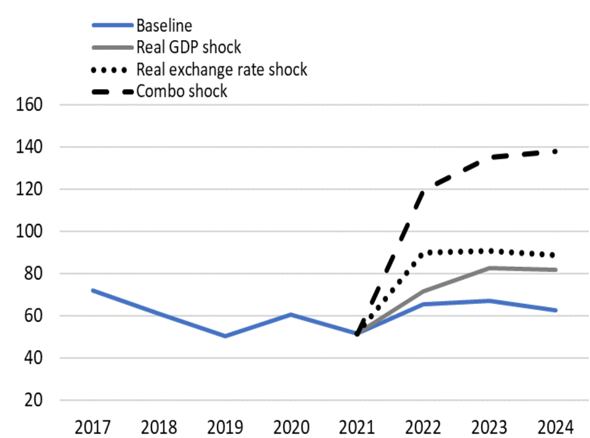
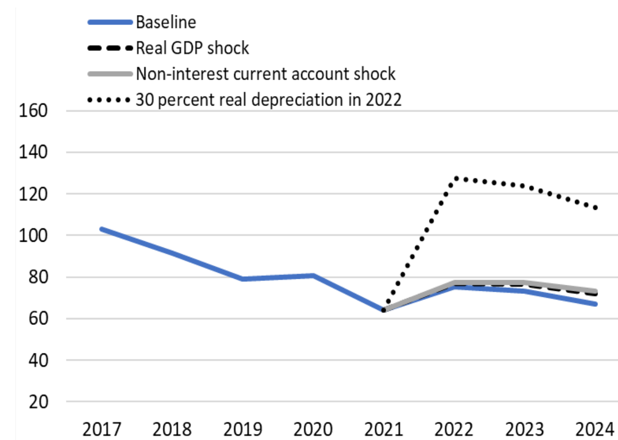


Figure 2: External Debt (percent of GDP)



Source: World Bank Staff estimates.

22. **External Sector DSA.** Similarly, the gross external debt from 64 percent to 75 percent of GDP in 2022 baseline scenario foresees an increase in. The external deficit is expected to widen substantially while FDI and portfolio investments are projected to decrease, close to their historical minimum. In the medium term external debt is expected to fall to about 67 percent of GDP as growth and FDI inflows pick up while the current account deficit will also be on a declining path. As with public debt, the external debt trajectory is subject to high risks. A 30 percent real depreciation shock in 2022 would drive debt to about 127 percent of GDP. Lower GDP growth (by half a historical standard deviation or 2.5 percentage points), and a non-interest current account shock (one percentage point above the baseline) would keep the external debt to GDP ratio elevated at close to 76 percent in 2022-2024. These risks are mitigated by the availability of low-cost funding from development partners. However, a meaningful reduction in vulnerability is contingent on the availability of additional external financing, e.g., in the form of a new

disbursing arrangement with the IMF or transfer of SDR reserve assets, which also help to anchor market risk perceptions and gradually reduce funding costs in external capital markets.

23. **Despite the severe shock and high levels of vulnerabilities, the macroeconomic policy framework is assessed to be adequate for the proposed Supplemental DPF, conditional on the mobilization of substantial additional external financing**. The outlook is acutely vulnerable to further downside risks, notably a longer duration of war, inducing a deeper and more protracted economic crisis. Key factors, including the externally driven nature of the conflict, cannot be mitigated by the GoU. However, the macroeconomic policy framework is assessed as adequate on the basis of the following factors: (1) demonstrated commitment to prudent macroeconomic policies, including the implementation of a monetary policy framework that has gained credibility, and strengthening of fiscal policy as reflected in counter-cyclical use of fiscal buffers during the COVID-19 crisis; (2) the demonstrated commitment to structural reforms (including those supported by the parent DPL-2 operation) since mid-November even as geopolitical risks increased, and simultaneous efforts to mitigate risks, as evidenced by use of SDRs to buyback debt; (3) commitments by donors and international partners to substantial additional emergency funding, currently estimated at about US$5.1 billion, that should help to ease near-term financing pressures, although meeting projected external liquidity needs will hinge on additional commitments in coming days from bilateral partners that fully cover the emerging gap. The ongoing second review between the IMF and Ukraine of the 2020 SBA program remains an important anchor and further emergency financial support is also expected.[7] Given the fluidity of the situation, the World Bank, along with other partners continues to monitor macroeconomic developments and to support the design and implementation of key reforms to adjust the policy framework.

3. RESPONSE TO THE CRISIS

3.1. THE GOVERNMENT'S RESPONSE

24. **Prior to the start of war, the GoU had proactively taken steps to monitor and manage macroeconomic risks.** The Government provided backstops of US$592 million to support airspace and air travel continuity with the country, given the lack of availability of commercial insurance. Towards the end of 2021, Ukraine used up about half of its 2021 IMF SDR allocation to buy back 10 percent of a Eurobond payments due in September 2022 and GDP linked debt warrants with the objective of reducing medium-term liquidity pressures and debt servicing risks.[8] More recently, Ukraine raised 8.1 billion Hryvnia (US$277 million) in a sale of war bonds at a yield of 11 percent, mostly to non-resident investors. In addition to measures taken over the last few years to strengthen the resilience of the banking system, the NBU was closely monitoring banking sector risks, especially operational/cyber-risks including testing of systems and advised on the development of contingency plans. The NBU maintains standard ELA

[7] https://www.imf.org/en/News/Articles/2022/02/25/pr2251statement-by-imf-md-on-ukraine

[8] In 2015, Ukraine's creditors agreed to write off 20 percent of their original holdings as part of a sovereign debt restructuring. In exchange, the bondholders received these GDP-linked warrants, which will have to be paid as soon as GDP growth exceeds 3 percent and nominal GDP exceeds $125.4 billion. The payouts become especially lucrative for bondholders once real GDP growth exceeds 4 percent, when Ukraine must pay 40 percent on wealth created above the $125.4 billion GDP threshold. In total, the Government bought 5 percent of outstanding GDP warrants in December, raising its holdings to 20 percent (up from 10 percent in 2020).

(Emergency Liquidity Assistance) instruments available to all solvent banks in case of needs, and it also has up to date information about the resilience of the banking system to shocks by conducting annual stress tests, the most recent one completed in Q4 2021 covering the 30 largest banks. Following the declaration of an emergency, on February 24, the NBU introduced temporary restrictions on bank cash withdrawal limits and foreign exchange market operations as to mitigate banking sector liquidity risks.

25. **In the gas sector, in anticipation of the need to replenish gas reserves in early summer, Ukraine began to take steps to import gas through guaranteed gas supply routes.** Ukraine increased its total import capacity by about 30 percent to 35 million cubic meters (mcm) per day starting January 1, 2022 through a new agreement signed with Hungary. This adds to the 27mcm of previously existing daily capacity from Slovakia and gives access to new sources of natural gas supply via Croatia.[9] Separately, in the power sector, after several years of preparatory regulatory and legislative reforms, Ukrenergo (the Transmission System Operator) was certified as compliant and independent, in line with EU energy legislation, enabling the process of synchronization with ENTSO-E. Ukraine has also completed technical studies for synchronization and certified ancillary service reserves. In recent months it has increased production of coal and coal imports to reduce reliance on gas imports during the winter, and mitigate risks associated to isolated mode operation of its electricity network prior to synchronization with Europe, planned for 2023.

3.2. THE BANK'S RESPONSE, STRATEGY, AND COLLABORATION WITH DEVELOPMENT PARTNERS

26. **To address the fiscal financing gap, the government has requested the proposed Supplemental DPF for US$350 million, which will be part of a larger package of bilateral and multilateral support (including IMF).** The proposed Supplemental DPF is complementary to other multilateral financing, including US$2.2 billion in remaining SBA disbursements by the IMF, €1.2 billion in MFA by the EU, and a US$1 billion currency swap agreement with Poland. It is also helping to catalyze additional financing from other donors in in the form of bilateral guarantees and parallel financing and is being complemented by a standalone MDTF, to channel donor resources to support the operation, as financing needs persist. Such financing instruments will help to provide immediate budget support to Ukraine, parallel to the World Bank Supplemental operation and may potentially be leveraged in a future DPL.

27. **The Supplemental DPF will provide resources to support the continued delivery of public services and finance social expenditures during a time of acute socio-economic and financing pressures~~.~~** The financing will come on top of the €300 million approved for DPL-2. The resources will finance part of the large emerging fiscal and external financing gap caused by the conflict, and – by safeguarding continued spending on critical social and public services – help to prevent a further deterioration in economic and social impacts of the crisis. Such an (avoidable) deterioration would not only jeopardize program and development results supported by DPL-2, but could have potentially long-lasting setbacks to poverty and development gains of recent years. The Government is also in discussions with the World Bank on a new US$500 million DPF, a second Additional Financing for Emergency COVID-19 Response and Vaccination project, and restructuring of existing loans in education and other essential services.

[9] Ukraine's total gas import capacity (35 firm and 252 interruptible) from the EU amounts to 287.2mcm of gas per day.

28. **The proposed Supplemental DPF aligns with the World Bank Group's strategic priorities and FY17-21 Country Partnership Framework (CPF).** The CPF[10] objectives are to promote sustained and inclusive economic recovery with a focus on four areas including: (i) making markets work; (ii) fiscal and financial sustainability; (iii) efficient, effective, and inclusive service delivery; and (iv) better governance, anticorruption, and citizen engagement. The proposed Supplemental DPF, as was the parent operation, aligns with these priorities. The CPF noted the potential adverse impact on the program from governance, political and conflict risks, and thus the importance of deep and sustained engagement by the Government and other stakeholders and partners, as well as the need for flexibility in programs and projects. The analytical underpinnings of the reforms supported in DPL-2 and this Supplementary DPF are anchored to the priorities identified in the 2017 Ukraine Systematic Country Diagnostic (SCD), the subsequent 2021 Update and a 2019 Growth Study.[11] The reform areas are also aligned with World Bank investment projects and technical assistance in energy, agriculture, transport, financial sector, and anticorruption. The proposed operation is also aligned with the second pillar of the WBG Strategy for Fragility, Conflict, and Violence 2020–2025 of remaining engaged during conflict and crisis situations to preserve hard-won development gains, protect essential institutions, build resilience, and be ready for future recovery.

29. **The World Bank's response strategy in Ukraine is part of a coordinated engagement between GoU and other development partners.** This operation is accompanied by linked parallel financing of US$100 million from Japan, and underpinned by guarantee coverage to IBRD under this Supplementary DPF amounting to €79.75 million, and US$50 million from the Netherlands and Sweden, respectively. The proposed MDTF co-financing would contribute to filling part of this unanticipated gap in financing. As of March 4, ECA has committed pledges from Iceland (US$0.5 million), Latvia (US$5.5 million), Lithuania (US$5.5 million), Denmark (US$20 million) and the UK (US$100 million), with additional contributions also expected.

4. THE REFORM PROGRAM SUPPORTED THROUGH ORIGINAL OPERATION: AN UPDATE

30. **The Ukraine Second Economic Recovery Development Policy Loan (DPL-2) was approved on December 17, 2021, and Ukraine demonstrated strong commitment to implement reforms, even during a severe increase in geopolitical tensions.** The Loan Agreement was signed, and the operation declared effective, on December 20, 2021, with disbursement on December 23, 2021. Prior to the onset of the war, the program was being implemented in compliance with the provisions of the legal agreement with the World Bank.

31. **Key reforms also remained on track: in the land sector, the government moved to implement land legislation to strengthen land management, streamline land transfer and registration procedures, and make emphyteusis rights transferable and mortgageable.** A total of 63 CMU resolutions were needed to regulate land legislation that has been enacted over the past two years, including in DPL-1 and DPL-2 (Laws # 340, 554, 711, 985, 1423, 1444 and 1865 in addition to the Land Turnover Law #552). Of these, 31 have been approved and work on all but 19 of the remaining ones has started. Since the opening

[10] Report # 114516-UA discussed at the Board on June 20, 2017.

[11] See World Bank (2017) "Toward Sustainable Recovery and Shared Prosperity" and World Bank (2021) "Pathways to Resilience, Sustainability and Inclusion" and World Bank (2019), Ukraine Growth: Faster, Lasting, Kinder."

of the land market, more than 100,000 land transactions for a total of some 250,000 hectares (ha) have been conducted. The government introduced electronic land auctions, with the CMU Resolution #1013 in September 2021 assigning the e-procurement platform Prozorro to carry out e-auctions of state and communal land. Since then, about 25,000 hectares have been e-auctioned, bringing the state and communes UAH1.3 billion (US$48 million) in lease and sale revenues. In addition, a technical audit of security, software, and data for the State Cadaster Center is currently being implemented. This is expected to result in the elaboration of a plan for transforming the State Geocadaster into a transparent and efficient technical service agency with proper protections against corruption which, once accepted, could be supported technically and financially.

32. **Ukraine also moved to operationalize the Partial Credit Guarantee (PCG) Fund** with a sound independent governance framework which will support the land purchase by small credit-constrained farmers. The related legislation came into effect on November 24, 2021 and was followed by the passage of the 2022 State Budget Law on December 2, 2021 that allocated UAH 200 million for the authorized capital of the PCGF. In parallel, the authorities have committed to provide a bridge guarantee instrument to support small farmers until the PCG Fund becomes fully operational. The relevant CMU resolution (Resolution #723) was adopted on July 14, 2021. Moreover, the resolution received the necessary conclusion issued by the Anti-Monopoly Committee on its compliance with state aid. The CMU resolution #1262, allocating limits to 12 financial institutions with Ukreximbank being the implementing agency, was adopted on December 02, 2021, with the bridge guarantee instrument becoming fully operational shortly thereafter. Other steps towards operationalization of the PCG Fund are also progressing well. The CMU adopted resolution #125 dated February 16, 2022, on establishing the PCG Fund and adopting the PCG Fund Charter. In line with the commitments set forward in the letter of development policy, the adopted PCG Fund Charter foresees that the PCG Fund’s Supervisory Board shall consist of five members, three of which shall be independent, and with its chairman selected among its independent members. Currently, the Ministry of Agrarian Policy and Food and CMU are working on the finalization of the remaining three resolutions.

33. **The GoU also progressed on implementing reforms in the inland waterway sector.** After the adoption of the inland waterway law in December 2020 to provide non-discriminatory access to inland waterways to both local and foreign vessels, promote competition and facilitate much-needed private investment to modernize the inland waterway system, the Rada recently passed law 5090 on “Amendments to the Budget Code of Ukraine", which also creates the state fund for inland waterways to help ensure the financing sustainability of inland waterways. On January 1, 2022 the Government lifted restrictions on the movement of foreign vessels, in keeping with the provision for non-discriminatory access to inland waterways for both local and foreign vessels. The Government is also in the final stages of preparing an Inland Waterway Transport Development Strategy and Action Plan 2021-2031.

34. **The GoU has remained committed to timely indexation of pensions**. The pension reform law 2148 of 2017 introduced annual indexation of pension benefits. The Law established the mandate and the process by which pensions would be indexed, but not the timing, leaving pensions still vulnerable to erosion of their value over time. In 2019-2021, the date for annual pension indexation was set by Cabinet decrees. The date of March 1 was set in 2021 and the same date was confirmed for 2022 by a Cabinet decree No 118 of February 16, 2022. In parallel, in February 2022, Draft Law 4668 promulgated by the Parliament confirmed March 1 as the permanent legal date for any future annual pension benefit

indexations, and it also linked the indexation of military pensions to the general pension indexation mechanism. This is an important achievement in the pension reform process, introducing predictability in planning and better ensuring benefit adequacy for pension beneficiaries. In the deteriorating fiscal conditions associated with the current geopolitical crisis, the state budget will be stretched to fulfill its legal commitment to the pensions increases. The incremental funding needed to meet indexation commitments from March 2022 (with a 14 percent increase in the base value of the benefit) is estimated at UAH 3-4 billion per month.

35. **As for other critical reforms supported by the DPL series, the anticorruption architecture has mostly been maintained and justice reform has made important progress.** Key anti-corruption reforms relating to asset declaration and verification were supported by the first operation in the DPL series (First Economic Recovery DPL, DPL-1) and reaffirmed in the Letter of Development Policy for DPL-2. The National Agency for Corruption Prevention (NACP, responsible for asset declarations) has carried out its mandate without any notable disruptions. The first Independent External Audit Commission of NACP's performance started its work.[12] The NACP also has met the target of 1,500 high-risk declarations verified by 2022 (result indicator #4 in the PO series) with 1522 declarations verified as of the end of 2021. The reform of the judiciary has made important progress in recent months with the launch of the Selection Commission for the High Qualification Commission of Judges and the Ethics Council of the High Council of Justice, both of which include international justice experts appointed based on recommendations from Ukraine's international partners. The High Anti-Corruption Court and its Appeals Chamber are continuing to deliver first instance and final judgments, including convictions against officials including former and current judges, former prosecutors and SOE executives.

36. **This progress notwithstanding, reform implementation is at risk due to the outbreak of war.** While government focus has shifted towards dealing with this crisis, it is expected to make further progress implementation of the program, conditional upon cessation of war and a gradual normalization of conditions. Nevertheless, fiscal pressures have increased, and these could lead to significant underfunding or diversion of allocated budget funds e.g., for the PCG fund, which is critical for small farmers (who are severely underbanked) to access low-cost financing to undertake productive investments; and for investment in strategic inland waterway infrastructure that is essential for supporting trade as about half of Ukraine's exports are maritime, and with a much larger percentage for agriculture products, almost all of them passing through the Black Sea. Fiscal pressure could also slow the reform agenda viz. the transformation of the state Geocadaster and the move towards a unified property registry and, as noted above, delay the timely indexation of pensions. Even if conflict were to cease quickly, it is likely that the results indicators of the DPL-2 operation will be met after the target date.

5. RATIONALE FOR PROPOSED SUPPLEMENTAL FINANCING

[12] This concept of the Audit Commission was introduced in the October 2019 amendments to the Law on Corruption Prevention (supported by DPL-1) to ensure oversight of NACP performance. To ensure the independence of the audit, the Law mandated that the members of the Independent External Audit Commission should be experts proposed by Ukraine's international partners and appointed by the CMU.

37. **The proposed supplemental financing is in line with the World Bank's DPF policy.** The Bank's DPF policy provides for supplemental financing—a separate loan additional to a DPO that has not been closed—in exceptional cases when an unanticipated gap in financing jeopardizes a reform program that is otherwise proceeding on schedule and in compliance with the agreed policy agenda. More specifically, supplemental financing is approved when: (a) the Program is being implemented in compliance with the provisions of the Loan Agreement; (b) the Borrower is unable to obtain sufficient funds from other lenders on reasonable terms or in a reasonable time; (c) the time available is too short to process a further free-standing Bank operation; and (d) the Borrower remains committed to the Program and the implementing agencies have demonstrated competence in carrying it out.

38. **Ukraine satisfies all four criteria for supplemental financing. First, on criteria (a) and (d), Ukraine has made progress on implementing reforms supported by DPL-2 as well as the broader development agenda.** Prior to the onset of war, the DPL-2 reform program was on track and being implemented in compliance with the provisions of the legal agreement with the Bank, as described in detail in the previous section. In addition, the broader development agenda remains intact—as reflected in further progress on judicial reforms that are crucial to anchoring broader investor confidence in the rule of law, or financial sector reforms[13] that are vital for financial deepening and lifting private investment—which should support Ukraine's medium-term growth performance. Although not possible to monitor the further implementation of reforms given the war, reform reversals (e.g., legislative reversals) have not occurred. As conditions normalize, implementation is expected to continue. The GoU and implementing agencies remain committed to the program and are supported by technical assistance in land, energy, social protection, anti-corruption and financial sectors. The financial package by development partners, including the World Bank, helps to mitigate macroeconomic and liquidity risks that threaten gains in poverty reduction and development in Ukraine.

39. **On criteria (b), the geopolitical crisis has created a large and unanticipated financing gap while significantly constraining financing sources.** As discussed in Section 2, sizeable fiscal financing gaps have arisen since the war. At the same time, access to external commercial financing is curtailed, requiring a strong and coordinated effort by the development community to meet these financing needs. Given the timeframe for when resources are needed, the expected liquidity pressures, and the currently available financing sources, financial assistance from development partners, including the supplementary DPF from the World Bank, is needed. This will provide Ukraine with the fiscal space to maintain key social expenditure during a major crisis and conflict situation. By helping to cover part of the gap in external financing needs, it will shore up confidence in the currency and help to avoid a larger-than-needed adjustment in the exchange rate that could push up inflation, undermine purchasing power of households and threaten financial stability due to the high dollarization in the banking sector.[14] It will also help to preserve implementation and policy capacity to continue implementing structural reforms supported in DPL-2 (to which this supplemental is attached).

40. **With regard to criteria (c), given the urgency of unanticipated financing needs, there is insufficient time to process a free-standing DPL; however, the policy dialogue with Ukraine remains**

[13] Progress e.g., is reflected in the passage of the first reading of several draft laws strengthening key financial institutions, such as National Securities and Stock Market Commission, as well as strengthening bank resolution and recovery and debt restructuring by the Deposit Guarantee Fund.

[14] About 30 percent of deposits in the banking sector are in foreign currency.

robust, **and future DPLs are planned.** A rapidly disbursing supplemental operation provides financing when it is most needed. At the same time, policy dialogue on a future DPO remains active.

6. OTHER DESIGN AND APPRAISAL ISSUES

41. **The parent DPL supported the annual indexation of pensions for all categories of retirees no later than March 1st of each year from 2022 to 2024** (Resolution No. 548). While the annual indexation of pensions was established by the Bank-supported pension reform in 2017, it allowed flexibility on the timing of statutory pension indexation, undermining the predictability of pension benefits and contributing to risks of volatility in purchasing power, especially in an environment of higher inflation. While the indexation rules have been consistently applied in 2020 and 2021—and have led to a decrease in the share of pensioners among the poor—the current fiscal pressures and high financing needs, exacerbated by high energy prices that are being absorbed by the budget, may lead the GoU to delay indexation of pensions. Additional fiscal resources are required to avoid this, as a delay in pensions indexation amid high inflation and increasing economic hardship would lead to large increases in poverty—as illustrated by the 2014/15 crisis, when a nominal pensions freeze led to a seven-fold increase in poverty among pensioner-headed households.

42. **Sustained currency pressures and the resulting inflation could have significant social impacts in a country where economic vulnerability is already very high**. Currency pass-through from a 1 percent depreciation is estimated at about 0.2-0.3 percent over 8-12 quarters in Ukraine, and about 0.4 percent for food prices. Food accounts for 46 percent of household spending budgets for the bottom 40 percent of the income distribution.[15] Currently one in five people live below the actual subsistence minimum, with standards of living further eroded by high inflation of close to 10 percent over the past several months. Livelihoods, furthermore, have been impacted by the COVID-19 crisis which upended a recovery in labor markets that started in 2017. Severe currency and economic pressures would have considerable social impacts, including through higher inflation and loss of income. In addition, inflation would also erode household savings with potentially long-term welfare consequences. About two-thirds of deposits in Ukrainian banks are in LCU and would lose much of their value in the face of high inflation.

43. **Currency depreciation also makes imported gas more expensive**. Over the past year, the GoU has tried to absorb higher global gas prices on Naftogaz' balance sheet and tried to limit the pass through to households by regulating prices. However, if there is a very large depreciation, and it is unable to continue doing so, higher costs that are passed on to households could also be problematic due to the already high share of utility spending in the total household budget (17 percent for the bottom 40 percent in 2020-subsidy included), and large housing and utility subsidy payments.

44. **There are no changes to the assessment of environmental effects set out in DPL-2.**

45. **Disbursements of resources will be subject to the same processes set out in DPL-2, under fiduciary arrangements discussed below**. Core PFM systems, including those in the central bank, remain as described in DPL2 and the FM due diligence carried out for that operation remains relevant.

[15] Faryna, O., (2016). "Nonlinear Exchange Rate Pass-Through to Domestic Prices in Ukraine." Visnyk of the National Bank of Ukraine, No. 236, 30–42.

46. **The IMF conducted safeguards assessments of the NBU in 2014, 2015, and 2019.** The assessments confirmed that the NBU has made progress in strengthening its governance and control environment. The NBU legal framework was amended in 2015, further improving financial autonomy and governance. In addition, the NBU's institutional framework has been substantially strengthened and modernized, focusing on core functions and improving its decision-making processes and internal controls. The NBU adopted a new ethics code for members of its decision-making bodies and for its staff. A new Audit Committee was established under the new NBU Council and an internal audit charter has been adopted. To address the credit risks stemming from the financial assistance to domestic banks, the loan management process and related risk management processes were reformed under a new loan management department. Consolidated financial statements of NBU prepared under requirements of IFRS were audited by Deloitte (year 2018) and by Ernst and Young (years 2019 and 2020). Independent auditors conducted respective audits under requirements of ISA and issued clean (unmodified) audit reports for these past three consecutive years.

47. **Disbursements.** The loan proceeds will be disbursed in one single tranche to the existing treasury account at the NBU, to be used for budget financing, and will form part of Ukraine's official foreign exchange reserves. The proposed loan will follow the WB's procedures for development policy lending. Disbursement will be made upon declaration of loan effectiveness and submission of a withdrawal application to the World Bank. Within seven days of remittance of funds by the Bank, the Government will provide a confirmation to the World Bank that the funds have been received by the treasury account in the NBU and that these funds are available for financing budget expenditures.

48. **Additional fiduciary arrangements will be required for this operation, given the current outbreak of war which could affect PFM institutions and processes.** Such additional arrangements may include additional assurance aimed to confirm receipt of the funds into government EUR account and their further exchange and transfer to the government State Treasury account in UAH, and onward incorporation into the government budget. Such assurance could entail either an independent audit of these steps in the funds flow process, or review by World Bank staff of the mentioned transactions. For the same reason, fiduciary risk is considered high, up from moderate in the original operation. Given the ongoing war, it should be noted that these additional fiduciary arrangements may not fully cover the risks attached to the situation in the country.

49. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank DPO may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

7. SUMMARY OF RISKS AND MITIGATION

50. **Relative to the DPL-2, the overall risk of the operation has been elevated to high, with a corresponding increase across all categories to this level**. The outbreak of war is expected to have severe macroeconomic, growth, financial and social impacts in Ukraine. This risk is partially mitigated by the proposed operation and the additional financing that it will help to catalyze from development partners; in particular, the increased resources will help the GoU to continue critical social and public spending during a period of extraordinary economic and social stress, and to manage disorderly macroeconomic adjustment. That said, vulnerabilities will remain heightened on account of the need to identify an additional US$6.7 billion in financing from partners. Mitigating the latter risk is partially contingent on the rapid mobilization of additional resources from bilateral partners and IFIs, including an IMF emergency response package (on top of the ongoing SBA). Against the backdrop of ongoing war, institutional capacity, technical design, stakeholder and fiduciary risks have also increased; additional fiduciary arrangements will be required for this operation to ensure appropriate use of funds prior to loan disbursement. The government has sizeable eligible budgetary expenditures that the DPF funds are expected to finance shortly after disbursement. An increase in program implementation risks is mitigated by the GoU's track record on implementation of DPL-2 supported reforms; although not possible to verify implementation during the current situation, it is reasonable to anticipate a "pause" in implementation. As conditions normalize, strong commitments by the GoU to complete reforms, coupled with strong policy dialogue and engagement with partners, and resumption of technical assistance, will help to mitigate these risks. Notwithstanding these mitigation factors, a large residual risk remains regarding the duration and severity of the current conflict. It is not possible to mitigate this risk.

51. **It is important to note that there are also risks associated with not proceeding with the proposed Supplemental DPF.** Without a rapid budget support instrument, the ability to mobilize a broad international coalition of partners to help the people of Ukraine would be undermined. It would also add to macroeconomic risks and policy implementation risks; these would arise from an (avoidable) disorderly macroeconomic adjustment that leads to a deeper than necessary economic and social crisis and erosion of institutional capacity. Not only would this have immediate impacts on reforms, and poverty reduction and development gains achieved in recent years, but it could also hinder recovery efforts in the future.

Table 4: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	● High
2. Macroeconomic	● High
3. Sector Strategies and Policies	● High
4. Technical Design of Project or Program	● High
5. Institutional Capacity for Implementation and Sustainability	● High
6. Fiduciary	● High
7. Environment and Social	● High
8. Stakeholders	● High
9. Other	● High
Overall	● High

ANNEX 1: PARENT PROJECT POLICY AND RESULTS MATRIX

Prior Actions and Triggers		Results		
Prior Actions under DPL-1	**Triggers for DPL-2**	**Indicator Name**	**Baseline**	**Target**
Pillar 1---Foster De-monopolization and Anticorruption Institutions				
Prior Action #1. Completed the unbundling of the state-owned gas transport system from Naftogaz on January 1, 2020 through: (i) the enactment of Law #264-IX on Unbundling; and (ii) the transfer of state-owned gas transport system's assets from the balance sheet of UTG to Gas TSO LLC.		**Results Indicator #1**: The share of gas transit revenues flowing in a transparent manner from Naftogaz to the new independent Gas TSO, based on the tariff set by the NEURC.	Baseline (2019): 0 percent	Target (2022): 100 percent
Prior Action #2. Enacted Law #155-IX on Concession to enhance the legal framework for attracting private investment in infrastructure and ensuring transparency in concession projects.	**Prior Action #1.** The Borrower has enacted Law # 1054-IX dated December 3, 2020 "On Inland Water Transport", and duly published in the Borrower's Official Gazette on January 9, 2021, establishing an open regulatory framework and enabling non-discriminatory access of operators to inland waterways.	**Results Indicator #2**: Number of port concession projects signed with private investment mobilized through project financing by lenders. **Results Indicator #3.** Number of voyages by ships (including cargo) on Dnipro River increases by about 20 percent.	Baseline (2019): 0 Baseline (2019): 11,938	Target (2021): 2 Target (2021): 14,300
Prior Action #3. Enacted Law # 140-IX to strengthen the governance of the National Agency of Corruption Prevention (NACP) and Law # 263-IX to restore liability for illicit enrichment and enable civil forfeiture of		**Results Indicator #4**: Number of full verifications of high risk declarations selected using prioritization criteria, assigned automatically to staff, and implemented using an	Baseline (2020): 0	Target (2022): 1,500

unjustified assets.		improved methodology.		
Pillar 2---Strengthen Land and Credit Markets				
Prior Action #4. Enacted Law # 552-IX to enable the sale of agricultural land and the use of land as collateral and Law # 554-IX to strengthen transparency by improving access to cadastral data and links between the cadaster and registry	**Prior Action #2.** The Borrower has enacted Law #1423-IX dated April 28, 2021 "On amendments to some legislative acts of Ukraine to improve the system of management and deregulation in the field of land relations", and duly published in the Borrower's Official Gazette on May 26, 2021, streamlining land transfer procedures and decentralizing land management, which simplifies procedures to create, transfer, and use land parcels; and transfer the ownership and administration of state land from the Geocadaster to local authorities. **Prior Action #3.** The Borrower has enacted Law # 1444-IX dated May 18, 2021 "On modification of some legislative acts of Ukraine concerning sale of the land plots and acquisition of the right of their use through electronic auctions", and duly published in the Borrower's Official Gazette on June 25, 2021, regulating local state land use, including mandating electronic auctions for state land sales. **Prior Action #4.** The Borrower has enacted Law #1865-IX dated November 4, 2021 "On the Fund for the Partial Guarantee of Loans in Agriculture" and duly published in the Borrowers' Official Gazette on November 23, 2021, creating affordable and effective financing instruments for small farmers through the establishment of a partial credit guarantee facility.	**Results Indicator #5:** Area of agricultural land previously under moratorium sold/purchased by eligible individuals **Results Indicator #6**: Loans are issued to small farmers and backed by Partial Credit Guarantee (PCG) facility	Baseline (2019): 0 hectares Baseline (2019): No	Target (2022): 150,000 hectares Target (2022): Yes

Prior Action #5. Issued NBU prudential regulations #49 and #52 on write-offs for fully provisioned NPLs and approved Cabinet of Ministers of Ukraine Resolution # 281 to enable state-owned banks NPL resolution through conventional tools including restructuring and sale with haircut on principal, as well as write-offs.		**Results Indicator #7:** Gross Pre-2020 NPL Portfolio of State-Owned Banks	Baseline (2019): UAH 397 billion	Target (2021): Under UAH 300 billion
Prior Action #6. Enacted Law # 79-IX to enhance the regulatory framework for nonbank financial institutions by abolishing the National Financial Services Commission and assigning the regulatory functions to the National Bank of Ukraine and National Securities and Stock Market Commission.		**Results Indicator #8:** NBU and NSSMC adopt action plan on reshuffling supervisory regimes for insurance, credit unions, pension funds, and other NBFIs.	Baseline (2019): No	Target (2021): Yes
***Pillar 3---Bolster the Social Safety Net*.**				
Prior Action #7. Approved Cabinet Resolution # 251 to set the date and rate for the statutory pension indexation in 2020 and bolster the purchasing power of the pension benefit.	**Prior Action #5.** The Borrower, through its Cabinet of Ministers, has approved the Budget Declaration for 2022-2024 and submitted it to the Verkhovna Rada of Ukraine through Resolution No. 548 dated May 31, 2021 "On the Budget Declaration for 2022-2024" requiring indexation of pensions for all categories of retirees not later than March 1st of each year from 2022 to 2024.	**Results Indicator #9:** Pension benefits increase in line with the indexation formula within the first half of each calendar year, allowing adequate support for pensioners, of which at least 65 percent are women.	Baseline (2019): No	Target (2022): Yes