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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

FIRST ECONOMIC RECOVERY DEVELOPMENT POLICY LOAN (DPL)

IN THE AMOUNT OF
US$ 350 MILLION

TO

UKRAINE

JUNE 1, 2020

Macroeconomics & Fiscal Management Global Practice (GMFDR)
Belarus, Moldova, and Ukraine Country Unit (ECCEE)
Europe and Central Asia (ECA)

Public Disclosure Authorized

UKRAINE – GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of May 30, 2020)

Currency Unit UAH
US$1.00 UAH 26.91

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS

CPF	Country Partnership Framework	MOF	Ministry of Finance
DB	Doing Business	NABU	National Anticorruption Bureau of Ukraine
DH	District Heating	NACP	National Anticorruption Prevention Agency
DPL	Development Policy Loan	NBU	National Bank of Ukraine
DTF	Distance-to-frontier	NPL	Non-performing loans
EBRD	European Bank for Reconstruction and Development	OECD	Organization for Economic Cooperation and Development
ECA	Europe and Central Asia	PDO	Program Development Objective
EFF	Extended Fund Facility	PEFA	Public Expenditure and Financial Accountability
EIB	European Investment Bank	PIM	Public Investment Management
EU	European Union	PIMA	Public Investment Management Assessment
FY	Fiscal Year	SBA	Standby-Arrangement
GDP	Gross Domestic Product	SFS	State Fiscal Service
HUS	Housing and Utility Subsidy	SOB	State Owned Bank
IAC	Inter-Agency Committee	TA	Technical Assistance
ICR	Implementation Completion and Results Report	UAH	Ukraine Hryvnia
IMF	International Monetary Fund	UN	United Nations
JICA	Japan International Cooperation Agency	USD	United States Dollars
M&E	Monitoring & Evaluation	VAT	Value-added Tax

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UKRAINE

FIRST ECONOMIC RECOVERY DEVELOPMENT POLICY LOAN

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P172597	Yes	1st in a series of 2

Proposed Development Objective(s)

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

Organizations

Borrower:	MINISTRY OF FINANCE
Implementing Agency:	MINISTRY OF FINANCE

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**350.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	350.00

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

Substantial

Results

Indicator Name	Baseline (2019)	Target (2021)
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.	0 percent	100 percent
Number of concession projects signed with private investment mobilized through project financing by lenders.	0	2
Number of full verifications of high-risk declarations selected using prioritization criteria, assigned automatically to staff, and implemented using an improved methodology.	0	1,000
Area of agricultural land previously under moratorium transacted by eligible individuals	0	100,000 hectares
Loans to small farmers issued backed by Partial Credit Guarantee (PCG) facility	No	Yes
Gross Pre-2020 NPL Portfolio of State-Owned Banks	UAH 397 billion	Under UAH 300 billion
NBU and NSSMC adopt action plan on reshuffling supervisory regimes for insurance, credit unions, pension funds, and other NBFIs	No	Yes
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.	No	Yes

**IBRD PROGRAM DOCUMENT FOR A PROPOSED
FIRST ECONOMIC RECOVERY DEVELOPMENT POLICY LOAN
TO UKRAINE**

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed First Economic Recovery Development Policy Loan (DPL) supports reforms to address impediments to Ukraine's economic recovery, in the context of the on-going COVID-19 pandemic.** The proposed DPL in the amount of $350 million—the first in a programmatic series of two operations—supports reforms to enable a recovery of investment and economic activity once the COVID-19 health crisis subsides as well as to bolster the social safety net with a focus on the elderly. It complements the recently approved additional financing for Health and Social Protection operations ($135 million and $150 million, respectively) to support the immediate response to COVID-19.[1] As in all countries, the pandemic is resulting in a sharp decline in economic activity in Ukraine. A key factor in the ability of the economy to rebound once the health crisis subsides will be progress on reforms that address long-standing structural bottlenecks to private investment and to support the vulnerable population.

2. **Ukraine has undertaken considerable reforms over the last 5 years to reinforce macroeconomic stability and bolster the foundations of economic growth, but the COVID-19 pandemic is resulting in a sharp economic contraction in 2020**. As a result of the reforms of the last five years, Ukraine entered the current crisis with stronger macroeconomic and financial sector conditions than during the 2014-2015 crisis. The economy grew by 3.3 percent in 2018-2019 and public and publicly guaranteed debt declined to 50 percent of GDP in 2019. Despite this, many structural bottlenecks remain that hold back investment and productivity. Fixed investment is at 17 percent of GDP, FDI at 2 percent of GDP, and the export structure has remained concentrated in basic commodities. If the health crisis subsides in second half of year and key reforms supported by the DPL are completed to support a recovery of investment, the economy is projected to rebound modestly in 2021 after contracting by 5-7 percent in 2020. With moderate poverty projected to rise from 18 percent in 2019 to 24 percent in 2020, the DPL also supports measures to bolster the social safety net and cushion the impact of the COVID-19 pandemic.

3. **As part of the government's effort to support economic recovery, the program development objectives of the proposed DPL are to (i) foster de-monopolization and anti-corruption institutions; (ii) strengthen land and credit markets; and (iii) bolster the social safety net.** Major impediments to investment and productivity were identified by the Ukraine Growth Study completed in 2019.[2] First, an anticompetitive environment and regulatory weaknesses in key sectors distort markets and serve as a barrier to entry and investment. In this context, the unbundling of the gas sector, with a large footprint of a state-owned monopoly, and clarifying the legislative framework for private investment in infrastructure through concessions can help promote competition and attract investment in important parts of the economy. Second, state capture by oligarchs and high levels of corruption undermine investor confidence. Addressing gaps in

[1] As part of the immediate response to the COVID-19 pandemic, the authorities have taken significant measures to finance urgent medical procurement and cushion the impact on households and firms. These measures include higher wages to medical staff and social workers, tax payment deferrals during the lockdown, one-off top ups for pensioners, and bringing forward the date for pension indexation.
[2] "*Ukraine Growth: Faster, Lasting, Kinder,"* World Bank, 2019.

the nascent anti-corruption architecture will help Ukraine's progress toward establishing accountability and a level playing field. Third, the absence of an agricultural land market reduces the security of land tenure, investment, and credit in the agricultural sector. In this context, it is important to establish a transparent and efficient market for agricultural land, with adequate safeguards and financing for small, credit-constrained producers. Fourth, the dominant position of state-owned banks (SOBs, accounting for 55 percent of banking sector assets) undermines the efficiency of credit allocation, while the high share of NPLs (49 percent overall, and 65 percent in SOBs) constrains credit growth and equity investment in SOBs. As such, it is important to provide the full suite of NPL resolution tools to SOBs. Finally, the economic and social fallout of the pandemic puts at risk these important and tough reforms. While pension and social assistance expenditures in Ukraine have a significant poverty mitigating impact, they are not designed to mitigate the impact on the most vulnerable population during a sharp economic downturn. It is thus important to scale up social protection spending to cushion the impact on the population during the COVID-19 pandemic, including increasing the predictability of pension benefits. The reforms supported by the DPL have been selected based on their criticality for achieving the development objectives under each pillar; the new government's priority to move forward with the reforms during the COVID-19 pandemic; and the World Bank's comparative advantage in contributing to their design and implementation.

4. **The political transition in 2019 has provided the Ukrainian authorities an unprecedented mandate and opportunity to address longstanding obstacles to economic growth and advance major economic reforms.** President Zelenskyy was elected in April 2019 with 73 percent of the vote. Subsequently, his party won the parliamentary elections in July 2019, obtaining 254 out of a total 424 seats in the Ukrainian Parliament (the Rada). The Government that took office at the end of August 2019 presented its 5-year program to Parliament in October setting ambitious and aspirational goals, including 5-7 percent annual GDP growth over five years; attracting US$50 billion in foreign direct investment (FDI); the development of infrastructure; the creation of 1 million new jobs; and significant poverty reduction and better public services for the population. The program also outlined key reform priorities including opening the agricultural land market, de-monopolization by unbundling the state-owned monopoly, Naftogaz, and making further progress in strengthening nascent anticorruption institutions. Meaningful reforms were advanced through February 2020, including those supported by this proposed DPL. A new government was appointed on March 4, 2020 and pledged to continue advancing the reform efforts, in addition to addressing the fallout from the COVID-19 crisis. The authorities have also indicated strong support for the National Bank of Ukraine (NBU) to continue its role in the oversight of the financial sector.

5. **Coordinated support from development partners has been critical in advancing the ambitious reforms supported by this proposed DPL.** With powerful vested interests standing in the way of reforms, building a coalition among reformers in government, Ukrainian civil society, and international development partners around key reforms has been critical to their progress. Financing and technical support from the World Bank, as envisioned by the FY17-21 CPF, in close coordination with the International Monetary Fund (IMF), the European Union (EU), the United States (US) Treasury, United States Agency for International Development (USAID), the United Kingdom (UK), and other bilateral partners, has been central to this effort. This proposed DPL follows the Development Policy Financing (DPF) approved in December 2018 in support of reforms completed in 2017-2018 to address the structural underpinnings of the weak growth recovery and fiscal vulnerabilities.[3] Support for reforms through the proposed DPL, complements the World Bank's

[3] This proposed DPL deepens and expands upon the growth-related reforms supported by the 2018 Policy Based

COVID-19 related financing for health and social protection, and has been coordinated with discussions on the new 18-month IMF Stand-by Arrangement (SBA) expected to be presented to the IMF Board in early June 2020. The Bank has led the discussions on land reform, which is also supported by the IMF SBA. The Bank and the IMF coordinate on the design and advocacy for financial sector reforms. The preparation of the proposed operation has also been coordinated with the EU Macro-Financial Assistance (MFA) program for Ukraine.

6. **Ukraine has made progress in recent years in strengthening its macroeconomic framework but faces significant financing needs in 2020-2022 and major vulnerabilities from the COVID-19 crisis.** Public and publicly guaranteed debt declined from 81 percent of GDP in 2016 to 50 percent of GDP in 2019. The fiscal deficit has been maintained at under 2.5 percent of GDP four years in a row (2016-2019), while public current expenditures have declined from 46 percent of GDP in 2013 to 38 percent in 2019. Despite this, Ukraine faces sizable public debt repayments in 2020-2022 of about 7 percent of GDP (US$10 billion) per year. In addition, in the context of the COVID-19 crisis, revenues are projected to decline by 3 percent of GDP (relative to earlier projections) and additional spending on health and social protection is projected at 1.7 percent of GDP. A budget amendment for 2020 was approved in April with the fiscal deficit revised to 7.6 percent of GDP from 2.5 percent. With limited access to international capital markets, the authorities need considerable budget support from official creditors. Going forward, in order to raise the necessary external financing on affordable terms when conditions in international capital markets ease, it will be even more important to deliver on the reform agenda to bolster investor confidence, maintain prudent macroeconomic management, and secure financing from international development partners.

7. **The proposed operation is subject to substantial risk.** Political and governance risks arise from the deep-rooted influence of powerful vested interests that could derail the reforms supported by this operation or reverse reforms in other important areas. In addition, progress on critical reforms could be undermined by the economic downturn resulting from the COVID-19 crisis. The risks associated with the agricultural land reform are particularly significant. Specifically, while initial legislative steps have been taken, expeditious approval and implementation of additional legislation is critical to ensure that the agricultural land market will be transparent and efficient, safeguard the rights of Ukrainian landowners, and provide adequate access to finance for small farmers. Uncertainty about the approval of the pending land laws which are triggers for the second DPL is a major risk associated with the overall land reform package. Macroeconomic risks come from the COVID-19 induced contraction of the economy, associated pressures on public finances, and large financing needs in 2020-2022. The economic recovery could be undermined by the duration of the pandemic, sensitivity of investor confidence to political and security developments, anemic credit to the private sector, and limited export diversification and foreign direct investment. Furthermore, the conflict in eastern Ukraine continues and could adversely impact economic prospects through weaker investor confidence. Risks of reform implementation come from weaknesses in institutional capacity and delays in decision making. These risks are mitigated by the government's efforts to advance reforms and safeguard macroeconomic stability, as well as the strong voice of Ukrainian civil society in advocating for continued reforms and Ukraine's strong cooperation with the international community and development partners.

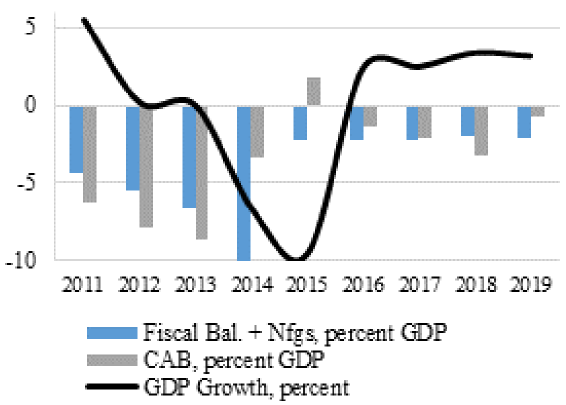
Guarantee. The implementation and follow-up on the reforms to enhance the fiscal sustainability and effectiveness of social services are being supported through investment operations.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

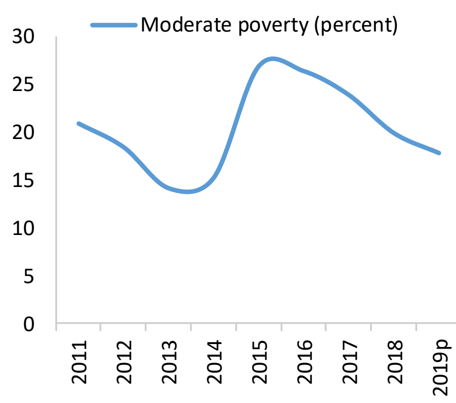
8. **While economic growth picked up in 2018-2019, weak investment and productivity continued to undermine strong and sustainable economic expansion.** Real GDP grew by 3.4 percent in 2018 and 3.2 percent in 2019, up from 2.5 percent in 2016-2017. At the same time, the pickup in growth was driven by sectors dependent on consumption. Household consumption grew by 9.3 percent in 2018 and 11.9 percent in 2019, supported by: (i) significant hikes in public sector wages and pensions in 2017-2018, and more modest increases in 2019; (ii) sizable remittance inflows due to labor migration to the EU countries;[4] and (iii) the resumption of growth in consumer lending in 2019. As a result, value added in wholesale and retail trade (comprising 15 percent of GDP) grew by 4.6 percent in 2018 and 3.6 percent in 2019, real estate services (comprising 7 percent of GDP) grew by 8.7 percent in 2018 and 7.5 percent in 2019, and the financial sector (comprising 3.5 percent of GDP) grew by 10.1 percent in 2018 and 3.7 percent 2019. At the same time, the growth in agriculture slowed to 1.3 percent in 2019 from 8 percent in 2018 and manufacturing growth remained weak at about 1 percent for the last two years. Sustainable growth in manufacturing and agriculture remain constrained by the lack of fixed investment. The level of fixed investment, at only 17.6 percent of GDP (average for the last five years) remains too low for strong and sustained economic growth. Investment was limited by (i) low foreign direct investment (FDI) of about 2 percent of GDP for the last three years; (ii) structural weaknesses in the financial sector (with limited progress made in resolving non-performing loans(NPLs)); and (iii) market distortions from the lack of an agricultural land market, an anticompetitive environment, and large numbers of SOEs. Fixed investment growth slowed to 14.2 percent in 2019, down from 16.6 percent in 2018.

Figure 1 GDP Growth, Fiscal and Current Account Balance 2011-19



Source: Ukrainian authorities and World Bank estimates

Figure 2 Poverty Rate, 2011-19



9. **The COVID-19 outbreak in 2020 has hit the economy hard.** Ukraine faced initial consequences of the COVID-19 outbreak in January-February 2020 (even before the first case was diagnosed in Ukraine)

[4] After Poland simplified work permit procedures for Ukraine in 2017, remittance inflows increased further from 7.6 percent of GDP in 2016 to 8.2 percent in 2018.

through sluggish external demand and a decline in global steel prices. Preliminary figures indicate that the economy contracted by 1.5 percent in the first quarter of 2020, due to a slowdown in industrial production (in particular, metals and mining). The lockdown that was announced in mid-March and expected to last through May has compounded the downturn, negatively impacting face-to-face services including passenger transport, restaurants, entertainment, and domestic trade beyond food retail. At the same time, in contrast to other countries in the region, there were fewer disruptions in manufacturing, the financial sector, and agriculture in Ukraine. On the whole, the lockdown has resulted in a sharp decline in consumption and purchasing power due to widespread layoffs and a fall in remittances. Since March, workers have filed 120,000 new unemployment claims, translating into an estimated 28 percent increase in the total number of unemployed. About 10 percent of the 2 million Ukrainian temporary workers in Poland have had to return to Ukraine, with the rest facing difficulties due to the economic slowdown in the EU.

Table 1: Key Economic Indicators

	2017	2018	2019	2020p	2021p	2022p	2023p
Nominal GDP, UAH *billion*	2,984	3,561	3,975	3,943	4,317	4,706	5143.6
GDP per capita, US$	2,646	3,102	3,673	3,129	3,545	4,150	4,536
Unemployment Rate (ILO defn), *percent*	9.5	8.8	8.2	12.0	11.0	9.0	8.5
Real GDP, *percent change*	2.5	3.4	3.2	-7.8	1.5	4.0	4.3
Consumption, *percent change*	8.4	7.1	8.1	-8.2	3.0	3.7	3.0
Investment, *percent change*	16.1	16.6	14.2	-5.1	2.7	6.5	11.7
Exports, *percent change*	3.8	-1.3	6.7	-3.7	1.8	3.8	4.8
Imports, *percent change*	12.6	3.0	6.3	-3.5	4.1	3.5	4.0
Monetary and External							
GDP deflator, *percent change*	22.1	15.4	8.1	7.0	8.0	5.0	5.0
CPI (eop), *percent change*	13.7	9.8	4.1	7.5	6.0	5.5	4.0
Credit to private sector (ER adj.) *percent change*	-1.5	6.3	-4.5	-8.0	10.0	8.0	11.0
Current Account Balance, *percent GDP*	-2.2	-3.3	-0.9	-2.0	-2.0	-1.8	-1.6
Exports of G&S, *percent GDP*	48.0	45.1	41.0	42.4	41.2	38.2	37.9
Imports of G&S, *percent GDP*	55.7	53.7	48.8	48.3	49.0	45.6	44.6
Foreign Direct Investment, *percent GDP*	2.3	1.8	1.6	0.8	2.0	2.3	2.6
Gross Reserves, *billion US$, eop*	18.8	20.8	25.3	20.8	24.8	27.3	28.9
In months of next year's imports	*3.2*	*3.3*	*4.8*	*3.4*	*3.7*	*3.9*	*3.8*
External Debt, *percent GDP*	102.8	87.8	78.7	90.0	81.4	69.9	65.6
Fiscal							
Revenues, *percent GDP*	39.3	40.0	39.7	39.7	39.8	40.5	40.5
Expenditures, *percent GDP*	41.5	42.0	41.8	44.8	44.3	43.6	42.5
Fiscal Balance, *percent GDP*	-2.2	-2.0	-2.1	-5.1	-4.5	-3.1	-2.0
Fiscal Bal. incl Naftogaz, *percent GDP*	-2.2	-2.0	-2.1	-5.1	-4.5	-3.1	-2.0
PPG debt (eop), *percent GDP*	71.9	60.6	50.4	62.3	59.6	57.0	56.1

Source: Ukrainian authorities and World Bank estimates
Note: Projections for 2020-2022 are based on the reform scenario (discussed in this section)

10. **While poverty declined significantly in recent years, this trend will be reversed as a result of the economic contraction resulting from the COVID-19 pandemic.** The recovery of consumption over the last three years helped reduce poverty. In 2017-2018, consumption growth was supported mostly by the significant increases in public sector wages and pensions, while in 2019 the growth in real wages was mostly

driven by the private sector due to the labor market pressures associated with outmigration. Real wages grew 9.8 percent in 2019, while remittances, which have also played a major role in supporting consumption growth, increased by 12 percent. The unemployment rate gradually declined from 9.5 percent in 2017 to 8.2 percent in 2019. As a result, moderate poverty (World Bank's national methodology for Ukraine) declined from a peak of 27 percent during the crisis in 2015 to 19.9 percent in 2018 and an estimated 18 percent in 2019.[5] With labor incomes, employment, and remittances impacted sharply by the COVID-19 crisis, poverty is projected to increase sharply in 2020.

Table 2: Fiscal Framework

	2017	2018	2019	2020p	2021p	2022p	2023p
Revenues	**39.3**	**40.0**	**39.7**	**39.7**	**39.8**	**40.5**	**40.5**
Tax revenues	34.2	34.6	34.4	34.4	34.6	35.5	35.5
Personal Income tax	6.2	6.5	7.0	7.3	7.3	7.3	7.4
Corporate profit tax	2.5	3.0	3.0	2.7	2.8	3.3	3.4
Payroll tax	6.2	6.9	7.1	7.5	7.6	7.7	7.7
Property tax	1.0	0.9	1.0	0.9	0.9	1.0	1.1
VAT	10.5	10.5	9.6	9.5	9.5	9.8	9.8
Excise tax	4.1	3.7	3.5	3.5	3.5	3.4	3.4
Taxes on international trade	0.8	0.8	1.0	0.8	0.8	0.8	0.7
Other taxes	2.9	2.4	2.3	2.2	2.2	2.2	2.0
Non-tax revenues	4.2	5.4	5.3	5.3	5.2	5.0	5.0
Expenditures	**41.5**	**42.0**	**41.8**	**44.8**	**44.3**	**43.6**	**42.5**
Current expenditures	38.1	37.8	37.7	42.1	39.5	38.3	37.2
Wages and compensation	10.6	11.0	11.0	12.0	11.0	10.5	10.3
Goods and services	6.7	6.7	7.1	8.6	7.0	6.5	6.2
Interest payments	3.7	3.3	3.2	3.7	3.7	3.8	3.6
Subsidies to corporations	1.5	1.5	1.2	1.2	1.5	1.3	1.1
Social benefits	15.5	15.2	15.3	16.6	16.3	16.2	16.0
Pensions	9.8	10.1	10.7	12.1	12.0	12.0	11.9
Unemployment, disability and accident insurance	0.8	0.9	1.0	1.2	1.1	1.1	1.1
Social programs	4.9	4.2	3.6	3.3	3.2	3.1	3.0
Other expenditures	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Capital expenditures	3.3	4.1	4.1	2.7	4.8	5.3	5.3
Primary Balance	1.6	1.3	1.1	-1.4	-0.8	0.7	1.6
Gen. Govt Balance	-2.2	-2.0	-2.1	-5.1	-4.5	-3.1	-2.0

Source: Ukrainian authorities and World Bank estimates
Note: Projections for 2020-2022 are based on the reform scenario (discussed in this section)

11. **Key structural reforms in the social sectors helped reduce current expenditures and public debt, with pressures from public sector wages easing somewhat in 2019.** To promote fiscal sustainability, structural reforms were introduced in the social sectors (pensions, housing utility subsidies, and health) in 2017-2018.[6] As a result, spending on social benefits declined from 16.3 percent of GDP in 2016 to 15.3 percent in 2019, benefiting from the pension reform and better targeting of social assistance. While health

[5] Figures for 2018-19 are projected based on HLCS-2016 data, assuming equal growth for all parts of the distribution.
[6] With the support of the World Bank's policy lending operation, these reforms included: (i) pension reform which

and education reforms have begun to overhaul inefficient financing mechanisms (although not yet in higher education), less progress was made on rightsizing the overstaffed networks. Public sector wages were also increased significantly in 2017-2018. As a result, the public sector wage bill grew from 9.3 percent of GDP in 2016 to 11 percent in 2018. In 2019, pressures on the wage bill eased with a more prudent than earlier increases in the minimum wage.[7] With increased spending on social protection and social sector workers in the context of the COVID-19 response, current expenditure pressures will remain significant. The COVID-19 package approved amounts to UAH 66 billion and includes medical procurement, wage top-ups for medical personnel, and increased spending on pensions. On the revenue side, performance improved modestly with tax revenues increasing from 33 percent of GDP in 2016 to 34.4 percent in 2019. The fiscal deficit was maintained below 2.5 percent of GDP in the last four years, with a primary surplus of 1.1 percent of GDP in 2019. Public and publicly guaranteed debt declined from 81 percent in 2016 to an estimated 50 percent in 2019, but will increase in 2020 to accommodate the COVID-19 pressures.

12. **Ukraine enters COVID-19 crisis in better macroeconomic condition than previous crises due to prudent macroeconomic management over the past several years that helped reduce inflation and interest rates.** To manage domestic demand pressures arising from higher wages and remittances, the NBU increased the policy rate to 18 percent in 2018, which helped reduce inflation from 13.7 percent at end-2017 to 9.8 percent at end-2018. In 2019, tight monetary policy, together with the efforts to control public sector wages and current fiscal expenditures helped reduce inflation, with CPI inflation declining to 4.1 at end-2019 and further to 2.1 percent in April 2020. This allowed NBU to reduce the key rate from 17 percent in July 2019 to 11 percent in January 2020, and further to 8 percent in April 2020, with forward guidance on further reductions in 2020.

13. **Improved investor sentiment following the 2019 elections, coupled with attractive interest rates on financial instruments, attracted significant portfolio inflows to local currency government bonds and led to appreciation of the Hryvnia.** As uncertainty associated with the 2019 elections subsided, foreign portfolio flows attracted by high yields on local currency government bonds increased markedly to reach US$4.5 billion (3.2 percent of GDP) in 2019. The share of Hryvnia bonds held by non-resident investors increased to 15 percent, from near zero at the beginning of 2019. As a result, for the first time since the 2014-2015 crisis, the Hryvnia appreciated significantly by 15 percent in nominal terms to UAH 23.3 per dollar at end-2019 before stabilizing at UAH 24.2 per dollar in January-February 2020. The COVID-19 outbreak in March 2020 triggered some volatility in the currency market, but the exchange rate has stabilized at UAH 26.6 per dollar. Foreign investors holding domestic bonds have not actively pursued their sale during the crisis.

14. **The trade deficit remained elevated in 2019 due to strong domestic demand and remittances, and continued dependence on commodity exports.** Ukraine's exports continue to be dependent on commodities, limiting export growth. In fact, merchandise exports declined from 36 percent of GDP in 2016 to 30 percent

stabilized pension spending at 10-11 percent of GDP (and the pension replacement rate at 30 percent), instead of a no-reform scenario of spending rising to 14 percent of GDP (and the replacement rate falling under 20 percent); (ii) improved targeting of Housing Utility Subsidies (HUS) which reduced the number of beneficiary households from 8 million to 3.8 million, with spending on HUS down from 2.1 percent of GDP in 2017 to 1.4 percent GDP in 2019; and (iii) historic health reform that changed the financing formula and created incentives for more efficient spending.

[7] The minimum wage more than doubled in 2017-2018, while the increase in 2019 was 12 percent in nominal terms.

in 2019 as metal prices softened, despite the growth of agricultural exports in this period. At the same time, strong domestic demand and remittances in 2019 bolstered imports, with merchandise imports remaining steady at about 43 percent of GDP during 2016-2018. In 2019, despite the appreciation of the Hryvnia, merchandise imports grew by 8 percent (in dollar terms), with the merchandise trade deficit growing 12.7 percent (in dollar terms) but narrowing slightly as a share of GDP to 9.2 percent (form 9.8 percent in 2018). Continued growth of remittances (at 12.2 percent in dollar terms, to reach 9 percent of GDP) in 2019 together with the surplus of services trade helped fully cover the merchandise trade deficit. Overall, the current account deficit narrowed to 0.9 percent of GDP (vs 2.5 percent expected) due to one-off Naftogaz receipts of $2.9bn at end-December 2019 from the settlement on Stockholm Arbitration accounted as secondary income. However, with a decline in exports and remittances, triggered by the COVID-19 crisis, the current account pressures are likely to reemerge in 2020.

15. **The composition of current account financing is tilted toward public sector borrowing (external and domestic), while FDI remains low.** During 2016-2018, cooperation with the IMF and other development partners as well as the return to the Eurobond market helped international reserves strengthen to $20.8 billion (equal to 3.3 months of imports) at end-2018 from $13.3 billion (equal to 3 months of imports) at end-2015. In 2019, reserves continued to grow further and reached US$25.3 billion due to two factors: (i) the inflows of foreign portfolio investments and (ii) the renewed access to the international financial markets for the government and quasi-sovereign borrowers. FDI has, however, remained low at about 2 percent of GDP. Despite some temporary pressures in the currency market in March 2020, international reserves remained practically unchanged at US$25.7 (4.8 months of imports cover) at the end of April, safeguarding macroeconomic stability.

16. **The banking sector has been stabilized and supervision has been strengthened but SOBs now account for half of assets and credit to the enterprise sector remains anemic.** In response to the financial sector crisis of 2014-2015, the authorities put in place a framework to resolve and recapitalize banks and strengthen supervision. As a result, 96 out of 182 banks were resolved with the largest and systemic bank (Privatbank) nationalized at end-2016 due to the failure of its former owners to deliver on agreed recapitalization plans. This significantly changed the financial landscape, with the share of SOBs rising to 55.2 percent in December 2019 from 18 percent in 2013. All banks have now undergone multiple rounds of asset quality reviews and stress testing as well as related party diagnostic, and all surviving banks have returned to compliance with minimum capital adequacy requirements. Regulatory capital in the banking system grew by 37 percent since the end of 2016 and the capital adequacy ratio increased to 19.7 percent in December 2019 (from 12.7 percent in December 2016). Deposits grew strongly in recent years: UAH retail deposits grew 59 percent over 2017-2019, but only a third is longer than 6 months. Deposit rates in local currency have declined significantly from 13.4 percent in January 2019 to 10 percent in January 2020 and 7.4 percent in February 2020, while rates for FX deposits declined from 3 percent to 2 percent during this period. Lending rates have declined but remain elevated: 16.3 percent overall in national currency in 2020 (13 percent to businesses and 34 percent for households). The high cost of funds and unresolved NPLs (49 percent of total loan portfolio at the end of 2019) remain the key impediments for credit growth to the private sector. During 2019, retail loans in Hryvnia grew by 25 percent (mostly driven by consumer lending), while loans to enterprises declined by 8 percent in general or by 4 percent in solvent banks, which is one of the key factors constraining stronger and sustainable economic growth.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **The economy has been hit by the COVID-19 pandemic and its recovery depends not only on the duration of the lockdown, but also on reforms to address bottlenecks to investment and safeguard macroeconomic sustainability.** The COVID-19 outbreak has hit the economy through both supply and demand shocks, with consumption and purchasing declining from a loss of labor incomes and remittances. Unemployment is expected to rise to 12 percent in 2020 (from 8.2 percent in 2019) and remittances are expected to decline to 5.4 percent of GDP in 2020 (from 8.4 percent in 2019). Given low level of domestic savings (15 percent of GDP) and limited fiscal space to provide large scale support to the private sector and households, economic recovery will require establishing the conditions for private investment to recover once the lockdown eases. Under the scenario where the health crisis gradually subsides in the second half of the year, the economy is projected to contract by 7.8 percent in 2020, with moderate poverty projected to rise to 24 percent in 2020 (from 18 percent in 2019). At the same time, if progress is made on key pending reforms, the economy is expected to rebound by 1.5 percent in 2021 and 4 percent in 2022. Addressing structural impediments to a recovery in investment and productivity will require reforms in the following areas: (i) attracting private investment into tradable sectors by establishing a transparent market for agricultural land, demonopolizing key sectors to strengthen competition, privatizing state-owned enterprises, and tackling corruption; (ii) increasing the efficiency and growth of bank lending to the enterprise sector by completing the reform of state-owned banks and reducing NPLs; and (iii) safeguarding macroeconomic stability. These reforms will help restore investor confidence and support markets resulting in a recovery of fixed investment in 2021-2022 after 5 percent decline projected in 2020. Domestic consumption is also expected to recover gradually to 4 percent in 2022 from an 8 percent contraction this year. Inflation is projected to stabilize around 6 percent by 2021 on the back of low energy prices and suppressed domestic demand, thus allowing the key policy rate to continue declining by the end of 2020. This, together with the resolution of NPLs, should enable a pickup in bank lending to the private sector and a lower cost of funds, supporting the gradual recovery of the private sector from the COVID-19 crises.

18. **Ukraine faces major fiscal pressures in 2020 from declining revenues, additional spending related to the COVID-19 response, and large debt repayments.** The 2020 Budget was revised with a deficit of 7.6 percent of GDP (from 2.5 percent of GDP). However, given limited financing options, it is expected that budget savings will need to be identified, with the fiscal deficit projected at 5 percent of GDP in 2020. Fiscal revenues are expected to decline by 3 percent of GDP in 2020 (relative to the earlier budget) due to the economic contraction and tax deferrals introduced during the lockdown. Additional COVID-related expenditures that include medical procurement, higher wages to health workers, and pension top-ups are estimated at 1.7 percent of GDP. Public debt repayment needs amount to 7.7 percent of GDP in 2020 (of which 5.9 percent of GDP is denominated in foreign currency). Financing the fiscal deficit and repaying public debt will require mobilizing adequate domestic and international financing. Given the current situation in international capital markets and reduced foreign investor interest globally, support from developing partners is expected to be the key source of funding. In 2020, Ukraine expects to receive about 4.3 percent of GDP in official budget financing, from the IMF, the EU and the World Bank. The remaining financing needs are expected to be covered via domestic borrowings. Going forward, debt repayment needs will remain significant at about 7 percent of GDP in 2021 and 2022, and the efficient use of the limited fiscal resources will be critical. This will require: (i) further implementation of health and education reforms, to improve productivity in the sectors while managing wage bill pressures; (ii) resisting further populist pressures to

tinker with the newly established pension indexation; and (iii) better targeting of social assistance programs to ensure adequate support of the vulnerable through the pandemic. These measures will allow the fiscal deficit to decline to 3 percent of GDP by 2022 to safeguard fiscal sustainability.

Table 3: Balance of Payments Financing Requirements and Sources (US$ billions)

	2017	2018	2019	2020p	2021p	2022p	2023p
Financing requirements (US$ Bn)	**31.0**	**33.8**	**31.4**	**29.7**	**26.9**	**27.5**	**26.1**
Current account deficit	2.4	4.4	1.3	2.6	2.9	3.1	3.0
Public redemptions (incl. IMF)	3.3	4.3	5.7	4.9	4.6	4.6	4.7
Govt redemptions	2.4	2.2	4.1	3.8	3.3	2.5	2.5
IMF repayment	0.9	2.1	1.6	1.1	1.3	2.1	2.2
LT private debt amortization (incl. portfolio)	5.2	4.3	5.4	6.9	5.2	5.1	5.5
ST private debt and trade credit	20.1	20.8	19.0	15.3	14.2	14.7	12.8
Financing Sources (US$ Bn)	**39.4**	**33.8**	**31.4**	**29.7**	**26.9**	**27.5**	**26.1**
FDI	2.6	2.4	2.4	1.0	3.0	4.0	5.0
Privat portfolio investment	0.4	0.7	4.7	0.5	1.0	1.0	1.0
Public borrowing (incl. IMF)	6.2	6.1	8.9	5.6	6.0	6.4	6.5
Govt borrowing	5.2	4.7	8.9	2.1	4.5	6.4	6.5
IMF disburesement	1.0	1.4	0.0	3.5	1.5	0.0	0.0
LT private debt disbursement (incl. portfolio)	8.4	7.6	4.5	3.9	6.2	5.8	4.8
ST private debt disbursements	26.2	19.0	15.3	14.2	14.7	12.8	10.4
Drawdown in reserves	-4.4	-2.0	-4.5	4.5	-4.0	-2.5	-1.6

Source: Ukrainian authorities and World Bank estimates
Note: Projections for 2020-2022 are based on the reform scenario (discussed in this section)

19. **Managing external vulnerabilities stemming from the global pandemic will require maintaining cooperation with the IMF and other official creditors and gradual recovery of exports and FDI.** The current account deficit is projected to widen to US$2.6bn (or 2 percent of GDP) in 2020 as the reduction of exports and remittances will be partially balanced by lower imports from lower domestic demand and gas import prices. Government debt redemptions on Eurobonds and other debt will remain high in the medium term, while FDI is projected to remain low and portfolio inflows are expected to moderate during the crisis. In this context, financing the current account and external debt amortization will require higher official financing. Going forward, reforms to bolster investor confidence and continued cooperation with official creditors are critical to enable a gradual increase in FDI and development of nontraditional and higher value-added exports. These conditions would allow rebuilding international reserves after the crisis to 3.8 months of imports by 2022 to safeguard against external shocks.

20. **Ukraine has managed to reduce its debt burden in recent years, but the Debt Sustainability Analysis (DSA) shows that public and external debt are vulnerable to shocks.** Public and publicly guaranteed debt declined to 50.4 percent of GDP in 2019 due to solid economic growth, Hryvnia appreciation, and large repayments. The repayment on public external debt also resulted in the external debt ratio declining to 79 percent of GDP. The baseline DSA projections under the reform scenario are consistent with the overall macroeconomic framework, including: a gradual recovery of economic growth; successful implementation of the fiscal program to meet deficit targets; a stable exchange rate; and continued official financing inflows, along with a recovery of FDI and portfolio investment.

Figure 3: Public and Publicly Guaranteed Debt
(percent of GDP)

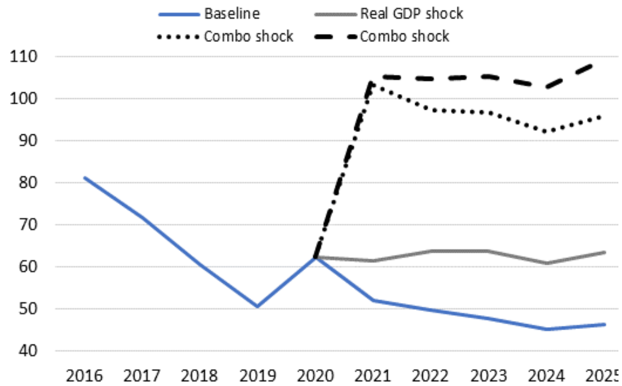
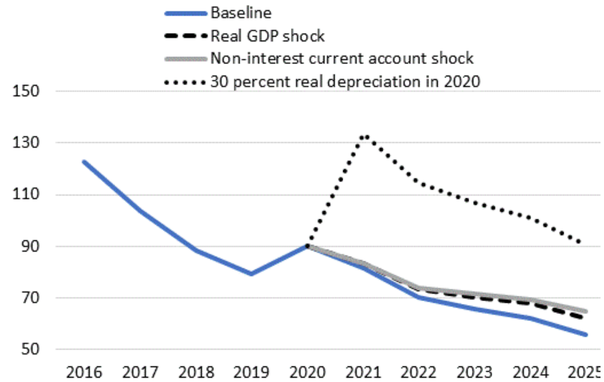


Figure 4: External Debt
(percent of GDP)



Source: World Bank staff estimates.
Note: Projections for 2020-2025 are based on the reform scenario

- **Public Sector DSA:** In the baseline scenario, public and publicly guaranteed (PPG) debt is projected to pick up to 62.3 percent of GDP in 2020 due to higher fiscal deficit and some currency depreciation, but is expected to gradually decline to 48 percent GDP by 2025 due to a recovery of economic growth and return to primary surplus of the general government balance. Risks to the base case are substantial. Exchange rate risks are particularly critical given the large share of FX denominated debt (about 67 percent of total PPG). A real exchange rate shock[8] could push the PPG debt level to 103 percent of GDP in 2021 (Figure 3), while a combined macro-fiscal shock[9] would keep PPG debt at over 100 percent of GDP during the next 5 years. Macroeconomic stability is thus critical to maintaining public debt sustainability.

- **External DSA:** In the baseline scenario, total external debt is projected to decline from 79 percent in 2019 to 90 percent in 2020 and will gradually return to the current levels by 2022 as reforms are implemented and FDI inflows gradually pick up. As with public debt, the external debt trajectory is subject to high risks. The external debt adjustment path is also particularly sensitive to exchange rate shocks. A 30 percent real depreciation shock in 2020 would drive debt to about 134 percent of GDP in 2021. 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 around 80 percent in the next two years (Figure 4).

21. **Ukraine's overall macroeconomic policy framework is adequate for policy lending.** The COVID-19 intervention package, while increasing pressures on public debt and fiscal deficit, is appropriate to cushion the COVID-19 shock and is temporary in nature. The authorities are committed to reducing public debt in the medium term. While the size of the COVID-19 package and the economic downturn will generate a rise in public debt, it is expected that debt will begin to decline in 2021 as growth resumes. The monetary authorities have also taken necessary steps to keep the exchange rate flexible and stable. Furthermore, key pillars

[8] Maximum historical movement of the exchange rate and pass-through to inflation with elasticity of 0.3.
[9] Shock size and duration based on all macro-fiscal shocks (constant primary balance shock, real GDP growth shock, interest rate shock and real exchange rate shock).

underpinning the adequacy of the macroeconomic framework include a commitment to implementing the reforms supported by this proposed programmatic operation and the new IMF SBA under preparation. This would help: (i) support economic recovery in 2021 and onward by bolstering investment and productivity; (ii) gradually reduce fiscal deficit and public debt after the crisis; (iii) raise exports and attract FDI to support external sustainability; and (iv) support credit growth to the private sector by strengthening the governance of state-owned banks and reducing NPLs.

2.3. IMF RELATIONS

22. **This proposed DPL is closely coordinated with the IMF, including in supporting the design and implementation of key reforms, and in monitoring the macroeconomic and fiscal program.** The IMF Board of Executive Directors approved a one-year, $3.7 billion SBA for Ukraine in December 2018. The IMF reached staff level agreement with the authorities in December 2019 on a new 3-year, $5.5 billion, EFF program that would support major structural reforms on anticorruption and the rule of law, the financial sector, and establishing the agriculture land market. In the context of the COVID-19 crisis, with unprecedented uncertainty surrounding the economic and financial outlook and the need to focus policy priorities on near term containment and stabilization, discussions have shifted to a $5 billion SBA through end-2021. The expected Board date is in early June 2020.

3. GOVERNMENT PROGRAM

23. **The Government that took office in August 2019 highlighted higher economic growth and poverty reduction as key priorities of its program.** The Government's Action Program for 2019-2024 was presented to Parliament and adopted on October 4, 2019. The Program set ambitious and aspirational goals, including: 5-7 percent annual GDP growth over the next five years; attracting US$50 billion in foreign direct investment (FDI); the development of infrastructure, including renovation of 24,000 km of main roads and construction of 5 new deep-water sea ports and 15 new airports; the creation of 1 million new jobs; and significant poverty reduction and better public services for the population.

24. **To respond to the COVID-19 pandemic in early 2020 and limit its social and economic impact, the new Government that took office in March 2020 launched a comprehensive relief and stimulus package**. On March 26, 2020, the parliament adopted the Law on COVID-19 responses, followed by the adoption of the 2020 Budget amendment. The introduction of the measures was swift, time-bound, and transparent. The measures aimed at dealing with the health emergency, while supporting household incomes and firms. The legislation provided for direct support to the health sector and introduced social and economic measures (Box 2). The Government allocated US$1.4 billion to direct COVID-19 related expenditures that included additional wages for medical workers and procurement of medical supplies. At the same time, effectively supporting the economic recovery and ensuring the adequate protection of the vulnerable requires implementation of additional reforms, including those supported by this DPL.

Box 1: Ukraine's Measures to Mitigate the Impact of COVID-19

Key measures introduced in March 2020 by the Ukrainian authorities in response to COVID-19 include:

- *Medical procurement and personnel.* Special procedures were introduced for urgent specialize medical procurement. In addition, wages for medical personnel (medical and other workers directl dealing with COVID-19) were increased with weekly wage supplements of up to 200 percent of wage for the period of the outbreak.
- *Social protection*. The annual indexation of pensions (envisaged by the recent Pension Reform) wa brought forward from December to May to ensure a better protection of the most vulnerable (whicl is supported directly by this operation). In addition, a one-time top-up of UAH 1,000 was paid to thos with pensions of less than Hryvnias 5,000.
- *Taxation.* Simplified tax audits (with current tax audits were suspended till May 31), simplified fines and penalty accruals for the period of the lockdown were introduced. In addition, land and propert taxes payments were deferred from March to end-June 2020. The eligibility criteria for the simplifie tax regime was eased.
- *Employment support*. On March 30, a special legislation was approved to introduce the concept o remote work and compensation to the employees who lost their jobs due to the COVID-19 outbreak with additional support for employees in SMEs.
- *Liquidity and credit*. The NBU introduced 5-year refinancing loans for banks, intended to suppor liquidity in the banking system and lending to the private sector. The Government is also introducin a program to provide loans to SMEs on relaxed terms, and has banned banks from charging penaltie or increase interest rates on existing consumer loans.

25. **As part of the Government's effort to establish the conditions for economic recovery, the proposed DPL supports key structural reform priorities of the government.** These reform priorities include: establishing a transparent and effective agricultural land market; de-monopolization by unbundling of Naftogaz, and making further progress in strengthening anticorruption institutions. The Program motivates the opening of the agricultural land market as an instrument to increase investment and productivity in agriculture and stipulates measures to clean up the cadaster, strengthen land governance and ensure financial support to farmers. These measures were developed in close cooperation with the World Bank and are supported by the proposed operation. In addition to the reform priorities supported by the proposed DPL, the government program targets a significant reduction in market concentration in the 5 largest markets; development of an effective instrument for structural divestiture of monopolies; large-scale privatization of SOEs and strengthening the governance of the strategic SOEs, that will remain in state ownership.

26. **The Government Program also targets further progress in the effectiveness and sustainability of social services, which were supported by the World Bank's DPF in 2018, as well as ongoing technical assistance and investment lending.** In particular, the Program confirms the government's intention to continue implementing the health, education and social assistance reforms started earlier. Both the education and health reforms described in the Program intend to further improve the financing formula in high education and tertiary healthcare, respectively. This will allow a more efficient use of public resources, while simultaneously improving the quality of services. The Program also aims to further rationalize social assistance, including better targeting of HUS and scaling-up the Guaranteed Minimum Income program to increase support to the most vulnerable households and poor families with children (covered as a disbursement linked indicator for the Bank's Additional Financing for the Social Assistance Project).

4. PROPOSED OPERATION

4.1. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

27. **The proposed operation backs reforms that are critical to address impediments to Ukraine's economic recovery and mitigate the impact of the COVID-19 pandemic on the population.** With expectations that the health crisis will begin to subside in the second half of 2020, the authorities are pursuing reforms to support a recovery of investment and economic activity, while bolstering support to vulnerable households and firms. To support an inclusive and sustainable recovery, Ukraine needs to overcome the impediments to low investment rate and lagging productivity. Fixed investment remained at 17 percent of GDP in 2018-2019, while FDI remained at 2 percent. An average worker in Ukraine produces in one year what an average worker in Germany produces in 17 days. The export structure also remains concentrated in basic commodities rather than higher value-added products integrated with global value chains. An anticompetitive environment and regulatory weaknesses distort key markets, while state capture by oligarchs and high levels of corruption lead to low investor confidence. The absence of an agricultural land market is a bottleneck for investment and credit flow to the agricultural sector. Overall, credit growth remains constrained, with the dominant position of SOBs (55 percent of the banking sector) reducing the efficiency of allocation of credit across the economy. Furthermore, the high share of NPLs constrains private equity investment in the SOBs and the prospects for improving efficiency and credit growth going forward. In addition, the social safety net has proven inadequate in previous crises to cushion the impact of sharp economic downturns. In particular, the elderly are most vulnerable both to the health shock and to income volatility during the COVID-19 pandemic. In this context, the program development objectives of the proposed DPL are to: (i) foster de-monopolization and anti-corruption institutions; (ii) strengthen land and credit markets; and (iii) bolster the social safety net to cushion the impact of the crisis on the vulnerable elderly population.

Pillar 1: Fostering De-monopolization and Anti-Corruption Institutions

28. **The reforms under the first pillar help demonopolize key sectors of the economy and strengthen anticorruption institutions to bolster investor confidence.** The unbundling of the gas sector, with a large footprint of a state-owned monopoly, and clarifying the legal framework for private investment in infrastructure through concessions are intended to promote competition and attract investment in important parts of the economy. The unbundling of Naftogaz is also important to preserve Ukraine's role as a long-term gas transit partner for Europe after 2019. Clarifying the legal framework for concessions would help increase private participation in infrastructure development and facilitate much-needed investment in a key area. Strengthening anticorruption institutions addresses investor concerns about the lack of a level playing field and weak trust in the rule of law. Overall, these reforms should help attract investment and increase productivity in key sectors of the economy as well as across the board.

<u>Demonopolize and unbundle ownership of the gas sector</u>

29. **Ownership unbundling of gas transmission from Naftogaz and certification of the new Transmission System Operator (TSO) are critical for the liberalization of the gas market in line with the EU Association Agreement and the 2015 Gas Market Law.** Unbundling is also critical to ensure that Ukraine remains an important long-term gas transit route for supply of gas to Europe, after the 2009 contract

with Gazprom expired at end-2019, and to prevent the risk of the "zero gas transit revenue scenario". Both Gazprom and the EC publicly had stated that a new agreement would not be possible without unbundling of the TSO in line with EU rules. Furthermore, unbundling is critical for attracting investment to maintain and modernize the gas transport network. The vertically integrated structure of gas transit and production, with gas transmission assets and transit revenues (about US$2.5 billion in 2018) within Naftogaz, had been a significant roadblock in advancing negotiations on the new long-term gas transit agreement and in attracting investment in the transport network. Due to the Stockholm Arbitration (SA) decision of February 2018, the core transport assets (Gas Transport System, GTS—operated by UTG, UkrTransGaz) could be transferred from Naftogaz to an independent Gas TSO (fully owned by MGU, Mahistralni Gazoprovody Ukrainy) only after the previous transit contract with Gazprom expired on December 31, 2019.

30. **The unbundling of the Gas TSO from Naftogaz was completed on January 1, 2020, leading to a new 5-year gas transit agreement.** The transfer of gas transmission assets from UTG (fully owned by Naftogaz) to Gas TSO LLC (fully owned by MGU) took place on January 1, 2020. This final step of unbundling followed a chain of important steps taken since September 2019. The new government approved Cabinet Resolution #840 in September 2019 with an agreed action plan on unbundling. On October 31, the Law No. 264-IX on Unbundling was approved by the Rada with 341 votes (a strong majority representing all factions), with the law enacted on November 29, 2019. This was followed by the signing of Sales and Purchase Agreement (SPA) between Naftogaz/UTG and MGU, and the Economic Management Rights Transfer Agreement which allowed for the transfer of state-owned GTS assets from UTG to Gas TSO. On November 22, the Energy Regulator (NEURC) issued a preliminary certification for the new Gas Transmission System Operator (TSO) and on December 17, the Energy Community Secretariat (ECS) issued its certification which recognizes the Gas TSO as an independent TSO in line with the EU 3rd Energy Package and the Gas Market Law of Ukraine. This enabled the signing of a new 5-year gas transit agreement between Naftogaz and Gazprom under which: (i) Gazprom paid $2.92 billion to Naftogaz as part of the Stockholm Arbitration settlement and both parties agreed to drop any future claims from the contract signed in 2009; (ii) the minimum transit volume will be 65 bcm in 2020 and 40 bcm in 2021-2024; and (iii) transit revenues will flow in a transparent manner from Naftogaz to the Gas TSO, based on the tariff set by the Energy Regulator (NEURC).

<u>Prior Action 1</u>: *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.*

<u>Expected Result</u>: *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, increases from 0 percent in 2019 to 100 percent in 2021*. This major milestone to demonopolize and increase transparency in the gas market in Ukraine will help Naftogaz and the new Gas TSO focus on improving efficiency and investment in their respective business areas of production and transmission. It should provide better incentives for Naftogaz to address the stagnation of gas production and for the Gas TSO to address unauthorized gas offtakes and invest in maintenance and modernization of the transmission network. The elimination of unauthorized gas offtakes (estimated at UAH 10 billion in 2020) will require continued reforms in the gas sector, including tariff adjustments for gas distribution and district heating companies.

<u>Improving the legal framework for investment through concessions</u>

31. **Weaknesses in the legal framework for private investment have hindered infrastructure development in Ukraine.** Transport, energy and social infrastructure remain inadequate. Ukraine ranked 119th among 160 countries on the quality of trade and transport infrastructure in the World Bank's Logistics Performance Index (LPI) for 2018. It also remains one of the most energy-intensive economies in the world and is burdened by a medical system with an oversized and outdated hospital network. Infrastructure investment has been very reliant on the public sector, but the government has had limited fiscal space for public investment. Increasing private sector participation in infrastructure investment, including through concessions, is thus an important priority. The authorities have overhauled the Law on Concessions to catalyze private and foreign direct investment in infrastructure development.

32. **The new Law on Concessions establishes a framework based on international best practice to attract private investment in infrastructure and is in compliance with EU standards and regulations pertaining to concessions.** Key enhancements of the new Law include: (i) a transparent procedure for selection of the concessionaire on a competitive basis; (ii) clear ownership control; (iii) provisions to enable bankability such as compensation in case of early termination, step-in rights, and direct agreement between project lenders, concessionaires, and grantors; (iv) simplified procedures for licenses and permits and for allocating land plots; (v) the possibility of dispute resolution by international commercial or investment arbitration; and (vi) a clear mechanism for monitoring fulfillment of the concession agreement. In addition, the new Law on Concessions is aligned with the PPP Law, including provisions for rigorous economic appraisal of project proposals. The authorities have been developing regulations that will enable effective implementation of the new Concessions Law. As a result of the new Concessions Law, two pilot port concession projects (Olvia port and Kherson port) are expected to be signed in 2020, with initial private investment of $140 million in Olvia and $11 million in Kherson. Although both tenders were implemented under the old concessions law, the new law has made commercial and financial closing possible by creating necessary conditions for project financing by lenders.

<u>Prior Action 2</u>: *Enacted Law # 155-IX on Concession to enhance the legal framework for attracting private investment in infrastructure and ensuring transparency in concession projects*.

<u>Expected Result</u>: *The number of concession projects signed with private investment mobilized through project financing by lenders increases from 0 in 2019 to 2 in 2021*. A key improvement in the new Concessions Law is that concessional projects will be "bankable" and can take advantage of project financing. Such improvements in the bankability of concession projects, together with the broader improvements in transparency and clarity, should help increase private investor participation in infrastructure development in Ukraine.

<u>*Strengthen anticorruption institutions*</u>

33. **Strengthening the governance of the asset declaration system, restoring liability for illicit enrichment, and providing a civil forfeiture remedy are important to address key weaknesses that have emerged in the new anti-corruption architecture established after 2014.** Ukraine's economy has for long faced an anticompetitive environment arising from rent-seeking, weak rule of law, and state capture by powerful vested interests. Since 2014-2015, in response to popular demand, a set of key anti-corruption institutions were established, including the National Agency for Corruption Prevention (NACP, responsible for asset declarations), the National Anti-Corruption Bureau (NABU, with investigative functions), and the Special Anti-Corruption Prosecutor Office (SAPO). However, at end-2018, despite widespread suspicions of

illicit enrichment based on asset declarations and officials' lifestyles inconsistent with legal sources of income, and despite hundreds of cases investigated by NABU and sent to the courts, no major corruption convictions had taken place. The resulting public outcry lead to the creation of the new High Anti-Corruption Court (HACC), which began functioning on September 5, 2019, with judges selected with the support of international partners. The HACC is expected to play a significant role in ending this impunity and establishing accountability. Despite this institutional progress, two important weaknesses in the nascent architecture have emerged. First, the governance of NACP was compromised at an early stage through political interference and ineffective leadership, which has undermined the verification of asset declarations and the creation of an effective conflict of interest system. Second, in March 2019, the Constitutional Court rejected the provisions criminalizing illicit enrichment, creating a hole in the nascent anticorruption architecture.

34. **In order to address the weaknesses in the system, legislation to strengthen the governance of NACP and restore liability for illicit enrichment were enacted in the fall of 2019.** The law to strengthen the governance of NACP with a decisive role for international experts in the selection process of a single director, was approved by the Rada and enacted by the President in October 2019. This is expected to strengthen and depoliticize the management of the NACP, with the new NACP head appointed in January 2020. The NACP legislation also provides for true risk-based and non-discretionary electronic verification process. Under a revised verification regulation agreed in late April 2020, prioritization criteria adopted in May 2020, and changes to the risk indicators underpinning the e-verification system, NACP will be able to strengthen the verification process with stronger automatic risk analysis, an increased role for cross-checking information in all declarations and random assignment of high risk declarations for full verification by NACP staff. These changes will allow for a more coherent, comprehensive and, eventually a more expedited e-verification of all submitted asset declarations. Second, legislation to restore criminal liability for illicit enrichment was approved by the Rada at the end of October 2019 and enacted by the President in November 2019. The legislation also introduced a new remedy for the civil forfeiture of assets that cannot be explained by an official's legitimate wealth, which would be limited to cover officials under NABU's jurisdiction and with cases to be adjudicated by the HACC. The draft legislation underwent broad consultations with domestic and international experts as well as civil society, and the drafting of the new provision took into consideration the Constitutional Court's analysis of the previous illicit enrichment law. The World Bank and the EU also commissioned expert analyses of the civil confiscation provisions, which confirmed that the draft legislation included the principles of legal clarity, right to a fair trial, and protection of property rights. With these two important weaknesses addressed, and the operation of the HACC since September 2019, it is expected that Ukraine's anti-corruption architecture is better prepared to deliver the results promised by the Government. As of May 8, 2020, the HACC had issued 70 criminal decisions with six convictions, including one for money laundering, while its investigative judges handled over 7,000 motions and actions.

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 unjustified assets*.

Expected Result: *Number of full verifications of high-risk declarations selected using prioritization criteria, assigned automatically to staff, and implemented using an improved methodology increases from 0 in 2019 to 1,000 in 2021*. Carrying out a significant number of detailed verifications of asset declarations based on a more risk-sensitive approach with reduced discretion should help increase accountability and bolster investor's confidence in Ukraine's nascent efforts to establish a level playing field.

Pillar 2: Strengthening Land and Credit Markets

35. **The reforms under the second pillar will support the economic recovery and increase the efficiency of allocation of resources by establishing an agricultural land market, resolving NPLs in SOBs, and strengthening the supervision of NBFIs.** Establishing a market for agricultural land with adequate safeguards for transparency and efficiency, as well as improved access to credit, would help attract investment and increase productivity by enabling more productive farmers to expand and providing incentives for less productive farmers to upgrade their productivity or exit. Strengthening the NPL resolution framework for SOBs and more broadly strengthening the governance of SOBs would help attract private equity investment to SOBs, improve the efficiency of allocation of credit across the economy, and enable higher credit growth to the enterprise sector. Strengthening the supervision of NBFIs would help address a major source of fraud and vulnerability in a rapidly growing part of the financial sector.

Establish a transparent market for agricultural land with adequate safeguards

36. **Ending the moratorium on agricultural land sales is critical to improve the security of land tenure, increase investment in higher value-added agriculture, and enable the use of land as collateral to access credit.** Ukraine has the largest endowment of arable land in Europe—33m hectares, compared to 18m hectares in France and 11m hectares in Poland. However, agricultural productivity in Ukraine is much less: US$440 per hectare in 2018, compared to US$1,100 in Poland and US$2,450 in France, in part because Ukraine focuses on lower value-added products (such as grains). The moratorium on agricultural land sales undermined the security of land tenure and incentives to undertake productivity enhancing investments such as irrigation and manage the land in a sustainable manner, including perennials, and crop rotation. The moratorium also undermines the flow of financing to small and medium producers because land cannot be used as collateral. Estimates show that establishing a transparent and efficient market for agricultural land, with adequate safeguards and access to finance would have a positive impact on economic growth.[10] The impact would be at the higher end of the range with fewer restrictions on size or foreigners, and with effective and sustainable access to financing for small, credit constrained farmers, to enable them to participate in the market and enhance their productivity.

37. **The land turnover law (LTO) approved by Rada with a market opening date of July 1, 2021 is an important first step toward establishing a transparent and efficient agricultural land market.** The approved law lifts the 20-year old moratorium on agricultural land sales and allows purchases by individuals up to 100 hectares from July 1, 2021 and purchases by legal entities from 2024. The right to buy agricultural land would initially be limited to Ukrainian citizens. With polls showing opposition to foreign purchases of agricultural land at 70-80 percent, the approved law also temporarily excludes foreigners until a referendum on the issue is held.[11] Going forward, to increase the impact of the reform, it will be important to explore the

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[10] The main channel of impact would be the expansion of producers with higher productivity and incentives for lower productivity producers to improve or exit, as the price of land rises. These estimates are reported in Deininger and Nivievskyi (2019) "Economic and distributional impact from lifting the farmland sales moratorium in Ukraine", based on accounting data for agricultural producers in Ukraine in 2013-2015.

[11] The law does contain a provision that would enable foreign participation without purchases: specifically, it enables the transfer of the pre-emptive right of the current lessee to purchase land. This would enable existing foreign farmers (cultivating some 3 percent of agricultural land) to enter into unincorporated joint venture agreements with their preferred Ukrainian partners who would own the land.

possibility of expanding participation and competition in the market by bringing forward the participation of legal entities, relaxing restrictions on the size of land purchases, and enabling the sale of state land. Importantly, the LTO allows for the use of land as collateral, with banks able to assume ownership of land with the requirement to sell it within two years. This is an important provision for unlocking credit to the agricultural sector.

38. **In order to safeguard the transparency and efficiency of the market once it is opened, and to prevent monopolization, it is also critical to expeditiously enact a set of complementary legislation.** This set of complementary legislation includes: (i) providing free and open access to the cadaster data and to mandate interoperability between the cadaster and registry, which is important to reduce manipulation of ownership records and opportunities for corruption (Law #554-IX, approved April 13, 2020); (ii) streamlining land transfer procedures and decentralizing land management, which streamlines procedures to create, transfer, and use land parcels; and transfers the ownership and administration of state land from the Geocadaster to local authorities (Draft Law #2194); (iii) regulating local state land use, mandating electronic auctions for state land sales; and restricting discretionary handouts of state land by local authorities (Draft Law #2195); and (iv) preventing multiple registrations and raider attacks by fully automating exchange of information between the registry and cadaster, mandating digitization of all paper records to registry, and requiring registration of all transaction prices for sales and leases (Law #340-IX, approved December 5, 2019). Laws 554-IX and 340-IX have been enacted. Prompt enactment of the pending Draft Laws # 2194 and 2195 is essential to allow enough time for implementation prior to the land market opening on July 1, 2021. Furthermore, expeditious implementation of all four complementary laws is critical to ensure that the land market will be transparent, efficient, and safeguard the rights of million landowners.

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.*

Trigger 1 (DPL-2): *Enact legislation to strengthen land management, streamline land transfer and registration procedures, and make emphyteusis rights transferable and mortgageable.*

Trigger 2 (DPL-2): *Enact legislation to introduce electronic auctions and restrict discretionary handouts of state land via free privatization.*

Expected Result: *Area of agricultural land (previously under moratorium) transacted by eligible individuals increases from 0 hectares in 2019 to 100,000 hectares in 2021*. The establishment of a record of transparent agricultural land transfer transactions, with registered prices, would help increase the security of land tenure and facilitate investment in higher value-added agriculture. It would also boost financing for agriculture, particularly to small farmers, by enabling the use of land as collateral.

39. **Access to financing for small, credit-constrained farmers through sustainable and effective financing instruments will allow them to effectively participate in the land market.** Small farmers in Ukraine (i.e. those cultivating less than 500 hectares) are significantly credit constrained because banks consider them high risk. With no performance data on loans to this cohort, perceived risk is higher than actual risk. To address this market failure, a partial credit guarantee (PCG) facility can help reduce credit risk and enable lending to small farmers. The authorities are working on a draft legislation to establish a small agency with an independent governance structure to administer the PCG on a commercial basis. In order to be

effective and sustainable, the PCG facility needs to have a professional and independent supervisory board, free from political influence. While it would initially need to be capitalized by the state, it should be run on a self-sufficient basis in line with international best practice, with guarantee fees covering operational expenses of the fund. Allowing private sector participation would also facilitate contributions from international development partners to the capital of the facility. Expeditious approval and implementation of this legislation is critical to make the facility operational prior to the land market opening in July 2021. In addition, access to financing for small farmers can benefit from improving the targeting agricultural subsidies. While fiscal support to agriculture has declined in the last 5 years (due to reduced tax expenditures), direct subsidies still amounted to $250 million (0.15 percent of GDP) in 2019, with most of this benefiting large and influential producers. International experience suggests that the support should be: (i) targeted to small farmers (under 500 hectares) who are most credit constrained; and (ii) provided through upfront matching grants (rather than interest rate subsidies) to defray interest and fixed costs during the initial years, provide incentives to increase profitability, and involve stable fiscal costs. Action can be taken to further specify the allocation of agricultural subsidies for 2021 and improve their targeting to predominantly small farmers (under 500 hectares) in the form of matching grants rather than interest rate subsidies. In the absence of an effective PCG facility and improved targeting of agricultural subsidies, small farmers could face exclusion from the agricultural land market, with increased concentration of land and lost opportunity for small farmers to contribute to increased productivity and diversification into higher value-added products.

Trigger 3 (DPL-2): *Establish affordable and effective financing instruments for small farmers by: (i) enacting legislation to create a partial credit guarantee facility; and (ii) approving a Cabinet resolution to improve the targeting of agricultural subsidies*.

Expected Result: *Loans to small farmers issued backed by Partial Credit Guarantee (PCG) facility initiated in 2021*. Improved access to finance for small, credit constrained farmers would allow them to participate in the land market and expand opportunities for agriculture to move into higher value-added products in Ukraine. Supporting small farmers to participate in the land market would also help support the economic recovery from the COVID-19 crisis. It would also help prevent the concentration of land ownership once the market opens.

Strengthen the NPL Resolution Framework

40. **Resolving NPLs and strengthening governance of SOBs in Ukraine is critical to improve the efficiency of credit allocation and increase credit to the private sector, particularly in the context of the COVID-19 crisis.** The banking system in Ukraine, with a history of related party lending, came under considerable stress following the 2014-2015 economic crisis. The authorities responded with major reforms to resolve and recapitalize banks and strengthen supervision. As a result, a total of 96 out of 182 banks were resolved since 2014; and PrivatBank, the largest systemic bank in Ukraine with a large related party portfolio, was nationalized in December 2016 after the former owners failed to implement agreed recapitalization and restructuring plans. While these reforms helped strengthen financial sector stability, a large share of SOBs (55 percent of banking sector assets) and a high share of NPLs (49 percent overall and 65 percent in SOBs as of April 2020) continue to undermine the efficiency of financial intermediation and credit growth to the private sector.[12] The COVID-19 crisis is expected to again impact the quality of bank assets, further

[12] The NPL ratios in UkrEximBank and OshchadBank were 58.3 percent and 56.8 percent as of end-2019, respectively. The ratio in PrivatBank was 80.3 percent, as these are mostly loans related to the former owners. UkrGasBank had

underscoring the need to put in place a framework for resolving NPLs. A pre-requisite for achieving this in SOBs has been to strengthen corporate governance. SOBs in Ukraine have long operated under the political influence of vested interests that have distorted the allocation of capital. An opportunity to address this challenge has been created by the enactment in 2018 of the SOB Law intended to establish independent supervisory boards. While the supervisory boards were selected by November 2019, the process proved challenging, underscoring the need to continue monitoring threats to their independence.

41. **Moving forward, the priority is to establish an enabling framework for NPL resolution in SOBs.** The authorities also took initial steps toward this objective, including strengthening creditor rights, issuing regulations on the tax treatment of write-offs, and approving a new Insolvency Code. Going forward, with independent supervisory boards in place, the resolution of NPLs in SOBs has been expected to come from three sources: (i) write-offs of fully provisioned NPLs (through NBU prudential regulation); (ii) restructuring and sale of NPLs with haircuts on principal without threat of prosecution; and (iii) resolving complex, multi-creditor NPLs involving powerful business groups, which will require a special approach combining technical resolutions tools with strong political will. A major challenge in restructuring and sale of NPLs has been that legislation on criminal penalties for misappropriation of state funds leads to a high risk for SOB supervisory boards and management when the recoveries on NPLs are below the outstanding principal. SOBs are thus reluctant to take difficult decisions on haircuts when restructuring and selling NPLs below book value. In order to address this challenge, a Cabinet Resolution has been approved in April 2020 enabling SOBs to make use of all conventional NPL resolution tools, including those involving haircuts on principle, without threat of prosecution. In addition, NBU prudential regulations were approved in February and April 2020 to facilitate write-offs of fully provisioned NPLs. Going forward, it will be important to expeditiously implement the new NPL resolution framework. This will involve preparation of NPL resolution plans by the SOBs.

<u>Prior Action 5</u>: *Issued NBU prudential regulations #49 and #52 on write-offs for fully provisioned NPLs and approved Cabinet 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.*

<u>Expected Result</u>: *Value of gross Pre-2020 Non-Performing Loan (NPL) portfolio in State-Owned Banks (SOBs) declines from UAH 397 billion in (end) 2019 to under UAH 300 billion in 2021*. This significant reduction in the NPL portfolio would enable the SOBs to focus their staff resources on identifying and assessing new lending opportunities, thus improving prospects for greater credit to the private sector. The reduction in NPLs would also help increase interest from private investors in taking an equity position in these state-owned banks, which is one of the major medium-term objectives of the government's strategy for state-owned banks.

<u>*Strengthen supervision of non-banking financial institutions*</u>

42. **Strengthening the supervision of NBFIs is expected to address a major source of fraud and vulnerability in a rapidly growing part of the financial sector.** The regulation of NBFIs, including insurance, pension funds, non-bank lenders, and credit unions is very weak, leading to significant fraud and money laundering, especially in the insurance industry. This is impeding the NBFI sector from playing a productive role in supporting economic growth and is also a vulnerability for the economy. Many insurance companies (including the largest in the system) collect substantial premiums that are transferred fully to

relatively low NPL ratio of 19.3 percent.

obscure local re-insurance schemes without paying claims, while the effective loans rates of non-bank lenders are often hundreds of percent. While the banking sector was contracting in 2014-2017, some segments of NBFI sector (financial companies) experienced unprecedented growth, almost doubling their total assets, including by acquiring low-quality assets of failed banks. The current financial sector regulation is fragmented between three regulators with the NBFI regulator being the weakest, non-functional, lacking both independence and capacity, while being tasked with "supervising" about 2200 institutions. The solution is to abolish the NBFI regulator and split its functions between the National Bank of Ukraine and the National Commission for Securities and Stock Market (NCSSM), which are two institutions with much more credibility and capacity. This would be accomplished by the recently approved Law also referred to as the "Split Law".

Prior Action 6: *Enacted Law # 79-IX to enhance the regulatory framework for non-bank 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*.

Expected Result: *NBU and NSSMC adopt action plan on reshuffling supervisory regimes for insurance, credit unions, pension funds, and other NBFIs*. This would help significantly improve supervision and confidence in the non-banking financial sector in Ukraine. It would also help the development of a more diverse set of financial assets, which is important to establish the pre-conditions for Ukraine's aspirations promote the development of individual retirement accounts, and thus longer-term savings and investment opportunities.

Pillar 3: Bolstering the Social Safety Net

43. **Bolstering the social safety net, with a focus on the elderly population, is important to cushion the impact of the COVID-19 crisis.** The welfare of poor and vulnerable households is being affected by the pandemic due to several factors, including the loss of labor income, lower remittances, and higher expenditures on key services including health, transportation, and other necessities. The elderly population is among the most vulnerable both to the health shock and to income volatility resulting from the pandemic. The largest part of the social safety net in Ukraine is pensions, with spending on pension benefits amounting to about 11 percent of GDP. Pensions also account for a significant part of household incomes, particularly for those in the bottom 40 percent of the population. In this context, bolstering pension benefits, especially for the elderly in the bottom part of the income distribution, is an important instrument to cushion the impact of the crisis on the elderly population.

Bolster pension benefits

44. **Indexation of pensions is a key tool for preserving the real incomes of the elderly.** Prior to the Pension Reform adopted in 2017, no clear rules of indexation existed for existing pensioners. Pension indexation was done in an ad-hoc basis and in a pro-cyclical manner. During 2014-2015 crisis, pensions were not indexed, eroding the real income of the old-age population relying almost exclusively on pensions. As a result, the relative position of pensioners in the income distribution worsened, with 15 percent of them falling into the bottom quintile (compared to 10 percent before the crisis) and accounting for 33 percent of the bottom 40 percent in 2016 (compared to 29 percent in 2014). One of the key features of the pension reform law approved in 2017 was the introduction of systematic rules for annual indexation of the pension benefit, to safeguard the income of pensioners in real terms, including during downtowns. However, the law provided

flexibility on the date of the statutory pension indexation each year, thus undermining the predictability of the pension benefit each year and resulted in some volatility of purchasing power.

44. **In response to the COVID-19 pandemic, the Government has brought forward the date of pension indexation in 2020, which has introduced greater predictability in pension benefits for the year.** The initial budget allocation for pensions in 2020 would have allowed for the indexation this year to only kick in toward the end of the calendar year. The Cabinet Resolution # 251, adopted on April 1, 2020, stipulated an 11 percent increase in the pension benefit for most beneficiaries, applying to the pension benefits starting from May 1, 2020. The decision to proceed with the statutory indexation in May required an additional allocation of UAH 12.4 billion to the Pension Fund of Ukraine, which was part of the budget amendment approved in April 2020. To further protect the elderly, the government also introduced a one-time top-up of UAH 1,000 for those who receive less than UAH 5,000 per month, which is expected to cover 10.6 million pensioners. In addition, the government introduced a temporary top-up of UAH 500 per month for pensioners above 80 years of age, covering 1.5 million people. These measures are expected to have a significant positive impact in bolstering pension benefits during the COVID-19 crisis. Going forward, it will be important to take measures to improve the predictability on a permanent basis, including timely indexation and clear rules for supplementary benefits for those over 80 years of age.

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*.

Trigger 4 (DPL-2): *Improve predictability and sustainability of pension benefits, including timely indexation and clear rules for supplementary benefits for those over age 80.*

Expected Result: *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*. Reducing discretion in the date of pension indexation each year will provide greater predictability in the purchasing power of the pension benefit each year, which is particularly important during a sharp economic downturn. With incomes of elderly women relying more on pension benefits, greater predictability in the benefit addresses an important gender related disparity.

45. **The prior actions supported by the proposed operation are based on thorough analytical and advisory work.** The key pieces of analytical work and technical assistance carried out by the World Bank and other partners are summarized in Table 4 below.

Table 4. DPL Prior Actions and Analytical Underpinnings

Prior actions	**Analytical Underpinnings**
Pillar 1: Fostering De-monopolization and Anti-Corruption Institutions	
Prior action 1: Unbundling Gas Sector	WB Energy Sector Technical Assistance (2018-2020)
Prior action 2: Concessions Law	IFC and WB Technical Assistance on Concessions and PPPs
Prior action 3: Anti-Corruption	WB Technical Assistance on Anticorruption (2018-2020).
Pillar 2: Strengthening Land and Credit Markets	

Prior actions 4: Agricultural land market	WB, "Special Focus Note on Reforming land markets for agricultural growth", 2019; WB ASA, "Supporting transparent land governance in Ukraine" (2017); Kyiv School of Economics, "Restrictions on farmland sales markets: a survey of international experience and lessons for Ukraine" (2016)
Prior action 5: NPLs in SOBs	WB "Assessment of NPL resolution framework and policy options in Ukraine" (2019); WB Financial Sector Technical Assistance (2018-2019)
Prior action 6: NBFI Supervision	WB Financial Sector Technical Assistance (2018-2019)
Pillar 3: Bolster the Social Safety Net	
Prior action 7: Pensions	WB Technical Assistance on Pensions (2019-2020)

4.2. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

46. **The proposed DPL is closely aligned with the objectives of the Ukraine Country Partnership Framework (CPF) for FY17-21.** The objective of the CPF (Report # 114516-UA discussed at the Board on June 20, 2017) is to promote sustained and inclusive economic recovery through a program focusing 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 DPL is a central component of the CPF's strategy to prioritize support for critical reforms. The CPF recognizes that the achievement of results will depend on reforms that face opposition from vested interests and thus require deep engagement by the Government and other stakeholders. The reforms supported by the DPL are closely tied to the priorities identified in the 2017 Ukraine Systematic Country Diagnostic on "Toward Sustainable Recovery and Shared Prosperity" and the 2019 study on "Ukraine Growth: Faster, Lasting, Kinder." The SCD and the Growth Study provides the analytical underpinnings for many of the reform areas supported by the DPL. The reform areas supported by the DPL are also closely aligned with World Bank investment projects and technical assistance in energy, agriculture, transport, financial sector, and anti-corruption. Importantly, this operation complements the COVID-19 support by the World Bank, including the recently approved Additional Financing for the Social Safety Net Project and Additional Financing for the Health Project.

4.3. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

47. **The authorities have carried out consultations with stakeholders on the reforms supported by this proposed operation.** The reforms supported by this operation are consistent with the Government's program approved by the Parliament in October 2019, which has been discussed with civil society, development partners, and the public through various channels. More specific consultations have been held on the different reform areas. On land reform, for instance, the authorities have held consultations through a variety of channels, including events with a wide variety of farmers, farmer associations, landowners, and the general public. A parliamentary working group with support from the World Bank and other development partners has been working on the legislative framework. The President and the Prime Minister have publicly advocated for the reform. On the anti-corruption reforms, extensive discussions and debate has taken place including the government, members of parliament, and civil society representatives in the media. On the financial sector reforms, discussions have taken place with banking sector representatives and the private

sector. Across various reform areas, government representatives have appeared on media programs to explain the rationale, design, and outcomes of the reforms.

48. **Collaboration among development partners has been a cornerstone in the effort to support policy reforms in Ukraine.** The World Bank has coordinated the proposed DPL's support for reforms closely with the IMF, the European Union/Commission, the European Bank for Reconstruction and Development (EBRD), the United States/USAID, UK/DFID, Switzerland, Canada, Japan, Sweden, and other development partners. In addition to collaboration with international development partners, the Bank's support for policy reforms has also collaborated closely at the national and subnational level with the private sector, academia, and civil society to organizations to ensure knowledge sharing and coordination of efforts.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

49. **The prior actions under this proposed DPL are expected to have positive or neutral poverty and social impacts in the context of the COVID-19 crisis**. Several prior actions are institutional in nature, aimed at addressing the bottlenecks to investment, such as strengthening credit markets and anti-corruption institutions. While these reforms are not expected to have direct welfare or distributional impact on households, their impact on households, including the poorest households, are expected to be felt through economic recovery. A faster economic recovery from the on-going COVID-19 crisis will help in the recovery of incomes and consumption of vulnerable households. Going forward, more sustainable economic growth would help to support incomes and consumption in the medium term. For instance, the de-monopolization and unbundling of ownership of the gas sector (prior action 1) may not have a direct impact on energy tariffs but is important for attracting investment to maintain and modernize the gas transport network, which supports macroeconomic stability and economic recovery. The reforms supporting the strengthening the NPL resolution framework (prior action 5) aim at removing the constraints to credit growth to the private sector, where small- and medium-sized borrowers are the most credit constrained.

50. **While growth has been crucial for poverty reduction in Ukraine, it is important to ensure that the recovery remains inclusive and that safety nets are in place to protect vulnerable households.** Incomes of the bottom 40 percent grew at a higher rate prior to the economic contraction of 2014-2015, and even though incomes fell throughout the distribution in 2014-2015, their contractions were smaller in magnitude at the bottom of the income distribution. The recent Commitment to Equity (CEQ) analysis, conducted using the 2016 household survey data, finds that the fiscal system in Ukraine has a notable redistributive and poverty reducing effect, primarily on account of pensions and direct transfers, with the latter being the most cost-efficient in terms of their effect per Hryvnia of budget allocated to the programs. However, there is room for improvement in terms of targeting, as many programs designed to support low-income groups transfer non-negligible shares of their budgets to higher-income deciles. Improved targeting of Housing Utility Subsidies (HUS) was a key reform supported by the World Bank's DPF approved in December 2018. Going forward, the Bank is working closely with the new Government (through technical assistance and the planned Additional Financing for the Social Safety Net project) on a vision to further improve the effectiveness and fiscal sustainability of the overall social safety net package. The aim is to expand the means-tested Guaranteed Minimum Income (GMI) program, while further consolidating the HUS program. Preliminary simulations suggest that the reforms would double the coverage of households eligible

for the GMI program, with a higher share (from 30 to 55 percent) of the combined HUS and GMI budget reaching the bottom 20 percent of the distribution.

51. **The prior action to bolster pension benefits for the elderly is expected to benefit some of the most vulnerable members of society.** The results of the recent CEQ analysis suggest that pensions play a major role in fighting poverty and inequality in Ukraine. The poorest decile almost completely depends on transfers and other benefits, of which pensions is the largest. According to the most recent HBS data available, the big share of pensioners is concentrated at the bottom of the distribution-- more than 35 percent of the pensioners are located in the bottom 40 percent of the welfare distribution. For the households with pensioners this share is even higher–42 percent of them are located in bottom 40 percent of the distribution. The poverty rate among pensioners is considerable at 19.4 percent. For the pensioners that do not work, the poverty rate is even higher at 21.6 percent. Timely indexation of pensions, especially under the current economic circumstances, can therefore be expected to impact positively the households with pensioners and be particularly beneficial for the pensioners in the bottom quintiles.

52. **The measures supporting the establishment of a market for agricultural land, are expected to have an overall positive distributional effect in the medium term, although significant risks remain in completing and implementing the legislative package on land reform.** An estimated 5 million small landowners (2 million households) who often rent out their land, currently do so for a fraction of its economic return; furthermore, for them land rights are often undermined by weaknesses in the cadastre and registry. Allowing market-based land valuation would help boost their incomes. This is the most direct pathway through which the prior actions supporting land reform would affect household welfare. Simulations based on household budget survey data suggest that an increase in the land rental price of 147 percent[13] would result in a 1.3 percent increase in household incomes in the bottom 40 percent and would be associated with a 0.6 percentage point reduction in moderate poverty. The ability of using land as collateral would provide small landowners with improved access to credit that can be used as for investment, including in self-employment and non-agricultural businesses. Finally, improved agricultural productivity would also be expected to have a positive effect on incomes of agricultural workers. While it is not possible to simulate the magnitude of this effect, it would be particularly beneficial to households in the lower end of the income distribution. According to HBS data, households from the bottom 40 group are more likely to be engaged in, and derive income from, agricultural activity – thus, share of employed in agriculture among bottom 40 (10.7 percent among all employed) is higher than for the rest of population (8 percent).

53. **The prior actions on pensions, agricultural land market opening, land financing, and supervision of non-banking financial institutions are expected to address gender-related disparities in Ukraine.** More than 70 percent of pensioners are women, primarily due to higher female life expectancy. Bolstering pension benefits and strengthening their predictability and purchasing power would address a major gender related disparity in the impact of the pandemic. Older women account for a large share of the 4.5 million landowners in Ukraine. With most landowners renting out their land and with rental prices depressed below their real economic returns, the lack of an agricultural land market depresses the rental incomes of women. The opening of the agricultural land market is thus expected to address this gender related disparity. Second, women are more likely to face constraints in access to finance. In agriculture, a greater share of small agricultural farmers, who are most credit constrained, are likely to be women. The trigger on land financing, which improves access to finance for small, credit-constrained farmers, is likely to address this gender related

[13] This is equal to the historical growth of rental prices between 2015 and 2018.

disparity. Third, women are more likely to face predatory pricing and fraud in the non-banking financing sector. The prior action to strengthen supervision of NBFIs is likely to address this gender related disparity.

5.2. ENVIRONMENTAL ASPECTS

54. **Potential environmental impacts.** The proposed prior actions are assessed as having either beneficial or no adverse environmental effects (see Annex 4 with the Environmental and Poverty/Social analysis table). At the same time, actions under Pillar 1 and 2 will require careful integration of environmental issues to effectively mitigate any potential adverse environmental impacts. The prior actions on gas and concessions can reduce unauthorized gas offtakes and facilitate private investment in gas supply and infrastructure, including new technologies with better environmental performance. Efforts should be dedicated to avoiding any risks that might emerge from civil works (e.g., solid waste, air and water pollution, occupational health), supported by the regulatory framework governing these issues. Similarly, the prior action on agricultural land can increase private investment, including in better natural resource management, energy efficiency, and climate adaptation technologies. Increased investment in agriculture should safeguard against land degradation, soil and water pollution, and increased pesticide use in agriculture.

55. **Country environmental policy framework.** Ukraine has environment policies and regulations aimed to mitigate and manage potential impacts of economic activities and is in the process of further aligning those with the EU. The existing Environmental and Social Assessment (ESA) legal and administrative system, critical to mitigate any potential adverse impacts of new investments, in particular, for infrastructure and agricultural sectors, is overall well developed. Technical assistance from development partners is helping the authorities to further harmonize with international practices and build capacity for better enforcement and compliance.

56. **Climate and Environmental benefits.** The proposed operation promotes climate and environmental benefits in the most important areas of climate related challenges for Ukraine, namely its large agricultural sector which is a source of GHG emissions, and the energy intensive infrastructure. Three out of the seven prior actions supported by the operation can yield environmental and climate benefits First, the prior action to establish an agricultural land market can strengthen the security of land tenure and provide incentives for landowners and land users to more sustainably manage land assets and undertake investments to manage climate impacts. Second, the prior action to unbundle Naftogaz is expected to stimulate energy efficiency investments and measures to reduce gas transmission system losses, which should cut help cut GHG emissions. Third, the prior action on improving the legislative framework for private investment in infrastructure through Concessions should help in attracting greater private investment toward less energy-intensive infrastructure.

57. **Climate and environmental implications of the gas sector unbundling prior action.** This reform to unbundle the gas sector is expected to bring significant positive climate change mitigation benefits by reducing greenhouse gas (GHG) emissions related to the consumption and transmission of natural gas. Ukraine is ranked fifth in the world for energy intensity and is also one of Europe's largest energy consumers. It is also a major source of energy transmission from Russia to Europe. In 2015 and 2016, the authorities embarked upon a historic energy tariff adjustment program which raised heating and gas tariffs between 250 to 500 percent. The successive adjustments in energy tariffs progressively incentivized greater energy efficiency in the residential sector. In 2017, Ukraine's total natural gas consumption has decreased by 4 percent compared to 2016 (from 33.2 to 31.9 bcm). Out of this total, household consumers used 11.2 bcm of gas in 2017, which is 6 percent or 0.7 bcm less than in 2016. The unbundling of the gas TSO from the

vertically integrated Naftogaz will further stimulate efficiency improvements, including the elimination of "unauthorized gas offtakes" estimated at 1.5bcm (worth about UAH 10 billion) in 2019. Also, the newly established independent TSO will prioritize investments in modernization of gas transmission infrastructure including digitalization of metering, billing and balancing system, as well as efficiency improvements of outdated compressor stations. Such measures will significantly reduce gas consumption and losses in the gas transmission system of Ukraine and, therefore, cut GHG emissions.

58. **Climate and environmental implications of the Concessions prior action.** This reform is expected to contribute to positive climate mitigation and adaptation impacts. Transport, energy and social infrastructure in Ukraine remain inadequate requiring significant investment. Infrastructure investment has been dominated by the public sector and has not benefitted from the efficiency, innovation, and green orientation that the private sector brings today. The new Law on Concessions establishes a clear and sound framework based on international best practice to catalyze private and foreign direct investment in infrastructure development. The Law, in compliance with EU standards and regulations pertaining to concessions, will enable Ukraine to continue to shift its infrastructure investment toward a more climate friendly and greener path, in line with its commitments to the EU as outlined in its Association Agreement. The new law includes specific provisions that incentivize energy efficiency in concession investments. In particular, Article 8 of the law specifies limits on the amount of losses and thermal energy per unit of service provided for heating, water supply and wastewater disposal facilities, which must be part of the terms of the concessions' agreement. With appropriate strengthening of the environmental assessment system and enforcement mechanisms, foreign and private investors will be expected to increase social responsibility awareness and introduce climate-friendly and environmentally sound technologies and practices that support climate adaptation and mitigation.

59. **Climate and environmental implications of the land market prior action.** Ukraine is one of the largest agricultural producers in the world and a significant portion of the population relies on the agriculture sector for livelihood. However, this sector is highly vulnerable to climate change, which threatens this major source of economic growth and household incomes. Higher temperatures could cause shifts in agricultural zones across Ukraine, and floods and water deficiencies have had a significant impact on agricultural output and household incomes over the last 20 years. An exacerbation of these vulnerabilities through the anticipated impacts of climate change could undermine Ukraine's overall development objectives, as well as the objectives of this operation. By undermining incentives to sustainably manage land and undertake adaptation investments, the insecurity of land tenure and limited access to finance for small farmers leaves Ukraine's agricultural sector and associated household livelihoods even more vulnerable to climate change. The prior action to establish a transparent and efficient market for agricultural land would provide better incentives for landowners and land users to sustainably manage land and undertake investments in strengthening climate resilience. This prior action thus has both climate change mitigation and adaptation benefits. In this context, Draft Law #2194 (on land management and streamlining land transfer procedures) is intended to include safeguards provisions to identify environmentally sensitive lands, while Draft Law #2195 is intended to prevent discretionary handouts of environmentally sensitive state-owned land.

60. **Improved security of land tenure is critical to mitigate climate change.** The academic literature (e.g. Nizalov et al. 2016) as well as case studies document that inability of Ukrainian farmers to acquire secure land ownership rights has led to short-term profit maximization without regard to long-term environmental costs. This has led to a failure to adopt climate smart agriculture and sustainable land management practices such as zero tillage, and is contributing to ongoing irreversible degradation of Ukraine's soil due to soil mining, failure to capture carbon via perennials, GHG emission through large-scale peatland conversion, and inefficient use of other resources such as water. By allowing farmers to own the land they cultivate, the land-

related actions in the DPL will help reverse this trend and provide the basis for adoption of more sustainable practices in agriculture.

61. **With small farmers in Ukraine particularly vulnerable to climate change, improving the security of land tenure and enhancing access to credit will help build resilience to these impacts.** Available data shows that Ukraine's climate has already started changing. Climate modeling indicates that air temperature will continue to rise, and the precipitation region will alter through the year. Anticipated impacts include change in climatic seasons and growing season duration, reduced stable snow cover, changes in water resources availability (with likely down trend), increased frequency and magnitude of extreme weather events, shifts in ago-ecological zones, and increases in diseases and pests. All these factors will directly impact agricultural production. Assessments by experts show that about 60-70 percent of losses caused by extreme climate events fall to agriculture and crops losses (mostly due to droughts) fall in the range of 10-70 percent. In this context, improving the security of land tenure and access to credit will allow small farmers to implement necessary adaptive measures to cope with the changing climatic conditions, and bounce back from potential adverse impacts of extreme whether events and climate-related disasters.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

62. **The government has made progress in strengthening the PFM system in recent years.** The PFM Reform Strategy approved in 2017 aimed at establishing a modern and efficient PFM system that provides quality public services by allocating spending in line with medium- and long-term development priorities. The latest Public Expenditure and Financial accountability (PEFA) assessment for Ukraine was undertaken in 2019. It concluded that since the previous assessment in 2016, the Government has made progress in: (i) implementing medium-term budget planning; (ii) increasing transparency in public financial management through the introduction of an open budget portal; (iii) integration of International Public Sector Accounting Standards (IPSAS) into Ukraine's statutory framework and the adoption of the 2025 public sector accounting (PSA) strategy; (iv) improving macroeconomic and budget forecasting tools; (v) fiscal risk management, and (vi) gradually introducing a gender-oriented approach to budgeting. At the same time, some challenges remain in: (i) the lack of strategy and transparency in public investment management, as the clear criteria for project selection are not used beyond the state budget; (ii) limited progress toward a comprehensive medium-term expenditure framework, including absence of reporting against outcomes and focus of the overall fiscal strategy only on the budget year; and (iii) weak payroll system, as information on employees and remuneration is not reconciled across budgetary agencies.

63. **Public access to fiscal information is strong.** The Chart of Accounts, which underpins budget preparation, execution and reporting, is comprehensive. Government finance statistics are produced monthly and are available on the MoF website and the State Treasury website. In addition, the MoF recently created a new e-data portal (spending.gov.ua), which provides detailed information on public expenditure. Ukraine's rank on the Global Open Data Index was 31st out of 94 countries in 2017.

64. **Ukraine has also advanced its public procurement system, but the share of contracts based on competitive bidding could increase further.** A new Law on Public Procurement (LPP) was adopted in December 2015 that establishes legal and economic principles for procurement of goods and services. During 2016-2018, the LPP was strengthened further to introduce a new framework on online monitoring of procurement by the State Audit Service using automatic risk indicators. Starting from 2016, all public procurements are made through the ProZorro centralized electronic procurement system. The tool provides for quick and thorough analysis of information on tenders, with easy and unlimited access granted to civil

society. The ProZorro system has been recognized internationally and received several awards. However, the share of competitive procurement via ProZorro system could be increased. In 2018, the total cost of all public procurement on a competitive basis using electronic auctions was 78 percent.

65. **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 also 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.

66. **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. No additional fiduciary arrangements, including audit, are required for the operation, given the progress in public financial management reforms.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

67. **The Ministry of Finance is responsible for the overall coordination of the proposed operation.** While the Ministry of Finance is the primary coordinating counterpart, some of the line ministries are responsible for implementation in their respective areas. The Ministry of Economic Development, Trade and Agriculture, the Ministry of Finance and the Ministry of Justice have the responsibility for implementing the land reform, including safeguards and land financing, the Ministry of Finance in coordination with the National Bank of Ukraine has the responsibility for implementing the banking sector reforms, the Cabinet of Ministers and the Ministry of Energy have the responsibility for implementing Naftogaz unbundling. The Ministry of Economic Development and Trade has responsibility for implementing the Concessions law.

68. **The specific expected results indicators, set out in Annex 1, will be used to monitor implementation of the operation.** The Bank, in collaboration with the Ukrainian authorities, will monitor and evaluate the program's achievement of these results.

69. **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 Development Policy Operation 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*.

6. SUMMARY OF RISKS AND MITIGATION

70. **The overall risk to the proposed operation is substantial.** The risks to the proposed DPL have been assessed using the Standardized Operations Risk-rating Tool (SORT), as summarized in Table 5. The main risks to the proposed operation that are rated Substantial are political (including security) and governance risks; macroeconomic risks; sector strategies and policies; and institutional capacity for implementation. The achievement of the development objective of this operation crucially depends on the containment of the COVID-19 pandemic, the associated length and depth of the economic downturn in 2020, and the ability of the authorities to address the health crisis, while maintaining the momentum on advancing reforms and moving forward with their implementation.

71. **Political and governance:** Substantial political and governance risks arise from the deep-rooted influence of powerful vested interests that could derail or even reverse reforms supported by this operation. The reform of state-owned banks, for example, requires safeguarding majority independent and competent supervisory boards, while the anti-corruption reforms require safeguarding the independence of key anticorruption institutions. The reform to establish an agricultural land market faces opposition from vested interests who benefit from the status quo of low rents, nontransparent access to state agricultural land, and preferential access to financing. These risks are mitigated by the government's willingness to advance major reforms, the strong voice of civil society in advocating for continued reforms, and Ukraine's strong cooperation with the international community and development partners. Another dimension of political and security risk is the conflict in eastern Ukraine which could intensify and adversely impact economic prospects through weaker investor confidence.

72. **Macroeconomic:** While the macroeconomic framework remains satisfactory, with sound exchange rate management and prudent fiscal policies, the country's exposure to shocks is substantial. Key macroeconomic risk factors include the sharp economic contraction resulting from the COVID-19 pandemic, lower revenues from the economic contraction, expenditure pressures from a large public-sector wage bill, COVID-related spending, and large debt repayment needs in 2020-2022. A prolongation of the COVID-19 crisis, combined with potential further deterioration of the economic outlook of key trading partners, could result in an even stronger economic contraction, exchange rate pressures, and widening of fiscal imbalances. Economic recovery could be undermined by the sensitivity of investor confidence to political and security developments, anemic credit to the private sector, and limited export diversification and foreign direct investment. The proposed operation contributes to mitigating macroeconomic risks by supporting reforms to bolster investor confidence, while cushioning the impact of COVID-19. The close engagement of the authorities with the World Bank, IMF and the EU on reviewing the macroeconomic policy framework, as well as in design and implementing key reform measures is another key mitigating factor.

73. **Implementation risks (including sector policies and institutional capacity).** The risks pertaining to sector strategies are closely intertwined with the risk pertaining to the institutional capacity for implementation. Reforms in key sectors require follow up actions to yield results. The risks associated with the agricultural land reform are particularly significant, given the complex and politically charged nature of the reform, with significant vested interests. Specifically, while initial legislative steps have been taken, expeditious approval and implementation of additional legislation is critical to ensure that the agricultural

land market will be transparent and efficient, safeguard the rights of Ukrainian landowners, and provide adequate access to finance for small farmers. Uncertainty about the approval of the pending land laws which are triggers for the second DPL, as well as uncertainty about the expeditious implementation of the full set of land legislation is a major risk associated with the overall land reform package. This risk is mitigated by the government's commitment to pursue enactment and implementation of the pending land legislation, as well as policy advocacy and technical assistance from international development partners on land reform. Many of the reforms supported by the proposed DPL also require strong capacity for implementation and monitoring. In establishing the agricultural land market by July 2021, it will be critical to expeditiously implement the complementary legislation on transparency, efficiency, and small farmer financing. The Concessions Law will require putting in place the new regulatory framework and attracting private investment will take time. Implementation could be undermined by a number of factors including weaknesses in institutional capacity, delays in decision making, and opposition from vested interests. These risks are mitigated in part by technical assistance provided by development partners and by close engagement of civil society organization to resist vested interests.

Table 5: Summary Risk Ratings

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

ANNEX 1: POLICY AND RESULTS MATRIX

Objectives	Prior Actions (DPO 1)	Triggers (DPO 2)	Results
PILLAR 1: FOSTER DEMONOPOLIZATION AND ANTICORRUPTION INSTITUTIONS			
Demonopolize and unbundle ownership of the gas sector	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.		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 (2021): 100 percent
Improve the legal framework for concessions	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.		Number of concession projects signed with private investment mobilized through project financing by lenders. Baseline (2019): 0 Target (2021): 2
Strengthen anticorruption institutions	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 unjustified assets.		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 (2021): 1,000

Objectives	Prior Actions (DPO 1)	Triggers (DPO 2)	Results
PILLAR 2: STRENGTHEN LAND AND CREDIT MARKETS			
Establish a transparent market for agricultural land with adequate safeguards	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.	Trigger 1: Enact legislation to strengthen land management, streamline land transfer and registration procedures, and make emphyteusis rights transferable and mortgageable. Trigger 2: Enact legislation to introduce electronic auctions and restrict discretionary handouts of state land via free privatization	Area of agricultural land previously under moratorium transacted by eligible individuals Baseline (2019): 0 hectares Target (2021): 100,000 hectares
Enhance access to finance for small farmers		Trigger 3: Establish affordable and effective financing instruments for small farmers by: (i) enacting legislation to create a partial credit guarantee facility; and (ii) approving a Cabinet resolution to improve the targeting of agricultural subsidies.	Loans to small farmers issued backed by Partial Credit Guarantee (PCG) facility Baseline (2019): No Target (2021): Yes

Objectives	Prior Actions (DPO 1)	Triggers (DPO 2)	Results
Strengthen the NPL Resolution Framework	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.		Gross Pre-2020 NPL Portfolio of State-Owned Banks Baseline (2019): UAH 397 billion Target (2021): Under UAH 300 billion
Strengthen supervision of non-banking financial institutions	Prior Action #6: Enacted Law # 79-IX to enhance the regulatory framework for non-bank 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.		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 SOCIAL SAFETY NET			
Bolster pension benefits	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.	Trigger 4: Improve predictability and sustainability of pension benefits, including timely indexation and clear rules for supplementary benefits for those over age 80.	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 (2021): Yes

ANNEX 2: FUND RELATIONS ANNEX

The IMF Assessment Letter dated June 4, 2020 is appended below. The presentation of the SBA program to the IMF Board is expected on June 9, 2020.

Ukraine—Assessment Letter for the World Bank
June 4, 2020

1. Ukraine's track record in macro-stabilization over the last 5 years and under successive Fund-supported programs has been strong. Growth had gradually picked up pace to 3¼ percent in 2019. Fiscal consolidation had been impressive, with the overall fiscal deficit limited to just above 2 percent of GDP in the last three years, and public debt down from its peak of 85 percent of GDP in 2014 to 50 percent of GDP by end 2019 (aided by the 2015 debt restructuring). Inflation had gradually come down to just over 4 percent by end-2019, within the central bank's (NBU) target range of 5±1 percent, before declining further in the first quarter of 2020. The current account deficit narrowed, while strong foreign exchange inflows allowed the NBU to continue to build reserves, to just over US$25 billion (3½ months of import coverage or about 80 percent of the Fund's reserve adequacy metric), while lifting exchange restrictions and easing capital controls. Ukraine's external position at end-2019 was broadly in line with fundamentals and desirable policy settings. Following the banking crisis of 2014–16, the soundness of the banking sector has been successfully restored, although the fiscal cost of bank recapitalization amounted to around 15 percent of GDP.

2. Despite prudent macroeconomic policies which delivered stabilization, the goal of robust and inclusive growth remains elusive in the absence of sustained and comprehensive structural reform. After some initial successes under recent IMF-supported programs reform efforts were hindered by increasing resistance from vested interests and adverse court rulings, especially in tackling corruption and financial sector reforms. Growth was undermined by lack of private investment that was held back by a difficult business environment. In the fall of 2019, political circumstances were auspicious to address this long-standing challenge, with the President's anti-corruption platform supported by an unprecedented absolute majority in parliament. However, the outbreak of the COVID-19 pandemic has significantly worsened the outlook and has refocused government policies on containment and crisis response.

3. Uncertainty is large, and the economy is projected to contract sharply, by 8.2 percent in 2020, as strict containment measures—in Ukraine and globally—led to sizable falls in domestic and external demand. The budget is expected to be hit hard, with a sharp decline in revenues and large emergency spending needs to address the crisis, widening from 2¼ percent of GDP in the original budget to almost 8 percent of GDP in the approved revised budget. Inflation is expected to increase in 2020 driven by adverse supply shocks and depreciation of the exchange rate, but weak demand pressures and stabilization of the exchange rate are projected to return inflation to within the NBU's target band over the course of 2021.

4. The external position is projected to deteriorate. The exchange rate has depreciated by about 15 percent since the end of 2019, although it has recently stabilized. Both imports and exports are expected to fall significantly, although exports by somewhat less as they include food staples such as grains. Remittances will also decline, by up to 25 percent, as Ukrainian workers abroad are laid-off. Against large gross external financing needs, and despite a successful 10-year US$1.4 billion Eurobond issuance in January, gross international reserves are projected to fall to about US$19 billion by end-2020, or 3 months of import coverage (70 percent of the ARA metric).

5. The Ukrainian authorities have requested a new 18-month Stand-By Arrangement (SBA). The new SBA, with a requested access of SDR 3.6 billion (equivalent to US$5 billion), aims to provide balance of payments and budget support to help the authorities address the effects of the COVID-19 shock, while consolidating achievements to date, and moving forward on important structural reforms to reduce key vulnerabilities. This will ensure that Ukraine is well-poised to return to growth and resume broader reform efforts when the crisis ends. The arrangement is also expected to catalyze additional bilateral and multilateral financial support, including from the World Bank (via a new Development Policy Loan) and the EU, with the release of the second €0.5 billion tranche under its existing Macro-Financial Assistance (MFA) operation and a new €1.2 billion MFA operation in response to the crisis. With appropriate fiscal and monetary policies, and assuming the financing from other IFIs and bilateral creditors materializes as projected, this would be adequate to help Ukraine meet its financing needs, while rebuilding reserve buffers to 3½ months of imports (nearly 80 percent of the ARA metric) by the end of the program.

6. Policies under the new arrangement will focus on four priorities: (i) mitigating the economic impact of the crisis, including by supporting households and businesses, while safeguarding medium-term fiscal sustainability; (ii) ensuring continued central bank independence and a flexible exchange rate, with the central bank's inflation target as a nominal anchor; (iii) safeguarding financial stability while recovering the costs from bank resolutions; and (iv) moving forward with key governance and anti-corruption measures to preserve and deepen recent gains. The authorities have already taken a number of prior actions which mitigate vulnerabilities in the financial sector, in the anti-corruption framework, in tax administration, and in energy policy.

7. Fiscal policies under the program will be directed at addressing the impact of the crisis, while ensuring medium-term fiscal sustainability. The widening of the general government deficit this year to almost 8 percent of GDP in the supplementary budget is an appropriate response to the crisis. Public debt, which is expected to rise to 65 percent of GDP by end-2020, will be kept at manageable levels, although up considerably from 50 percent of GDP at end-2019. As the recovery sets in, fiscal policy will need to be tightened to place public debt back on a downward path. Fiscal consolidation will need to be supported by broadening the tax base, strengthening revenue administration, and rationalizing current expenditures. Public debt is assessed to be sustainable, although risks remain very high—especially in case of further unexpected shocks to the exchange rate and/or GDP.

8. Monetary policy will remain focused on price stability in a flexible exchange rate framework. A credible, flexible IT regime should continue to anchor inflation expectations, allowing the NBU room to smooth economic cycles and mitigate liquidity stress. The NBU has eased monetary policy to support the economy, reducing its policy rate by 550 basis points in 2020, and is committed to ensuring sufficient financial system liquidity, allowing banks to function normally and finance the private sector and government.

9. The NBU is utilizing the flexibility within the regulatory framework to enable banks to absorb the impact of the crisis. Looking forward, financial sector policies focus on improving the banking system's health and governance and enhancing financial intermediation. Efforts to recover assets from failed banks and hold former bank owners accountable will continue.

10. More generally, the SBA envisages moving forward on a streamlined set of critical structural reforms, some already delivered as prior actions, focusing on fiscal, financial, and energy sector policies to safeguard sustainability and reduce vulnerabilities, and on governance, given its criticality to achieving program objectives. The authorities have already taken a number of prior actions which mitigate vulnerabilities in the financial sector, in the anti-corruption framework, in tax administration, and in energy policy.

11. The IMF staff level agreement is still subject to approval by the IMF Executive Board. Board consideration is expected in early June, as all prior actions have been completed. Risks are very large. The policy responses supported under the program are appropriate, with existing policy space augmented by a sizable (about $8 billion in total) increase in external financing. However, the uncertainty about the severity and length of the global downturn is exceptionally high, as are estimates about the magnitude of the cyclical and structural impact of the crisis, including with respect to balance sheet damage. In addition, in the current stressed political environment sound policy responses could lose out to populism, and, in the absence of a strong focus on sustaining an anti-corruption agenda, the power of the state to insulate resources from the control of vested interests may weaken. The conflict in the eastern part of Ukraine continues to weigh on the outlook.

Ukraine: Selected Economic Indicators, 2019–2021

	2019 Act.	2020 Proj.	2021 Proj.
Output			
Real GDP growth (percent)	3.2	-8.2	1.1
Labor market			
Unemployment rate (ILO definition; percent)	8.5	12.6	12.0
Nominal wage growth	18.5	3.6	11.4
Prices			
Consumer prices (period average)	7.9	4.5	7.2
Consumer prices (end of period)	4.1	7.7	5.9
Public finance (percent of GDP)			
Revenue	39.4	39.7	40.0
Expenditure	41.4	47.4	45.3
General government balance 1/	-2.0	-7.7	-5.3
Public debt (end of period)	50.4	65.4	62.7
Money and credit (end of period, percent change)			
Broad money	12.6	4.0	11.0
Credit to non-government	-9.8	-7.3	-12.4
Balance of payments (percent of GDP)			
Current account balance	-0.7	-1.7	-2.0
Foreign direct investment	1.6	0.8	2.1
Gross reserves (end of period, billions of U.S. dollars)	25.3	19.3	23.4
Reserves in months of next year's imports of goods and services	4.8	3.1	3.4
Reserves in percent of short term debt (remaining maturity)	68.5	63.6	70.7
External debt (percent of GDP)	78.8	93.0	84.6

Sources: State Statistics Committee of Ukraine; Ministry of Finance; National Bank of Ukraine; World Bank; World Development Indicators; and IMF staff estimates and projections.
1/ The general government includes the central and local governments and social funds.

IMF PRESS RELEASE NO. 20/223

IMF and Ukrainian Authorities Reach Staff Level Agreement on a New Stand-By Arrangement to Help to Address COVID-19 Pandemic

May 21, 2020

Washington, DC – An International Monetary Fund staff team led by Ms. Ivanna Vladkova Hollar concluded remote discussions with the Ukrainian authorities on May 21 and reached a staff-level agreement on economic policies for a new 18-month Stand-By Arrangement (SBA).

At the conclusion of the discussion, Ms. Vladkova Hollar made the following statement:

"The International Monetary Fund (IMF) staff and the Ukrainian authorities have reached staff-level agreement on economic policies for a new 18-month Stand-By Arrangement (SBA). The new SBA, with a requested access of SDR 3.6 billion (equivalent to US$5 billion), aims to provide balance of payments and budget support to help the authorities address the effects of the COVID-19 shock, while consolidating achievements to date, and moving forward on important structural reforms to reduce key vulnerabilities. This will ensure that Ukraine is well-poised to return to growth and resume broader reform efforts when the crisis ends. The arrangement is also expected to catalyze additional bilateral and multilateral financial support.

"The agreement is subject to approval by Fund Management and the IMF Executive Board. Board consideration is expected in the coming weeks."

ANNEX 3: LETTER OF DEVELOPMENT POLICY

КАБІНЕТ МІНІСТРІВ УКРАЇНИ

вул. Грушевського, 12/2, Київ, 01008, тел. (044) 256 7624, телефакс (044) 254 0584, www.kmu.gov.ua

УКРАЇНА:
Перша позика на політику розвитку
у сфері економічного відновлення

17624/0/2-20 від 28.05.2020

ЛИСТ ЩОДО ПОЛІТИКИ РОЗВИТКУ

Шановний пане Президенте!

1. Від імені Уряду України я б хотів скористатись цією можливістю висловити свої теплі почуття та вдячність Світовому банку і Вам особисто за підтримку в досягненні Україною найбільш критичних цілей розвитку. Наше успішне партнерство допомогло реалізувати ряд основних реформ, що підтримані запропонованою Першою позикою на політику розвитку у сфері економічного відновлення (далі — Позика). Зараз Україна переживає безпрецедентну кризу у зв'язку з поширенням на території України гострої респіраторної хвороби COVID-19, спричиненої коронавірусом SARS-CoV-2 (далі — COVID-19). Ми цінуємо бажання Світового банку підтримати наші невідкладні заходи проти кризи і створити умови для економічного відновлення після того, як криза у сфері охорони здоров'я припиниться. Ми віримо, що основні реформи, які підтримуються Позикою, є вирішальними для зусиль України щодо підсилення підвалин економічного відновлення шляхом посилення демонополізації і антикорупційних інститутів, зміцнення ринку землі і кредитного ринку, підкріплення системи соціальної підтримки.

2. Україна здійснює далекосяжні реформи протягом п'яти останніх років у рамках фінансування Світового банку на підтримку політики розвитку у 2014—2015 та 2018 роках. Ці реформи допомогли відновити стабільність макроекономіки і фінансового сектору та поновити економічне зростання. Як результат, економіка зросла на 3,4 відсотка в 2018 році і на 3,2 відсотка — у 2019 році. Дефіцит державного бюджету підтримувався на рівні не вище 2,5 відсотка валового внутрішнього продукту чотири роки поспіль (у 2016—2019 роках), а державний і гарантований державою борг знизився з максимального 81 відсотка валового внутрішнього продукту в 2016 році до приблизно 50 відсотків валового внутрішнього продукту в 2019 році. Дотримання монетарної політики Національного банку України щодо середньотермінової цінової

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стабільності допомогла знизити інфляцію з максимального 61 відсотка в квітні 2015 року до 4 відсотка наприкінці 2019 року. Ці досягнення допомогли Україні взяти курс на реформи і досягнення результатів розвитку.

3. Водночас ми усвідомлюємо, що стоїмо перед великими викликами розвитку, які посилились наслідками, спричиненими поширенням на території України COVID-19. Уряд України рішуче налаштований впоратись з цими викликами, щоб досягти вищих стандартів життя для Українського народу. Зокрема, незважаючи на прогрес останніх років, багато структурних викликів стримують потенціал національної економіки. Ми рішуче налаштовані на реформи для вирішення цих довготривалих викликів стосовно приватних інвестицій і продуктивності, щоб економіка змогла відновитись відразу, коли криза в охороні здоров'я закінчиться. Очікується, що економіка скоротиться на 5—7 відсотків у 2020 році, а помірна бідність зросте з 18 відсотків у 2019 році до 24 відсотків в 2020 році. Ми сподіваємось, що криза в охороні здоров'я вщухне в другій половині року, і з ключовими реформами, які підтримуються Позикою, економіка відновиться у 2021 році. Ми також здійснюємо важливі кроки для зміцнення соціального захисту, щоб пом'якшити вплив наслідків кризи на населення.

4. У контексті кризи, викликаної пандемією COVID-19, прогнозується, що податкові надходження зменшаться, а додаткові витрати на охорону здоров'я і соціальний захист є ключовими. Змінами до Державного бюджету України на 2020 рік, прийнятими в квітні ц. р., заплановано дефіцит державного бюджету в розмірі 7,6 відсотка валового внутрішнього продукту. Нас також очікують значні виплати за державним боргом у 2020—2022 роках. Ми рішуче налаштовані забезпечити макроекономічну і фіскальну стійкість. Підтримка Світового банку через Позику разом з підтримкою від МВФ та ЄС є невід'ємною частиною допомоги для фінансування наших потреб в ці складні часи. Надалі, коли умови на міжнародних ринках капіталу полегшаться, ми будемо розглядати можливості подальшого фінансування на прийнятних умовах.

5. Макроекономічна політика України сильна і підкріплена взятими зобов'язаннями щодо фіскальної та зовнішньої стабільності. Наша відповідь на кризу збільшить навантаження на державний борг і на дефіцит державного бюджету, але необхідно пом'якшити цей вплив на населення та на економіку. Ми прагнемо скоротити обсяг державного боргу в 2021 році, коли економічне зростання відновиться. Тим часом Національний банк України здійснює всі необхідні кроки для підтримання гнучкого і стабільного обмінного курсу. Ми також підтримуємо порядок денний наших структурних реформ, щоб (i) відновити зростання економіки в 2021 році і надалі шляхом сприяння інвестиціям і підвищенню продуктивності; (ii) знизити розмір дефіциту державного бюджету і обсяг державного боргу, коли відновиться економічне зростання; (iii) підвищити

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експорт і залучити прямі іноземні інвестиції для підтримки стійкості до зовнішніх викликів; і (iv) зробити можливим відновлення зростання обсягів кредитування приватного сектору. Макроекономічні показники України підтримуються Позикою, макроекономічною допомогою Європейського Союзу і очікуваною Угодою "Stand-by" з МВФ (SBA). 21 травня 2020 року ми досягли згоди щодо нової Угоди "Stand-by" з МВФ, і всі попередні заходи були виконані, що забезпечить погодження МВФ програми.

6. Уряд України також прагне розвивати свій амбітний порядок денний структурних реформ. Ми рішуче налаштовані здійснювати заходи, які є економічно обґрунтованими, технічно здійсненними і розроблені так, щоб викликати тривалий позитивний ефект. Підтримка міжнародних партнерів є дуже важливою для подальшого зміцнення нашого потенціалу реалізувати ці прагнення, і в той же час підтримувати імпульс інституційних і системних реформ, які зараз здійснюються в Україні.

7. Підтримка Світового банку є критичною для успіху амбітного порядку денного наших реформ. Запропонована Позика розроблена для підтримки ключових елементів порядку денного наших реформ, щоб усунути ключові перешкоди для інвестування і економічного відновлення, і в той же час зменшити вплив глобальної пандемії. Ключові реформи, які підтримує Позика, організовані за трьома напрямами, які повністю узгоджуються з нашими цілями розвитку: (i) сприяння демонополізації і антикорупційним інститутам; (ii) посилення ринку землі та кредитного ринку; і (iii) підкріплення системи соціальної підтримки.

8. Сприяння демонополізації і антикорупційним інститутам. Реформи за цим напрямом дають змогу демонополізувати ключові сектори економіки і посилити антикорупційні інститути, щоб підвищити впевненість інвесторів. Ми готові до анбандлінгу в газовому секторі, з його великим слідом монополії державної власності НАК "Нафтогаз України", і до роз'яснення правової бази приватних інвестицій в інфраструктуру шляхом концесій. Ми усвідомлюємо, що ці заходи допоможуть підвищити конкуренцію і привабити інвестиції у важливі галузі економіки, зберегти роль України як довготермінового партнера транзиту газу в Європу і підвищити участь приватного капіталу в розвитку інфраструктури. Ми також є прихильниками підсилення антикорупційних інститутів для подальшого підвищення прозорості та відповідальності і для створення рівного ігрового поля для інвесторів в Україні. Ці реформи повинні допомогти нам залучати і утримувати приватні та іноземні інвестиції протягом тривалого часу і підвищити продуктивність всієї економіки. З метою впоратись з цими цілями здійснено такі заходи:

забезпечено повний анбандлінг власності оператора газотранспортної системи від НАК "Нафтогаз України" 1 січня 2020 року шляхом введення в дію Закону про анбандлінг і підписання та вступу в дію Договору про

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купівлю-продаж і Угоди про передачу прав господарського управління активами державного оператора газотранспортної системи з балансу акціонерних товариств "Укртрансгаз" до "МГУ". Уряд України прагне повного впровадження цієї реформи, щоб досягти зростання частки платежів за транзит, що надходять прозоро до ТОВ "Оператор ГТС України", нового незалежного оператора газотранспортної системи, від 0 відсотків в 2019 році до 70 відсотків в 2020 році. Ця основна віха демонополізації та підвищення прозорості на газовому ринку України допоможе НАК "Нафтогаз України" та новому оператору газотранспортної системи зосередитись на підвищенні ефективності та інвестиціях у відповідні сфери виробництва і транспортування. Це повинно забезпечити кращі стимули для НАК "Нафтогаз України" в напрямі подолання застою видобутку газу, а для ТОВ "Оператор ГТС України" — в напрямі усунення несанкціонованих викидів газу та інвестування в обслуговування і модернізацію мережі транспортування;

введено в дію Закон про концесії, щоб покращити правову базу для залучення приватних інвестицій в інфраструктуру і забезпечити прозорість в концесійних проектах. Ми налаштовані повністю впровадити цю реформу і досягнути результату — підписати два пілотні портові концесійні проекти (порт Ольвія і порт Херсон) з приватними інвестиціями, мобілізованими через проекти, що фінансуються кредиторами. Покращення кредитоспроможності концесійних проектів разом із широкими удосконаленнями в прозорості та чіткості повинні допомогти підвищити участь приватних інвесторів в розвитку інфраструктури України;

введено в дію законодавство для покращення управління Національним агентством запобігання корупції (НАЗК) і відновлення відповідальності за незаконне збагачення і зроблено можливою цивільну конфіскацію непідтверджених активів. Ми цілком налаштовані впровадити цю реформу і досягнути результату — зростання кількості повних перевірок високоризикових декларацій (вибраних із застосуванням критеріїв ризику, автоматично розподілених працівникам і здійснених із застосуванням передових методик) від 0 в 2019 році до 1000 в 2021 році. Ми віримо, що проведення значної кількості детальних перевірок декларацій активів, які базуються на більш чутливому до ризиків підході з пониженою дискрецією, повинно допомогти підвищити відповідальність і підкріпити довіру до антикорупційних зусиль України.

9. Посилення ринків землі та кредитів. Реформи за цим напрямом допоможуть підвищити ефективність виділення ресурсів в економіку шляхом запровадження ринку сільськогосподарських земель, розв'язання проблеми непрацюючих кредитів в банках державного сектору і посилення нагляду за небанківськими фінансовими установами. Історична реформа запровадження ринку сільськогосподарських земель з належними гарантіями прозорості та ефективності, а також покращеним доступом до

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кредитування для малих фермерів повинні допомогти залучити інвестиції і підвищити продуктивність. Ця реформа є критичною для того, щоб підвищити безпеку землеволодіння, збільшити інвестиції в сільськогосподарські продукти з більшою доданою вартістю і зробити можливим використання землі як застави за кредитом. Посилення розв'язання проблеми непрацюючих кредитів у банках державного сектору і в широкому сенсі зміцнення управління державними банками сприятиме залученню інвестицій приватного капіталу в державні банки, підвищить ефективність розподілу кредиту в економіці та дасть змогу підвищити кредитування для підприємницького сектору. Посилення нагляду за небанківськими фінансовими установами допоможе усунути основне джерело шахрайства і вразливості у швидко зростаючій частині фінансового сектору. Щоб досягти зазначених цілей, вжито таких заходів:

введено в дію Закон про обіг земель сільськогосподарського призначення для надання дозволу на продаж сільськогосподарських земель і використання землі як застави з 1 липня 2021 року. Також введено в дію законодавство щодо посилення прозорості шляхом удосконалення доступу до даних кадастру і зв'язку між кадастром і реєстром. Для нас це важливий перший крок до запровадження прозорого і ефективного ринку землі. Зазначений прийнятий закон скасовує мораторій на продаж сільськогосподарських земель, що діяв два десятки років. Більше того, він дає змогу українським громадянам купувати до 100 гектарів землі; юридичним особам — купувати землю починаючи з 2024 року; але забороняє продаж сільськогосподарських земель державної власності. З метою посилення впливу реформи ми будемо продовжувати досліджувати можливості для розширення участі та конкуренції на ринку, включаючи участь юридичних осіб і послаблення обмежень за площею. Ми рішуче налаштовані прийняти додаткові закони, щоб забезпечити прозорість і ефективність ринку, як тільки його буде відкрито, і запобігти концентрації земель в руках потужних заінтересованих осіб. Це включає проект Закону України № 2194, що повинен підсилити управління землею, впорядкувати процедури передачі землі і реєстрації та зробити право емфітевзису таким, що можна передати іншій особі і в заставу; і проект Закону України № 2195, що запровадить електронні аукціони для державних земель і заборонить дискреційне роздавання державних земель у вільну приватизацію. Законопроекти № 2194 і 2195 були підтримані Верховною Радою України в першому читанні, і ми будемо просувати їх остаточне прийняття в липні. Ми розуміємо, що оперативний вступ в дію цих двох проектів законів є ключовим, щоб мати достатньо часу для запровадження відкриття ринку 1 липня 2021 року. Ми також повністю налаштовані на повне впровадження всіх згаданих законодавчих актів, щоб забезпечити, що ринок землі буде прозорим, ефективним і таким, що гарантує права мільйонів землевласників;

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ми цілком налаштовані на впровадження доступного і ефективного фінансового інструменту для малих фермерів шляхом прийняття проекту Закону України № 3205-1, щоб створити інструмент часткових кредитних гарантій до липня 2020 року; і затвердження постанови Кабінету Міністрів України для удосконалення спрямування сільськогосподарських субсидій у 2021 році. Ми розуміємо, що оперативне прийняття проекту закону про часткові кредитні гарантії є критичним, щоб цей інструмент запрацював до відкриття ринку в 2021 році. Ми повністю налаштовані на впровадження цих основ з метою досягнення результату — кредитування малих фермерів на базі інструменту часткових кредитних гарантій в 2021 році, причому щоб цей інструмент працював незалежно, вільно від політичного втручання. Ми віримо, що такий покращений доступ до фінансування для малих фермерів, які мають обмежені можливості для кредитування, дасть змогу їм взяти участь у забезпеченні розвитку ринку земель і розширити можливості сільського господарства України на шляху до продуктів з більшою доданою вартістю. Це також допоможе запобігти концентрації власності на землю відразу після відкриття ринку;

розширено правові рамки розв'язання проблеми непрацюючих кредитів з метою зменшення портфеля непрацюючих кредитів. Це включає пруденційне положення Національного банку України про списання повністю зарезервованих непрацюючих кредитів; і постанову Кабінету Міністрів України про надання можливості державним банкам вирішувати питання непрацюючих кредитів шляхом звичайних інструментів, які включають реструктуризацію і продаж з дисконтом основної суми боргу, а також списання. Ми цілком налаштовані запровадити цю реформу і досягнути результату — зниження валового обсягу портфеля непрацюючих кредитів, що виникли до 2020 року, у чотирьох банках державного сектору, з 395 млрд. гривень наприкінці 2019 року до менше ніж 300 мільярдів гривень в 2021 році. Таке значне скорочення портфеля непрацюючих кредитів дасть змогу банкам державного сектору зосередити свої кадрові ресурси на виявленні та оцінці нових можливостей кредитування, тим самим покращивши перспективи збільшення кредитування приватного сектору. Скорочення непрацюючих кредитів також сприяло б підвищенню заінтересованості приватних інвесторів до участі в капіталі банків державного сектору, що є однією з головних цілей Засад стратегічного реформування державного банківського сектору. Ми також цілком прихильні до незалежного корпоративного управління банками державного сектору відповідно до Закону про державні банки, прийнятого в 2018 році;

введено в дію законодавство для удосконалення правового поля небанківських фінансових установ шляхом ліквідації регулятора Національної комісії, що здійснює державне регулювання у сфері ринків фінансових послуг, і надання регуляторних функцій Національному банку України і Національній комісії з цінних паперів та фондового ринку. Ми налаштовані впровадити цю реформу і досягти результату — Національний банк України і НКЦПФР приймуть план заходів для перерозподілу режимів нагляду за страховими компаніями, кредитними спілками, пенсійними фондами та іншими небанківськими фінансовими установами.

10. Зміцнення системи соціальної підтримки. Криза, спричинена пандемією COVID-19, яка розгортається зараз, нагадала нам про важливість захисту вразливих груп населення, особливо наших громадян похилого віку. Найбільшою складовою системи соціальної підтримки в Україні є пенсії, а пенсійні виплати становлять значну частину доходів домогосподарств серед вразливих груп населення. Однією з ключових особливостей Закону про пенсійну реформу, прийнятого в 2017 році, є щорічна індексація пенсійних виплат. Однак закон дає змогу мати гнучкість в частині конкретної дати індексації пенсій кожного року, що підриває прогнозованість пенсійних виплат кожного року, а це проявляється в певній волатильності купівельної спроможності. Ми визначили дату встановленої законом індексації пенсій в 2020 році, що додало більшої прогнозованості і купівельної спроможності пенсійним виплатам цього року. Для досягнення зазначених цілей прийнято постанову Кабінету Міністрів України № 251 від 1 квітня 2020 року щодо встановлення дати і коефіцієнта індексації пенсій, передбаченої законом у 2020 році. Це покращило купівельну спроможність пенсійних виплат у ці складні часи. Це рішення провести індексацію, передбачену законом, в травні вимагало додаткового виділення 12,4 млрд. гривень до Пенсійного фонду України, яке було здійснено в рамках змін до Державного бюджету України, прийнятих у квітні 2020 року. На перспективу, ми готові до наступних заходів, щоб покращити передбачуваність і стабільність пенсійних виплат, включаючи своєчасну індексацію і чіткі правила щодо різних гарантій.

11. Я б хотів скористатись цією можливістю, щоб запевнити Вас про нашу цілковиту відданість принципам підзвітності та прозорості в контексті управління державними фінансами і співпраці з міжнародними партнерами. Останніми роками ми успішно впроваджували реформи, спрямовані на удосконалення середньострокового бюджетного планування, підвищення прозорості міжбюджетних трансфертів та зміцнення системи управління державними закупівлями і інвестиційного менеджменту в державному секторі. Ми залишаємось рішуче налаштованими застосовувати принципи повної підзвітності і прозорості, включно в контексті підтримки з боку всіх міжнародних партнерів.

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12. Ми працювали спільно і продуктивно з нашими колегами із Світового банку під час розроблення програми реформ, що підтримуються Позикою, і плануємо і надалі разом контролювати виконання програми реформ. Протягом наступного року ми готові підтримувати імпульс реформ, забезпечуючи якісний рівень реалізації реформ для досягнення озвучених цілей розвитку.

З повагою

Прем'єр-міністр України **Денис ШМИГАЛЬ**

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LETTER OF DEVELOPMENT POLICY

[UNOFFICIAL TRANSLATION]

Mr. David Malpass
President of the World Bank
Washington, DC

Dear President Malpass:

1. On behalf of the Government of Ukraine, I would like to take this opportunity to express our warm regards and appreciation to the World Bank and to you personally for your support in helping Ukraine advance toward its most critical development objectives. Our excellent partnership has helped to move forward a set of major reforms supported by the proposed First Economic Recovery Development Policy Loan (DPL). Ukraine is currently facing an unprecedented crisis resulting from the COVID-19 pandemic. We sincerely appreciate the World Bank's willingness to support our immediate response to the crisis and to establish the conditions for economic recovery as the health crisis subsides. We believe that the major reforms supported by the DPL are critical to Ukraine's efforts to strengthen the foundations of economic recovery by fostering de-monopolization and anti-corruption institutions, strengthening land and credit markets, and bolstering the social safety net.

2. Ukraine has undertaken far-reaching reforms over the last 5 years supported by the World Bank's Development Policy Financing in 2014-2015 and in 2018. These reforms helped reinstate macroeconomic and financial sector stability and restore economic growth. As a result, the economy grew by 3.4 percent in 2018 and 3.2 percent in 2019. The fiscal deficit has been maintained at under 2.5 percent of GDP four years in a row (2016-2019), and public and publicly guaranteed debt declined from a peak of 81 percent of GDP in 2016 to an estimated 50 percent of GDP in 2019. The monetary policy commitment of the National Bank of Ukraine (NBU) to medium-term price stability helped reduce inflation from a peak of 61 percent in April 2015 to 4 percent by end-2019. These achievements have helped establish Ukraine's track record on reforms and development results.

3. At the same time, we are fully aware that we face major development challenges, which have been exacerbated by the fallout from the COVID-19 pandemic. We are committed to addressing these challenges in order to deliver better living standards for the Ukrainian people. Specifically, despite the progress of recent years, many structural bottlenecks hold back the potential of our economy. We are fully committed to reforms to address these longstanding structural bottlenecks to private investment and productivity to enable the economy to rebound once the health crisisis over. The economy is expected to contract by 5-7 percent in 2020 and moderate poverty is expected to rise from 18 percent in 2019 to 24 percent in 2020. We hope that the health crisis will subside in the second half of year and with the key reforms supported by the DPL, the economy will rebound in

2021. We have also taken significant steps to bolster the social safety net to mitigate the impact on the population.

4. In the context of the COVID-19 crisis, fiscal revenues are projected to decline and additional spending on health and social protection is essential. Our budget amendment for 2020 approved in April projects a fiscal deficit of 7.6 percent of GDP. We also face sizable public debt repayments in 2020-2022. We are fully committed to safeguarding macroeconomic and fiscal sustainability. The support through the World Bank's DPL, in addition to support from the IMF and the EU, is an integral part of helping us meet our financing needs during these challenging times. Going forward, as conditions in international capital markets ease, we will be looking to raise further necessary financing on affordable terms.

5. Our macroeconomic policy framework is strong and underpinned by our commitment to fiscal and external stability. Our response to the COVID-19 crisis will increase pressures on public debt and the fiscal deficit, but is necessary to cushion the impact on the population and the economy. We are committed to reducing public debt in 2021 as economic growth resumes. Meanwhile, the monetary authorities are taking all necessary steps to maintain a flexible and stable exchange rate. We are also committed to our structural reform agenda to (i) support economic recovery in 2021 and onward by bolstering investment and productivity; (ii) reduce the fiscal deficit and public debt as economic growth resumes; (iii) raise exports and attract FDI to support external sustainability; and (iv) enable a resumption of credit growth to the private sector. Our macroeconomic framework is supported by this proposed DPL, by the European Union Macro-Financial Assistance (MFA), and by the expected IMF Standby Arrangement (SBA). On May 21, 2020, we reached staff level agreement on the new IMF SBA, and all prior actions have been completed to secure approval of the IMF SBA program.

6. The Government of Ukraine is also committed to moving forward its ambitious structural reform agenda. We are committed to actions which are economically sound, technically feasible, and are designed to trigger lasting positive impact. Support from international partners is very important to further reinforce our capacity to effectively deliver on this commitment, while at the same time sustain the momentum of institutional and systemic reforms that are underway in Ukraine.

7. Support from the World Bank is critical to the success of our ambitious reform agenda. The proposed DPL is designed to support key elements of our policy reform agenda to address critical impediments to investment and economic recovery, while cushioning the impact of the global pandemic. The key policy reforms supported by the DPL are organized under the following three pillars fully aligned with our development objectives: (i) fostering de-monopolization and anti-corruption institutions; (ii) strengthening land and credit markets; and (iii) bolstering the social safety net.

8. **Fostering de-monopolization and anti-corruption institutions.** The reforms under the this pillar help demonopolize key sectors of the economy and strengthen anticorruption institutions

to bolster investor confidence. We are committed to the unbundling of the gas sector, with a large footprint of the state-owned monopoly Naftogas, and to clarifying the legal framework for private investment in infrastructure through concessions. We are confident that these measures will help promote competition and attract investment in important parts of the economy, preserve Ukraine's role as a long-term gas transit partner for Europe, and increase private participation in infrastructure development. We are also committed to strengthening anticorruption institutions to further increase transparency and accountability and create a level playing field for investors in Ukraine. These reforms should help us attract and retain private and foreign investment over time and increase productivity across the economy. In order to address these objectives, we have completed the following ambitious reform actions:

- We have ensured full ownership unbundling of the gas Transmission System Operation (TSO) from Naftogas on January 1, 2020 by enacting the Law on Unbundling and signing and executing the Sales and Purchase Agreement and Economic Management Rights Transfer Agreement for the transfer of state-owned GTS assets on the balance sheet of UTG to MGU. We are committed to fully implementing this reform to achieve the result of increasing the share of transit revenues flowing in a transparent manner to MGU, the new independent GTSO from 0 percent in 2019 to 70 percent in 2020. This major milestone to demonopolize and increase transparency in the gas market in Ukraine will help Naftogaz and the new Gas TSO focus on improving efficiency and investment in their respective business areas of production and transmission. We believe it would provide better incentives for Naftogaz to address the stagnation of gas production and for Gas TSO to address unauthorized gas offtakes and invest in maintenance and modernization of the transmission network.

- We have enacted the Law on Concessions to enhance the legal framework for attracting private investment in infrastructure and ensuring transparency in concession projects. We are committed to fully implementing this reform to achieve the result of signing two pilot port concession projects (Olvia port and Kherson port) with private investment mobilized through project financing by lenders. The improvements to the bankability of concession projects, together with the broader improvements in transparency and clarity, should help increase private investor participation in infrastructure development in Ukraine.

- We have also enacted legislation to strengthen the governance of the National Agency of Corruption Prevention (NACP) and to restore liability for illicit enrichment and enable civil forfeiture of unjustified assets. We are fully committed to implementing this reform to achieve the result of increasing the number of full verifications of high-risk declarations (selected using risk criteria, assigned automatically to staff, and implemented using an improved methodology) from 0 in 2019 to 1,000 in 2021. We believe that carrying out a significant number of detailed verifications of asset declarations based on a more risk-sensitive approach with reduced discretion should help increase accountability and bolster confidence in Ukraine's anticorruption efforts.

9. **Strengthening land and credit markets**. The reforms under this pillar help increase the efficiency of allocation of resources in the economy by establishing an agricultural land market, resolving non-performing loans (NPLs) in state-owned banks (SOBs), and strengthening the supervision of non-bank financial institutions (NBFIs). The historic reform to establishing a market for agricultural land with adequate safeguards for transparency and efficiency, as well as improved access to credit for small farmers, would help attract investment and increase productivity. This reform is critical to improve the security of land tenure, increase investment in higher value-added agriculture, and enable the use of land as collateral to access credit. Strengthening the NPL resolution framework for State-Owned Banks (SOBs) and more broadly strengthening the governance of SOBs would help attract private equity investment to SOBs, improve the efficiency of allocation of credit across the economy, and enable higher credit growth to the enterprise sector. Strengthening the supervision of Non-Banking Financial Institutions (NBFI) would help address a major source of fraud and vulnerability in a rapidly growing part of the financial sector. In order to address these objectives, we have completed the following actions:

- We have enacted the Land Turnover Law (LTO) to enable the sale of agricultural land and the use of land as collateral starting July 1, 2021. We have also enacted legislation to strengthen transparency by improving access to cadastral data and links between the cadaster and registry. For us, this is an important first step toward establishing a transparent and efficient agricultural land market. The approved law ends a moratorium on the sale of agricultural land that lasted for two decades. Moreover, it allows land purchases by Ukrainian citizens up to 100 hectares; allows legal entities to buy land from 2024; but restricts the sale of state-owned agricultural land. In order to increase the impact of the reform, we will continue to explore opportunities to expand participation and competition in the market, including bringing forward the participation of legal entities and relaxing size limits. We are fully committed to seeking approval of additional legislation to safeguard the transparency and efficiency of the market once it is opened and to prevent concentration of land ownership in the hands of powerful vested interests. This includes Draft Law # 2194 to strengthen land management, streamline land transfer and registration procedures, and make emphytheusis rights transferable and mortgageable; and Draft Law # 2195 to introduce electronic auctions for state land and restrict discretionary handouts of state land via free privatization. Draft Laws 2194 and 2195 have been approved by Verkhovna Rada and we will seek final approval in July. We understand that prompt enactment of these two draft laws is essential to allow enough time for implementation prior to market opening on July 1, 2021. We are also fully committed to expeditious implementation of all of the aforementioned legislation to ensure that the land market will be transparent, efficient, and safeguard the rights of million landowners.

- We are fully committed to establishing an affordable and effective financing instrument for small farmers by seeking approval of Draft Law #3205-1 to create a partial credit guarantee (PCG) facility by July 2020; and approving a Cabinet resolution to improve the targeting of agricultural subsidies in 2021. We understand that expeditious approval of the draft PCG law is critical to make the facility operational prior to market opening on July 2021. We are fully committed to implementing this framework to achieve the result of loans to small farmers issued backed by the PBG facility in 2021, with this facility independently governed, free from political interference. We believe that improved access to finance for small, credit constrained farmers will allow them to participate in the land market and expand opportunities for agriculture to move into higher value-added products in Ukraine. It will also help prevent the concentration of land ownership once the market opens.

- We have enhanced the NPL resolution framework to reduce the stock of NPLs. This has included NBU prudential regulations on write-offs for fully provisioned NPLs; and a Cabinet Resolution to enable SOB NPL resolution through conventional tools including restructuring and sale with haircut on principal, as well as write-offs. We are fully committed to implementing this reform to achieve the result of reducing the gross value of the pre-2020 NPLs portfolio in the four SOBs from UAH 395 billion at end-2019 to under UAH 300 billion in 2021. This significant reduction in the NPL portfolio would enable SOBs to focus their staff resources on identifying and assessing new lending opportunities, thus improving prospects for greater credit to the private sector. The reduction in NPLs would also help increase interest from private investors in taking an equity position in these two large state-owned banks, which is one of the major medium-term objectives of the government's strategy for state-owned banks. We are also fully committed to the independent corporate governance of SOBs in line with the letter and spirit of the SOB Law approved in 2018.

- We have enacted legislation to enhance the regulatory framework for non-bank financial institutions by abolishing the NBFI regulator and assigning the regulatory functions to the National Bank and Securities Commission. We are committed to implementing this reform to achieve the result of the NBU and NSSMC adopting action plans on reshuffling supervisory regimes for insurance, credit unions, pension funds, and other NBFIs.

10. **Bolstering the social safety net**. The unfolding COVID-19 crisis has reminded us of the importance of protecting the vulnerable, especially our elderly. The largest part of the social safety net in Ukraine is pensions, with pension benefits accounting for a significant part of household incomes for the vulnerable population. One of the key features of the pension reform law approved in 2017 is the annual indexation of the pension benefit. However, with the law providing flexibility on the date of the statutory pension indexation each year, this undermined the predictability of the pension benefit each year, resulting in some volatility of purchasing power. We have brought forward the date of statutory pension indexation in 2020, which has introduced greater predictability and purchasing power of pension benefits this year. In order to address this objectives, we have completed the following specific action:

- We have approved Cabinet Resolution # 251 on April 1, 2020 to set the date and rate for the statutory pension indexation in 2020. This has enhanced the purchasing power of the pension benefit during these challenging times. The decision to proceed with the statutory indexation in May required an additional allocation of UAH 12.4 billion to the Pension Fund of Ukraine, which was part of the budget amendment approved in April 2020. Going forward, we are committed to further measures to improve predictability and sustainability of pension benefits, including timely indexation and clear rules of various guarantees.

11. I wish to take this opportunity to assure you of our strong commitment to the principles of accountability and transparency in the context of public finance management and donor coordination. In recent years, we have successfully implemented reforms aimed at improving multi-year budgeting, revamping intergovernmental transfers, and strengthening public procurement and public investment management systems. We remain strongly committed to applying these principles of full accountability and transparency, including in relation to all international partners' support.

12. We have worked closely and productively with our World Bank colleagues in designing the reform program supported by the DPL and we are committed to working closely to monitor implementation of this reform program. In the year ahead, we are committed to maintaining the reform momentum, while ensuring both the quality and the intended impact of these reforms.

Sincerely,

Denys Shmyhal
Prime Minister of Ukraine

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environmental effects (yes/no/to be determined)	Significant poverty, social, or distributional effects positive or negative (yes/no/to be determined)
Pillar 1: Foster De-monopolization and Anti-Corruption Institutions		
Prior action 1 Unbundling Naftogaz	Yes, positive, by stimulating energy efficiency investments and measures to reduce gas transmission system losses, which should cut help cut GHG emissions.	No
Prior action 2 Concessions Law	Yes, positive, by attracting greater private investment in infrastructure toward less energy-intensive infrastructure. Further strengthening environmental systems and enforcement will help mitigate potential adverse impacts.	No
Prior action 3 Anticorruption	No	No
Pillar 2: Strengthen land and credit markets		
Prior action 4 Land market	Yes, to be determined. This action can lead to better incentives to sustainably manage land and undertake investments to mitigate climate impacts but will also need to be accompanied by provisions to identify environmentally sensitive lands.	Yes, positive, through improved rental price for 5 million small landowners (2 million households) who often rent out their land. However, significant risks remain in the completion and implementation of the land reform legislative package, which could have negative distributional effects on landowners.
Prior action 5 NPLs in SOBs	No	No
Prior action 6 NBFI Supervision	No	No
Pillar 3: Bolster social safety net		
Prior action 7 Pensions	No	Yes, positive, through more timely indexation of pension benefits each year. This helps bolster the purchasing power and predictability of the pension benefit for the elderly population which is most vulnerable to sharp economic downturns.