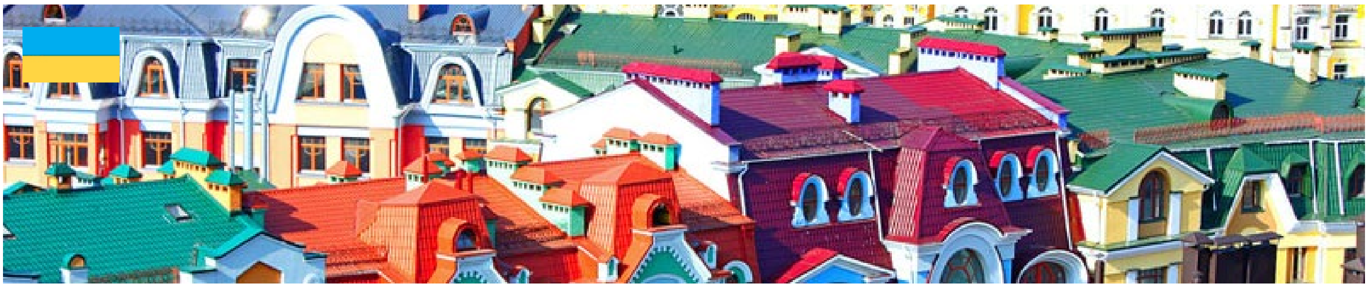

Ukraine

Highlights

- **The war has put Ukraine's economy under enormous stress.** Gross domestic product (GDP) declined by 15.1 per cent year on year in the first quarter of 2022, and by 37.2 per cent in the second quarter when the most severe and widespread fighting took place. Inflation rose to 23.8 per cent year on year in August 2022 because of production and logistical disruptions.
- **Extraordinary financial support from official creditors/donors did not fully close the budget and external financing gaps.** Foreign reserves fell by almost 20 per cent between January and August 2022 and the Ukrainian hryvnia (UAH) devalued by 20 per cent. The main creditors agreed that foreign debt repayments would be postponed for two years, but financing gaps remain substantial and further support from bilateral creditors is needed.
- **The European Council granted Ukraine the status of European Union (EU) candidate country.** After Ukraine submitted an official request for EU membership in February 2022, the European Council granted it candidate status in June 2022. This is the beginning of an important journey that requires more intense reform efforts in several areas, including completing the institutional restructuring of the judicial system, finalising the anti-corruption system set-up and putting in place effective mechanisms to tackle the influence of vested interests.

Key priorities for 2023

- **Emergency support for the economy is vital, but governance standards should be maintained and enhanced.** Access to fundamental services that will facilitate people's return to economic activity should be restored. Repairs to infrastructure damaged by the war and reconstruction after the war will require accelerated procurement processes, but this should not be at the cost of transparency, inclusion and sustainability assessments.
- **The authorities should strengthen energy resilience.** Technical synchronisation of the electricity transmission network with continental Europe, completed in the middle of March 2022, should be followed by synchronisation with the EU electricity market. Ukrenergo and Naftogaz should be supported to maintain energy supplies and prepare for the winter.
- **Efforts are needed to preserve financial sector stability.** Achieving equivalence of supervision status and professional secrecy compatible with EU law would enable more investments by EU-owned banks and allow the National Bank of Ukraine (NBU) to take part in joint supervisory and resolution colleges with authorities in the home countries of banks active in Ukraine. It would also be beneficial to prepare a detailed plan for post-war reconstruction that would include recapitalising local banks and taking the necessary preceding steps (diagnostics, asset quality reviews and stress tests).

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.4	3.2	-3.8	3.4	-30.0
Inflation (average)	10.9	7.9	2.7	9.4	20.6
Government balance/GDP	-2.0	-2.2	-5.8	-3.6	n.a.
Current account balance/GDP	-4.9	-2.7	3.4	-1.6	n.a.
Net FDI/GDP [neg. sign = inflows]	-3.7	-3.4	0.0	-3.4	n.a.
External debt/GDP	87.6	79.1	80.2	64.8	n.a.
Gross reserves/GDP	15.9	16.4	18.6	15.5	n.a.
Credit to private sector/GDP	30.1	24.3	22.2	18.6	n.a.

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Macroeconomic developments and policy response

The war has brought economic recovery to an abrupt halt. Russia's invasion of Ukraine has put the economy under enormous stress, with heavy devastation of infrastructure and production capacities and the unprecedented loss of human capital. After GDP growth of 3.4 per cent in 2021, the economy shrank by 15.1 per cent year on year in the first quarter of 2022 and by 37.2 per cent in the second quarter when the most severe and widespread fighting took place. Initially, combat operations were widespread in regions that generated 60 per cent of GDP in 2021, but in more recent months the fighting has become more concentrated, in areas generating around 20 per cent of GDP. Approximately 15 per cent of the pre-war population were registered as refugees abroad as of the middle of August 2022 and an additional 15 per cent were displaced within the country. All this is severely weakening companies' finances and exposing the banking sector to a drastic deterioration in asset quality, once the moratoria on changing the risk classification of banks' credit exposures is withdrawn.

Inflation has risen sharply, reserves have declined, and tax revenues have plummeted. On the day of the invasion (24 February 2022) the NBU fixed the exchange rate, limited cash withdrawals and introduced capital controls by preventing most cross-border transactions. Nevertheless, huge production and logistical disruptions had caused inflation to rise to 23.8 per cent year on year by August 2022, and it is likely that inflationary pressures will persist throughout the rest of the year and into 2023. The government has implemented a range of measures to curb the impact of high inflation, including export bans and regulated prices for a range of essential food items, reduced fuel taxes and utility price freezes. Plummeting tax revenues combined with soaring defence and social spending opened a fiscal gap of at least US$ 4 billion a month (3.3 per cent of estimated 2022 GDP). The fiscal gap is accompanied by a substantial external financing gap. Monetary financing of the fiscal deficit, allowed under martial law, could plug only a small portion of the gap without endangering macroeconomic stability. However, official sector external financing and the current account surplus due to official grants were largely exceeded by spending and cash withdrawals by Ukrainians abroad. As a result, international reserves have declined from US$ 30.9 billion at the end of 2021 to US$ 25.4 billion in August 2022. To ensure exchange rate stability and curb inflation, NBU more than doubled the policy rate from 10 per cent to 25 per cent at the beginning of June 2022. Yet in July NBU had to devalue the hryvnia by 20 per cent and fix it at the new lower level.

External financing remains crucial for preserving macroeconomic stability. The financing burden was partially alleviated by private-sector creditors who accepted the government's request to postpone repayments of, and interest payments on, Eurobonds for two years. This exercise is expected to provide liquidity of around US$ 6 billion until the end of 2023. It is also meant to be net present value (NPV) neutral because of interest capitalisation. At the same time, the Paris Club creditors said they would let Ukraine suspend debt service at least until the end of 2023, while holders of GDP warrants accepted the next payment arising from 2021 GDP growth exceeding the 3 per cent threshold to be postponed from 2023 to 2024. So far Ukraine has been paying its debt as scheduled, despite the war. While the requested postponement of repayments would reduce the external financing gap, it is still substantial, leaving the country dependent on bilateral creditors.

With such unprecedented levels of uncertainty, economic activity will depend on the war dynamics. In 2022 GDP is expected to decline by 30.0 per cent to be followed by an increase of 8.0 per cent in 2023 on the assumption that Ukraine will have acclimatised to a prolonged but static war. The forecast is sensitive not only to the duration and the war dynamics, but also to the level of external financing and availability of ports' export capacities.

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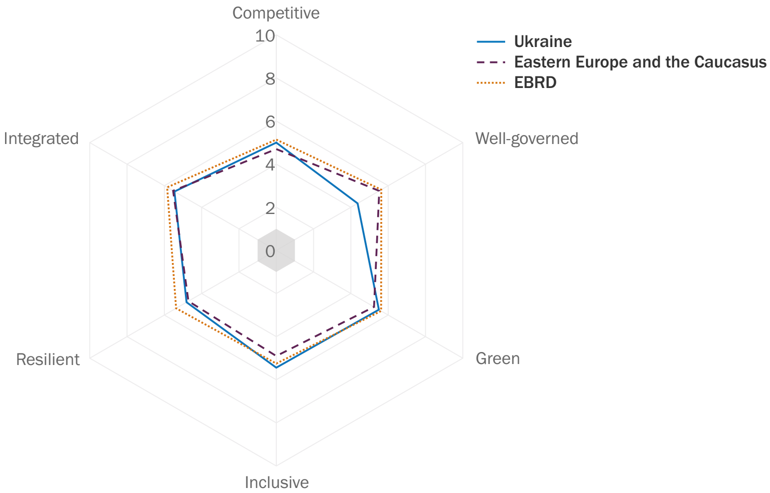
CHART Assessment of transition qualities (1-10)



NOTE: Belarus is not included in the EBRD region and respective regional averages.

Structural reform developments

The European Council granted Ukraine the status of EU candidate country. Soon after the Russian invasion in February 2022 Ukraine officially applied for EU membership as a first step in a long and complex process. In June 2022 the European Council granted it candidate status for EU membership and made further steps conditional on reform progress in seven areas outlined in the European Commission's opinion. By the end of the year, the Commission will assess Ukraine's progress on implementing judicial and anti-corruption reforms, preparation of a plan to reform the entire law-enforcement sector, limiting the excessive influence of oligarchs in the economy and politics and tackling vested interests, as well as reform of the legal framework for national minorities.

Efforts to tackle corruption have continued. In December 2021 the authorities selected the final candidate for head of its Specialised Anti-Corruption Prosecutors Office (SAPO), which had been vacant since August 2020. After a long delay, the appointment of the SAPO chief in July 2022 gave fresh impetus to the investigation of several high-profile corruption cases. Reinvigorating the work of anti-corruption bodies is a key element of the EU approximation process, while the selection of a new director of the National Anti-Corruption Bureau of Ukraine remains a key test outlined as priorities by the European Commission. Nonetheless, the country's EU candidate status and international support prompted parliament to adopt a new anti-corruption strategy to 2025, developed by the National Agency on Corruption Prevention (NACP). The new strategy pursues the EU criterion of accountable government and outlines the implementation of programmes to curtail corruption across the courts and law-enforcement agencies, taxation, construction and the defence sector, among others.

Judicial reform in Ukraine continues to progress. In November 2021 the authorities formed the Ethics Council as a key body for implementing judicial reform. Its main function is to review the integrity of the High Council of Justice, the highest judicial governance body in Ukraine. After a convoluted process, the Ethics Council selected and parliament appointed two reputable members to the High Council of Justice, a decision praised by international supporters of judicial reform. This sets high standards for the additional 15 appointments to follow. Civil society organisations noted that better communication between the Ethics Council and the public would increase the credibility of ongoing judicial reform.

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Digitalisation is enabling government services to function. In August 2022 NABU and SAPO resumed their service through the eCase Management System, which automates pre-trial investigation among detectives, prosecutors and judges. Since the war on Ukraine began, law enforcement agencies have faced difficulties preserving materials of criminal proceedings and investigative cases. The eCase Management System can store these materials electronically using online back-up, enabling critical legal materials to be preserved and transferred safely. Russia's full-scale invasion actually contributed to the expansion of the Diia platform as a one-stop shop for public services. Frequently used as a digital wallet to carry government-issued e-documents, the Diia platform has also been used by the authorities in recent months to detect military engagement, online fundraising and online registration of internally displaced persons.

Gradual progress in energy reforms has supported efforts to diversify energy sources. The war has destroyed many energy plants and led to a loss of energy production capacity. However, the authorities increased energy efficiency by integrating into the EU's single electricity network, the European Network of Transmission System Operators for Electricity (ENTSO-E). Accelerated integration into the EU electricity grid has enhanced energy security, providing Ukraine with greater energy independence from Russia and Belarus. It also has a positive impact on the Ukrainian electricity suppliers who can profit from the direct export of electricity to the European market.

The authorities ratified the Istanbul Convention to increase gender parity and tackle violence against women. In July 2022 Ukraine became the 36th state to ratify the Istanbul Convention. Once the Convention enters into force in November 2022 in Ukraine, the authorities will be more empowered to prevent gender-based violence and to carry out prosecutions related to gender-based abuse. This progress towards gender equality is expected to offer better protection to women and girls, who are disproportionately affected by the ongoing war on Ukraine.

The deposit guarantee system has been strengthened. In April 2022 the authorities passed a new bill to guarantee 100 per cent compensation for losses of bank deposits for the period of martial law and three months after it ends. Afterwards, the maximum compensation of deposits increases to UAH 600,000 (US$ 16,500) from the current UAH 200,000 (US$ 5,500). In addition, the state-owned Oschadbank, which was the only bank with a 100 per cent state deposit guarantee scheme before the war, eventually became a member of the Deposit Guarantee Fund, with the same deposit protection level as other banks in the system.