Appendix I. Letter of Intent

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

December 8, 2022

Dear Ms. Georgieva:

1. Russia's illegal and unjustified invasion of our country continues to bring enormous human, social, and economic costs. The war has caused large loss of life and the migration and internal displacement of over 14 million people. Unemployment has risen, real incomes have declined, and the poverty rate has climbed to over 20 percent. It has led to the widespread destruction of physical capital, significant logistical challenges, and disruptions to our pivotal agricultural and metal sectors. Recent attacks on our critical energy infrastructure are also threatening the population's access to basic needs (electricity, heating, water, and sewage) ahead of the winter season.

2. In spite of this unprecedented shock, we have successfully kept core government institutions and services functioning, while also maintaining macroeconomic and financial stability. Payment systems and online banking services continue to function normally, and banks' branches remain operational in most areas. Upon the outbreak of the war, we enacted emergency policy measures to support macroeconomic and financial stability and prioritize resources toward the war effort. These included fixing the exchange rate, applying regulatory forbearance in the financial sector, and introducing tax relief measures. As the economy adjusts to the war environment, we have continued to adjust our monetary and FX policy toolkit with the aim of safeguarding price and exchange rate stability and protecting FX reserves.

3. Large external bilateral and multilateral financial support provided to our country has also been critical to maintaining stability. In this regard, we are grateful for the support provided by the IMF this year. The two disbursements totaling about US$2.7 billion under the Rapid Financing Instrument, together with the additional US$2.2 billion that were channeled to Ukraine through the IMF Administered Account to date, have provided much needed budget support at a time of acute stress.

4. However, we continue to face tremendous challenges and our financing needs remain very large and subject to significant risks. A critical issue remains the scale, intensity, and duration of the war, and its impact on physical infrastructure, labor supply, human capital, purchasing power, and poverty. A further escalation by Russia, involving more damage to critical infrastructure, would magnify fiscal and BOP gaps through increased import needs, weigh on sentiment, and accelerate outward migration.

5. Against this background, we have requested a 4-month Program Monitoring with Board Involvement (PMB) to provide an anchor for near-term macroeconomic stabilization and build a strong track-record of policy implementation. The PMB will also provide a robust macroeconomic framework to assess external financing needs, thereby serving as a crucial avenue to catalyze international financial support. The principal objective of our economic policies under the PMB is to ensure adequate resources for core functions of the state, while safeguarding near-term macroeconomic and financial stability. The key policy areas and commitments to achieve this objective, which are laid out in detail in the attached Memorandum of Economic and Financial Policies (MEFP) include:

- On the fiscal side: increasing tax revenues to create room for better protecting social spending and critical capital expenditures. With the help of Technical Assistance from the IMF, we will develop (i) a roadmap of tax policy and administration measures (MEFP ¶15) and (ii) a concept note laying out our initial thinking on how to approach future social safety net reforms while safeguarding fiscal sustainability (MEFP ¶17), and (iii) we will also take steps to prevent and clear arrears (MEFP ¶12).

- An important policy objective is to shift toward a domestic financing mix that better supports macrofinancial stability with the aim of eliminating reliance on monetary financing in 2023. Together with external financing, this will require implementing measures to better mobilize financing through the domestic bond market (MEFP ¶25).

- Monetary and exchange rate policies will continue to focus on safeguarding price and external stability. The NBU will continue to implement appropriate measures to help manage liquidity and improve monetary transmission.

- Updating our financial sector strategy to safely unwind financial sector emergency measures and restore accounting and prudential norms. In the near term, we will prepare, in consultation with IMF staff, a Terms of Reference for bank diagnostics (MEFP ¶36).

- Strengthening transparency and governance. In particular, we will renew efforts toward good corporate governance practices in state-owned enterprises and banks, protect the independence of their supervisory boards, and preserve independent, competent, and trustworthy anti-corruption institutions.

6. We will continue to collaborate closely with the IMF when designing and implementing policy measures, and we will consult with IMF staff on our draft legislative proposals with material implications for economic and financial policies before we present them to the Parliament, as well as on any potential revisions to the policies contained in the MEFP. We are determined to preserve the hard-won gains from past Fund-supported programs and will refrain from policies that would be inconsistent with the program's objectives. In that regard, we intend to continue protecting the tax base from any further erosion and we remain strongly committed to safeguarding NBU independence.

7. We will provide IMF staff with the data and information it needs for the purpose of program monitoring, including by adhering to the data provision requirements described in the attached Memorandum of Technical Understanding (TMU). We will also resume the provision of data critical to macroeconomic and financial surveillance as agreed with IMF staff.

8. We do not intend to introduce or intensify exchange and trade restrictions and other measures or policies that would compound Ukraine's balance of payments difficulties. We will gradually remove restrictions as circumstances eventually normalize, in consultation with IMF staff.

9. The program will be monitored through one review based on an end-December 2022 test date and structural benchmarks. Table 1 of the attached MEFP presents the quantitative targets and Table 2 describes the structural benchmarks under the program. The March 2023 indicative targets will help guide our program implementation at the start of next year.

10. We expect that strong performance and appropriate data provision under the PMB will build a track record that would help facilitate the transition to a potential IMF Upper-Credit Tranche arrangement in 2023.

11. We consent to the IMF's publication of this letter, the MEFP, the TMU, and the accompanying Executive Board documents.

Sincerely yours,

/s /

Volodymyr Zelenskyy
President of Ukraine

/s /

Denys Shmyhal
Prime Minister of Ukraine

/s /

Sergii Marchenko
Minister of Finance of Ukraine

/s /

Andriy Pyshnyy
Governor, National Bank of Ukraine

Attachment I. Memorandum of Economic and Financial Policies

December 8, 2022

1. **Russia's illegal and unjustified invasion of our country continues to bring enormous human, social, and economic costs.** Russia's war of aggression has caused large loss of life and, according to the UNHCR, the migration and internal displacement of over 14 million people, over a third of our population. It has led to the widespread destruction of physical capital, including homes, roads and bridges, schools, hospitals, and factories, and brought forth significant logistical challenges, including loss of access to our seaports. The war has disrupted our pivotal agricultural sector, with dire consequences for Ukraine and the rest of the world, and destroyed capacity in our metals sector. Unemployment has risen, real incomes have declined, and as estimated by the World Bank, over 20 percent of our population has been plunged into poverty, threatening a dramatic loss in the living standards we have strived so hard to achieve since independence. More recently, attacks on our critical energy infrastructure, which have impacted more than 40 percent of our power grid, are hampering the population's access to basic needs (electricity, heating, water and sewage) ahead of the winter season. Each additional day of the war brings fresh damage to our economy, and the reconstruction costs will be enormous.

2. **In the face of this unprecedented shock, we have successfully kept core government institutions functioning, while also maintaining macroeconomic and financial stability.** Despite very difficult circumstances, government services have continued functioning, including revenue administration, the court system, law enforcement, and the anticorruption institutions. Payment systems and online banking services continue to function normally, and banks' branches remain operational in most areas. Upon the outbreak of the war, we enacted emergency policy measures to support macroeconomic and financial stability and prioritize resources toward the war effort. These included fixing the exchange rate, imposing FX restrictions, applying regulatory forbearance in the financial sector, and introducing tax relief measures. We sought and agreed upon debt service suspension on our Eurobonds (through August 2024) and bilateral debt (until end-2023) to preserve our scarce resources.

3. **However, as the war continues, economic policy challenges persist.** Public finances remain under immense pressure, with rapidly increasing expenditures (mainly for security and defense and social spending) and weak revenues leading to an unprecedented fiscal deficit. Despite sizable external official financing inflows, and amid lack of international market access, we have been forced to finance a sizable part of this deficit with monetary financing, presenting risks to macroeconomic and external stability. At the same time, inflation remains elevated due mainly to war-related supply disruptions. There are continuing imbalances in the FX market, as export proceeds are curtailed while FX demand remains steady, including for essential imports such as fuel and equipment and for deposit withdrawals by Ukrainian migrants living abroad. This imbalance has been straining our FX reserves and has led to periodic pressure on the exchange rate.

4. We firmly believe that strong implementation under the Program Monitoring with Board Involvement (PMB) will provide a clear anchor for near-term macroeconomic stabilization while catalyzing donor financing, help pave the way for an Upper-Credit Tranche facility, and thus help us navigate this very challenging period. Under the 4-month PMB, the principal objective of our economic policies is to safeguard near-term macroeconomic stability, including by increasing revenues and mobilizing domestic financing of the fiscal deficit to minimize monetary financing, while undertaking contingency planning in view of the prevailing uncertainty. The PMB will also provide a robust macroeconomic framework to strengthen internal coordination as well as help identify and communicate financing needs to external partners, thereby serving as a crucial avenue to harmonize and catalyze international financial support. We have requested a 4-month PMB.

5. We remain fully committed to implementing sound economic policies and to preserving the hard-won gains from past Fund-supported programs. We are committed to full program ownership and coordination across all relevant agencies toward this objective. We will consult with IMF staff on our draft legislative proposals with material implications for economic and financial policies before we present them to the Parliament. We are also committed to continue strengthening transparency and accountability, which will be important to sustain donor support. We also intend to continue protecting the tax base from any further erosion and to uphold recent governance reforms in state-owned enterprises, state-owned banks, and anti-corruption institutions. We reiterate our commitment to safeguarding NBU independence.

A. Economic Outlook

6. We expect economic activity to stabilize in 2023, although the outlook depends critically on the duration and intensity of the war.

- Following a drop by nearly a third in 2022, **real GDP** could rise modestly by about 1 percent in 2023, assuming a gradual strengthening of activity in areas not under active combat, continued access to the grain corridor, and no further escalation of the war. The slow recovery reflects the persisting impact of the recent damage to energy infrastructure into the first quarter of the year. Activity is expected to pick up in subsequent quarters, supported mainly by government spending, while the recovery in exports is expected to be only gradual (in view of the destruction to capacity and residual logistical bottlenecks), and consumption growth is expected to remain weak (mainly on account of the decline in purchasing power).

- **Inflation** is expected to moderate from 30 percent y/y in end 2022 to about 22.5 percent y/y at end-2023, reflecting the residual effects of supply disruptions and destruction of production facilities, amid an environment of softer global energy prices.

- The **current account** is expected to move to a deficit of around US$5.7 billion in 2023, following a projected surplus of US$6.4 billion in 2022. This reflects a widening in the trade balance, as the recovery in export proceeds is expected to be slow, while import demand is expected to

accelerate, due to continued demand for fuel, equipment, and materials for repair and rehabilitation. Sizable external financing inflows should support FX reserves levels of around US$21 billion by end-2023, equivalent to 2.5 months of imports.

7. **The economy could rebound more quickly if the security and infrastructure situation improve more quickly than expected.** The economy could register a much stronger recovery should there be a faster than expected decline in security risks and a swifter resolution of the ongoing challenges to energy and logistical infrastructure. Under such assumptions, growth in 2023 could strengthen to 3-4 percent. The outlook could be further boosted a quicker return of migrants as well as through a large-scale reconstruction effort that accelerates the recovery.

8. **Nevertheless, uncertainty is high, and risks to the outlook are tilted to the downside, with implications for our external financing needs.** The recovery in economic activity in 2023 could be much slower than expected. In particular, the recovery could be weaker should the impact of the recent attacks on critical infrastructure persist for longer than expected, the security situation deteriorate, the grain corridor shut down, or outward migration accelerate. In such scenarios, our external financing needs could be markedly higher.

B. Fiscal Policy

9. **From the onset of the war, we have taken measures to preserve macro-financial stability, including emergency measures aimed at protecting core government operations, and priority payments.** Following the adoption of Martial Law on February 24, 2022, we have prioritized spending on public wages, defense, social protection and other critical needs, given immediate liquidity constraints. At the same time, under Martial Law we undertook measures on the tax front to provide relief, including a reduction in tax rates, deferrals of payments for those unable to pay, relaxation of administrative requirements, and a move to simplified taxation for certain brackets. We remained current on all our external and domestic debt obligations until debt standstills were agreed upon with private and bilateral creditors in August and September 2022, respectively.

10. **As the war has continued, public finances have come under severe pressure.** Revenues have weakened due to the contraction of the economy and relief measures while expenditures have grown at a rapid pace due to security and defense and social spending. As a result, the nine-month cumulative general government fiscal deficit measured below the line, for 2022 is estimated at UAH 406.6 billion or 8.7 percent of 2022 GDP, supported by substantial external grants UAH 342.5 billion or 7.3 percent of 2022 GDP; the cumulative deficit excluding grants is UAH 749.1 billion (15.9 percent of GDP). The deficit has been financed primarily by external official financing and NBU monetary financing, whereas net financing from domestic banks and non-banks turned negative. In line with our objective of strengthening public finances, to monitor our progress in this area, a floor on the non-defense cash primary balance of the general government (excluding grants) **(*Quantitative Target, end-December 2022; Indicative Target, end-March 2023*)** and a floor on

the overall cash primary balance of the general government (excluding grants) **(*Indicative Target, end-December 2022 and end-March 2023*)** will be introduced.

11. Despite large-scale and extraordinary support from the international community, and our effort to keep public finances under control, we face a financing gap for the remainder of 2022. In these times of unprecedented uncertainty, we have been moving to realign our financing sources and spending needs on a monthly basis, reflected in several supplementary budgets adopted throughout 2022. The last supplementary budget approved by the Rada on October 18 increased the spending envelope by UAH 386.9 billion, for security and defense sector which includes current expenditures in the amount UAH 385.2 billion (including wages with accruals of UAH 232.7 billion) and capital expenditures (about UAH 1.7 billion). This, combined with uneven disbursements of committed external financing, has increased the financing gap for 2022.

12. We are identifying measures to close this financing gap, and will take steps to monitor, avoid and control arrears. Closing the gap without additional external resources will be extremely difficult. We will ensure financing for priority expenditures for 2022, drawing on resources from the Treasury Single Account as well as additional domestic borrowing, while identifying spending categories that can be underexecuted. Further measures would be required to fully close the gap, especially if additional shocks occur. Following this exercise, we will establish the level of arrears for state budget and social funds for end-2022, consistent with the national definition of overdue financial obligations, which would encompass any carryover from 2022 to the 2023 Budget. We will ensure monitoring of payment arrears across the general government consistent with the national legal definition of overdue financial obligations. To support these goals, we will develop an action plan to prevent and clear arrears over the course of the 2023 Budget and beyond **(*Structural Benchmark, end-January 2023*)**.

Fiscal Policy in 2023

13. Our 2023 Budget aims to achieve wartime spending goals while sustaining macroeconomic stability and preparing for the post-war era. Although the spending envelope is currently focused on defense and security, to the extent possible we have safeguarded resources for the social safety net and rebuilding damaged infrastructure by prioritizing capital expenditures. The deficit excluding external grants in the 2023 Budget (prepared amidst preliminary discussions on external financing next year), is projected at UAH 1,316.4 billion, or about 21.6 percent of GDP. This is 8.7 percentage points of GDP lower than the estimated 30.3 percent of GDP deficit excluding external grants for 2022.

14. Our budget projections for tax revenue reflect the impact of the war and slow economic recovery. We expect taxes on income will deteriorate, reflecting the deteriorated profit base of companies and the continued destruction to economic capacity; structural developments in the labor market; and a decline in the public sector wage bill. Taxes on goods and services are projected to improve somewhat as consumption recovers (from a low base) and measures under Martial law are lifted. We have already incorporated in the 2023 Budget about 0.6 percent of GDP in

revenue measures and adopted a timeline to restore excise and VAT on fuel toward pre-war policies from July 2023. The revenues from natural resource taxation (e.g., royalties) are expected to decline due to the continuing impact of war and volatility in prices. We acknowledge that the destruction of critical energy infrastructure by Russian missile attacks have led to urgent needs for imports of special equipment for electricity generation and distribution and heating supply, including generators, batteries, and transformers. To address these needs, we have decided to exempt such equipment from import VAT and duties, with generators exempt until March 1, 2023, and transformers and heavy equipment until the end of the Martial Law. The impact on revenues of the approved budget is estimated at UAH 0.3 billion.

15. We are committed to identifying additional revenue sources. With the help of Technical Assistance from the IMF, we will work on developing an integrated roadmap of tax policy and administration measures restoring in the short-term tax administration and policies to their pre-war setup. In the very near term, this will include submission of the following three draft laws to Parliament **(*Structural Benchmark, end-January 2023*)**: (i) on cancelling the moratoria on tax audits (effective July 1, 2023); (ii) on removing idiosyncrasies of the application of the simplified tax regime by taxpayers under the single tax of 2 percent, and restoring the pre-war regime for these taxpayers (effective 1 July, 2023); and, (iii) on ensuring full-scale enforcement of the usage of cash registers in retail outlets (and associated settlement and payment infrastructure), including restoring liability for violations (effective July 1, 2023). In addition, we are working to implement the automatic exchange of information for taxation purposes (Common Reporting Standard (CRS)) and intend to propose necessary legislation. The estimated revenue gains in 2023 from the reversal of the simplified tax regime is assessed at about 0.13 percent of GDP for 2023. We also remain committed to working on the broader design of tax policies and measures for building a modernized revenue administration (including among other things limiting the possibility for PIT tax evasion from using simplified tax regime by group 3 taxpayers) that would help us to achieve our fiscal policy goals in the post-war environment.

16. On the expenditure side, the challenges arising from the war have forced us to take difficult political decisions. First, the spending envelope necessarily focuses on defense and security, requiring an even greater effort to strengthen the efficiency of spending and contain fiscal risks. At the same time, there are increasing pressures from emerging war-related spending categories, including social assistance to IDPs and war veterans, and reconstruction and elimination of the consequences of Russian aggression. In view of the constraints we face, we took the difficult political decision to cut the total compensation envelope of employees in the budget sector by 27 percent in nominal terms relative to 2022, through both cuts in wages of individual categories as well as headcount limitations. Likewise, we capped social benefits, allowing only rule-based pension indexation.

17. We intend to protect the current level of social assistance for the most vulnerable groups in our population. The war has resulted in the emergence of new vulnerable groups of population (e.g., IDPs, war veterans), whose needs should be factored into future reforms of the social assistance framework. With this in mind, we will prepare a concept note that would lay out our

thinking on how to approach reforms of the social safety net—with the aim to achieve targeted, adequate, and efficiently delivered social assistance to the population, including the needs of these emerging categories ***(Structural Benchmark, end-January 2023)***. Safeguarding fiscal sustainability will be a key pillar of the concept note. We also intend to work on a medium-term strategy to transition the current wage bill framework that has a significant defense and security component to a peace-time wage bill framework.

18. We commit to provide adequate support to state-owned enterprises (SOEs) in the energy sector and district heating companies (DHCs). The war has compounded existing structural weaknesses in the energy sector. We are committed to implementing an ambitious structural reform agenda once the war is over. In the meantime, in this exceptional context, we are focusing our policies on crisis management.

- Given the damage to critical energy infrastructure, an important near-term focus is on assessing damage, repairing, and ensuring a basic level of service delivery where feasible. The National Energy and Utilities Regulatory Commission (NEURC) is currently considering a Transmission System Operator (TSO) tariff increase that could provide additional resources to Ukrenergo. If further resources would be needed for urgent repairs, we will ensure adequate financial support to Ukrenergo.

- The need to import at least 2 bcm of gas in the coming months to support the heating season and cover the increased use of gas in the electricity generation mix is putting pressure on Naftogaz finances. We are already providing implicit financial support to Naftogaz in the form of reduced gas royalties and will compensate the group for its public service obligations (PSO). In a downside scenario where larger volumes of imports would be required; we will ensure adequate sources of financing can be mobilized.

- Finally, restoring the financial health of the gas transmission system operator (GTSO) will primarily require right sizing the system and identifying new gas supply sources. In the interim, liquidity support may be required.

19. We have established a special fund within the state budget to channel resources for critical expenditure. The Fund for Liquidation of Consequences of the Russian Aggression will be used for reconstruction, including repairing damaged infrastructure. The budget law states that it will be funded by external financial sources, which have yet to be identified, as well as by the earmarking of 50 percent of profits from the NBU, preliminarily estimated at UAH 35 billion, although we plan to remove the latter provision at the first opportunity. In line with our experience of managing other special funds in state budget, we will ensure sound governance and transparency in the use of this fund's resources by: (i) preparing clear and transparent selection criteria and procedures for priority spending to be approved by the Cabinet of Ministers of Ukraine (CMU); (ii) including underlying amounts in budget documentation and fiscal reports; (iii) including cash resources in the Treasury Single Account; (iv) establishing safeguards on the use of funds and reporting on them; and, (v) conducting and publishing audits.

Fiscal Structural Reforms

20. Despite tremendous pressures and uncertainty, we are determined to continue improving our public financial management framework. Prior work on public finance management was halted with the inception of the war. In this area, we are committed to continue improving the predictability and credibility of the fiscal framework to better support budget preparation and minimize deviations during the execution phase. With the help of IMF Technical Assistance, efforts would aim at using fiscal risk analysis to inform formulation of macro fiscal aggregates and wider fiscal management. We will also work to develop upside and downside scenarios around our central projection of tax revenues. On the expenditure side, we will work to improve the link between fiscal risks assessment and their impact on spending categories, including risks arising from social funds, contingent liabilities especially PPPs, guarantees and SOEs. To this end, we will also work to enhance the institutional capacity, monitoring and assessment of risks from government guarantees.

21. To enhance further budget processes from planning to procurement and execution, we will take measures to enhance payment discipline. In the near-term, amendments to the legislation will be adopted, to restore the Treasury's authority to collect information essential for relevant categories of financial reporting. Subsequently, we will establish oversight over the budget arrears both on state and local level, as well as Social Security Funds to have a clear view of their stock on a monthly basis, with a clear monitoring mechanism aimed at preventing the accumulation of new arrears. With due consideration of the Martial Law, we will also take measures to settle the existing stock of such obligations in accordance with the requirements of budget legislation in a structured and transparent manner. Overall, we are committed to achieving the maximum transparency in data provision possible under Martial Law around all expenditures and on overdue financial obligations, which is also an important input into efficient treasury cash management and liquidity forecasting. To increase the predictability of available liquidity and reduce the risks of sudden financing pressures, we will continue to improve our cash forecasting and liquidity management in line with the objectives set out in the PFM Reform Strategy for 2022-2025, including through the improved exchange of information with key budget spending units and introduction of relevant analytical IT tools.

22. More broadly, to preserve macroeconomic stability and lay the foundations of a robust fiscal framework, we will (i) avoid any measures that would reduce tax revenues, erode the tax base or undermine the credibility of public finances; (ii) ensure realistic and transparent reflection of SOE dividends; and, (iii) exercise control over overdue tax obligations (including from SOEs and VAT refunds).

C. Budget Financing

23. Amid large and urgent financing needs, our overarching strategy is to secure commitments for a financing mix that supports macroeconomic stability. This financing mix will

involve ensuring adequate external financing and making concerted efforts to mobilize domestic bank financing, with the aim of avoiding reliance on monetary financing in 2023.

24. External financing will remain the central pillar of the financing mix. We are very grateful to all our international partners and donors for their crucial support in 2022, in particular the US$23.1 billion in external budget support loans and grants received through October 2022. Given the lack of international market access and our significant financing needs, external financing will remain essential to financing our budget in 2023, and thereby help maintain macroeconomic stability. To facilitate support by our international partners, we will take every effort to continue to communicate our fiscal financing needs in a regular, timely and transparent manner to donors and the IMF to ensure an adequate envelope of external financing, on concessional terms to the extent possible, and to identify additional external needs if they arise. We also commit to collaborating closely with our international partners and undertake the key reforms required under their respective arrangements.

25. As part of this strategy, we will take all necessary measures to create an environment that is supportive of domestic banks maintaining their overall sovereign exposure. Following the outbreak of the war, we continued conducting regular treasury auctions, offering "war bonds" to mobilize financing. Whereas the initial response was encouraging, cumulative net financing by domestic banks has been negative since the war started, with rollover rates declining from over 100 percent in March-May to 22 percent in August-September and picking up to 60 percent in October. The share of government securities in total bank assets thus declined in 2022 relative to end-2021, but it is likely to stabilize and increase in 2023, given weak loan demand and banks' demand for safe assets. Mobilizing domestic financing in the primary market, particularly by banks, will be vital to avoiding monetary financing of the budget deficit. To help achieve a significant increase in rollover rates, we intend to:

- Maximize the issuance of domestic government securities in the primary market, with an objective of covering the redemptions expected in 2023. In order to achieve this, we will implement a mix of actions: first, we commit to adjust the yields on government securities offered on the primary market to match market demand and support price discovery; second, we intend to launch a mechanism to allow banks to fulfill up to fifty percent of reserve requirements by benchmark bonds (see ¶30); and, third, we are undertaking a bank-by-bank analysis to better understand banks' current liquidity and credit risk preferences to support these market discovery efforts in reviving primary market auctions, and with the overall aim that banks maintain their exposure.

- Continue strengthening liquidity forecasting and cash management within the Ministry of Finance to ensure better predictability of financing needs (see ¶21). This would inform the appropriate design and calibration of auctions, thereby avoiding monetary financing of the budget deficit.

26. The availability of adequate external financing coupled with such measures to revive the domestic government bond market will support our goal of strictly limiting direct NBU financing of the state budget this year and eliminate it altogether in 2023. Excessive monetary financing would entail large risks for price and external stability. The NBU, in agreement with the Ministry of Finance, determined that it would keep purchases of domestic government securities at about UAH 30 billion per month, or below UAH 400 billion in 2022, and we expect to stay within this limit. This will be monitored by a ceiling on general government borrowing from the NBU **(*Indicative Target, end-December 2022*)**. In 2023, assuming that external financing commitments are disbursed in a timely manner, domestic government securities are issued on the primary market at sufficient volumes, adequate revenues are mobilized to reduce fiscal financing needs, and no further shocks materialize, we would be in a position to eliminate our reliance on monetary financing by the NBU **(*Indicative Target, end-March 2023*)** (see also ¶33). If there are unexpected critical financing needs or delays in external disbursements, we will first apply market-based tools to borrow additional funds; we will request monetary financing from the NBU only as a last resort.

D. Monetary and Exchange Rate Policies

27. Following the outbreak of the war, we undertook a number of emergency measures with the express aim of safeguarding macroeconomic and financial stability. The inflation targeting regime was suspended and a fixed exchange rate regime was introduced, providing an important nominal anchor to the economy amid unprecedented uncertainty. FX transactions were restricted to conserve international reserves. Following the imposition of Martial Law, and given urgent fiscal financing needs to support the war effort, monetary financing of the state budget was permitted.

28. With the war now protracted, we remain fully committed to safeguarding price and exchange rate stability and protecting international reserves. As the economy adjusts to the war environment, we have continued to adjust our monetary and FX policy toolkit in view of these overarching objectives, while at the same time considering the most urgent needs of our population, including migrants abroad. Although the large war-driven fiscal deficit and the resulting monetary financing has imposed constraints on the design and effectiveness of monetary policy, the objective of the NBU remains to maintain price stability and help preserve the value of hryvnia incomes and savings.

29. We will maintain an appropriate monetary policy stance that will help alleviate price pressures and increase the attractiveness of hryvnia assets. Inflation has risen on account of war related disruptions to supply chains, destruction of production facilities and hryvnia deprecation, amid high global inflation, which have driven an increase in inflation expectations. In June 2022, we raised the key policy rate (KPR) by 1,500 bps from 10 percent to 25 percent in a decisive manner to anchor inflation expectations, increase the attractiveness of hryvnia assets, and ease pressures on international reserves. In this regard:

- In our October MPC, we maintained the KPR at 25 percent, which is appropriate in view of high but stabilizing inflation and inflation expectations, the still incomplete transmission of the June hike, and continued headwinds to economic activity.

- In view of the balance of risks to the outlook for 2023-24, we project to keep the KPR at its current level at least until 2024Q2. Together with other measures (¶31), this should help support exchange rate stability and anchor inflation and inflation expectations. However, there are considerable upside risks to inflation, and we stand ready, should they materialize, to raise the KPR to a higher level and deploy additional measures to maintain price and external stability.

30. We have undertaken measures to manage liquidity, and thereby enhance the monetary policy transmission mechanism. Monetary transmission has been gradual, due to the record amount of hryvnia liquidity in the banking system (nearly UAH 300 billion as of end-October) as well as the slow adjustment of government bonds yields on the primary market and the abundant liquidity in large state-owned banks that has weakened incentives to increase deposit rates.

- To support banking system liquidity, in February, we introduced an emergency unsecured refinancing facility. In April, eligibility for this facility was tightened given ample bank liquidity. As system-wide liquidity continued to rise and the cost of refinancing increased with the KPR hike in June, outstanding amounts of refinancing had dwindled from UAH 161 billion in March to UAH 54.2 billion by end-October (refinancing under the unsecured refinancing facility amounted to UAH 26.1 million by end-October). In view of the record excess liquidity in the system, and dramatically reduced use of refinancing more broadly, we suspended the unsecured facility on November 5.

- We plan to tighten reserve requirements by 5 percentage points on demand deposits in hryvnia and foreign currency. We will also introduce a mechanism that would allow banks to fulfill up to half of their total reserve requirement with benchmark government securities. Of the part that can be fulfilled with government securities, up to 40 percent can consist of existing benchmark securities maturing after 1 January 2024, and the remainder with new benchmark securities offered by the Ministry of Finance in the primary market. The liquidity absorbed through the increase in the reserve requirement ratio (particularly through the part fulfilled through reserves) will tighten liquidity conditions, and thereby support the overall monetary policy stance. In addition, the proposed mechanism, by providing incentives to revive the Ministry of Finance's primary auctions, will help avoid monetary financing of the budget deficit by the NBU, preventing further liquidity injections from this source. We do not envisage this mechanism as being permanent feature of the of our monetary policy toolkit, and after the expiration of Martial Law we will develop a plan to phase it out.

- We are also actively studying the feasibility of other options to manage liquidity. On NBU Certificates of Deposits (CDs), we intend to restore the main operation of CDs from overnight to 14 days at the KPR, as before the war, and to consider issuing CDs with longer maturity to sterilize excessive liquidity; this would allow better control of liquidity conditions and enhance

monetary transmission. The infrastructure for the interbank repo/reverse repo market is also in place, which could help banks better manage their liquidity in the period ahead.

- The primary objective of the NBU remains to safeguard price and external stability. We expect that as yields in the primary government debt market necessarily increase with price discovery, higher volumes of domestic financing will help reduce the injection of liquidity from monetary financing. The resulting decline in liquidity, together with the measures outlined above, will enhance the effectiveness of the key policy rate and any further adjustments we make to the monetary policy toolkit, providing the necessary support to other rates in the economy.

- A liquid secondary market for domestic government bonds is an important element of strengthening monetary transmission, while at the same time, it enhances the ability of the government to tap the market to finance its budget needs. In this light, we will continue to support the development of the secondary market. We believe that the mechanism to form a portion of required reserves with benchmark government bonds will improve liquidity in these bonds and encourage greater participation in both the primary and secondary markets.

31. We have taken all necessary measures to manage pressures in the FX market, maintain exchange rate stability and safeguard international reserves. Amid the war-driven imbalances in the FX market, the NBU has become a net seller of FX, with cumulative net sales since February 24 of US$18.5 billion as of end-November. Nevertheless, sizable inflows of external financing, as well as, more recently, FX proceeds from the Black Sea Grain Initiative, have helped contain the loss in FX reserves, with reserves declining from US$30.9 billion in end-2021 to US$25.2 billion as of end-October. The FX restrictions imposed at the beginning of the war have helped to limit pressure on our FX reserves, but on the other hand, have broken the link between the interbank and cash segments of the FX market, generating a spread between the cash and official exchange rates, which has widened periodically. To help balance the FX market while supporting economic activity and defense and humanitarian efforts, support exchange rate stability, and protect reserves, we have undertaken several measures:

- In July, in response to increasing FX market pressures, we undertook a one-step devaluation of the exchange rate peg by 25 percent from USD/UAH 29.2549 to USD/UAH 36.5686.

- We have taken measures to ease pressures on the cash FX market (where there are currently no restrictions on setting exchange rates) by shifting demand to the noncash FX segment. Here, we have allowed cashless foreign currency purchases by individuals for the purpose of making 3-month or longer deposits within a monthly limit, and introduced a new FX-indexed term deposit facility to help households protect hryvnia savings from exchange rate fluctuations. We have also tightened limits on card withdrawals abroad and instituted a ban on P2P payments from hryvnia payment cards (issued by Ukrainian banks) to foreign banks.

- We have taken measures to facilitate humanitarian and defense efforts. We have allowed charitable funds greater flexibility (as compared to other legal entities) on the use of FX balances in their accounts, and allowed the use of FX, including domestically, for crowdfunding purposes.

Individual volunteers are allowed to conduct Swift transfers abroad (within a limit), and to use not only their FX payment cards (no limit) but also hryvnia payment cards abroad (beyond the monthly limit) for the purchase of a predefined set of goods to support the defense effort, where verified and approved by banks. We have finetuned the currency supervision requirements on banks for the import of humanitarian goods following the simplification of the customs procedures related to the imports of such goods.

- We have also adjusted measures to better support the needs of trading firms amid logistical difficulties. After narrowing the settlement deadlines for export and import transactions from 365 days to 90 days following the invasion, we increased the deadlines to 180 days to help them cope with prevailing supply chain disruptions that slow the physical delivery of goods. We have also allowed businesses, under certain limits and conditions, to transfer their available stock of FX cash abroad to support the operations of their foreign units and branches.

These measures aim to strike a balance of supporting economic activity while safeguarding monetary and financial stability. They have together helped reduce the pace of net FX sales by the NBU and narrow the spread between the official peg and the cash rate from nearly 25 percent in mid-July to around 10 percent as of end-November.

32. We will maintain an adequate level of FX reserves to support exchange rate stability and provide a buffer against adverse shocks, given prevailing uncertainty. In 2023, despite a current account deficit, we expect sizable external financing that will help ensure an adequate level of reserves and help keep exchange rate expectations well-anchored. At this point, in view of the continuing imbalances in the FX market, we intend to maintain generally the existing restrictions on FX transactions. However, we will continue to carefully monitor the effectiveness of these measures, and fine tune them in line with the needs of the economy and to limit circumvention. We will also continue to explore measures to further help strengthen the attractiveness of hryvnia assets. Progress in this area will be monitored by a floor on NIR ***(Quantitative Target, end-December 2022; Indicative Target, end-March 2023)*** to ensure an appropriate level of reserves in view of large uncertainty, as well as to support exchange rate stability.

33. Reducing and then eliminating monetary financing will help safeguard price and external stability and safeguard NBU independence. In 2022, despite monetary financing of the state budget amounting to 8 percent of GDP, we have successfully sterilized the associated liquidity injection with FX sales and NBU CDs, keeping nominal base money growth contained at about 12.3 percent y/y as of end-October. In 2023, with the envisioned elimination of monetary financing, we expect base money growth to decline, helping to support inflation deceleration. We will also strive to limit indirect forms of monetary financing that are outside the core functions of the NBU, such as through the directed provision of liquidity to banks or SOEs for the purchase of government securities on the primary market. We will not earmark any NBU profits for specific uses. Direct financing of off-budget programs by the NBU will be avoided altogether.

34. We remain fully committed to upholding the independence and institutional effectiveness of the NBU. A strong and independent NBU remains critical to achieving macroeconomic stability. In this regard, reducing and then eliminating monetary financing of the state budget will be crucial in strengthening NBU's independence (see ¶31). We will also ensure that the distribution of NBU profits to the state budget takes place in line with established procedures in a transparent manner. In November 2022, we also undertook changes to the NBU's organizational structure to better align it with its legal framework and support a more function-based organization model, in line with global best practices and recommendations from past IMF Technical Assistance. We are also committed to undertaking a new safeguards assessment of the NBU in early 2023, for which initial preparations are already underway.

E. Financial Sector

35. We have implemented wide-ranging emergency measures to preserve financial stability and will continue to closely monitor developments and make adjustments as necessary. Banks entered the war well-capitalized and liquid, thanks to the considerable progress achieved in cleaning up the banking system since 2014. Despite the severe impact of the war, almost 90 percent of bank branches have remained operational, online banking services are fully available to all clients with internet connectivity, the non-cash payment system is functioning normally, and liquidity has recovered for most banks. The licenses of four small banks (around 2.8 percent of system assets as of 1 January 2022), two of them Russian state-owned, have been revoked under martial law for reasons mostly unrelated to the economic impact of the war. The financial sector's continued operations is in part due to a number of emergency measures we have taken to preserve financial stability, including:

- Administrative controls were imposed to preserve FX liquidity and channel it towards priority imports;
- An unsecured funding facility was introduced with a maturity of up to one year for an amount up to 30 percent of banks' late-January retail deposits, but it was discontinued on November 5 due to a decline in usage (see ¶30);
- Enforcement actions on banks have been suspended for war-inflicted breaches of prudential requirements regarding capital, liquidity, credit risk, net open positions in FX and for delays in prudential reporting; audits of banks' financial statements have been postponed, and regular bank stress testing in 2022 was cancelled;
- Loans restructured during the martial law period are exempt from reclassification for credit risk;
- Banks have been prohibited from related party lending (except for consumer loans granted on standard terms, available to a wide range of borrowers), capital distributions (dividend payments and share buy-backs), and bonus payments; and

- Banks have also granted payment holidays on retail and corporate loans for 3-6 months depending on the type of product and temporarily cancelled fees and commissions on cashless payments as well as cash withdrawals.

36. In anticipation of a return to normality, we will update our financial sector strategy to safely unwind financial sector emergency measures and restore accounting and prudential norms. Our 2021 financial sector development strategy will be updated in consultation with IMF staff and serve as a living document requiring periodic review, modification, and action plans with implementation milestones. Inter alia, the strategy will include: (i) coordinated steps to safely unwind exceptional measures; (ii) diagnostics to identify bank re-capitalization needs and NPL resolution priorities; (iii) a framework to address any capital shortfalls; (iv) a prioritized action plan to monitor and tackle high NPL levels; (v) well-developed contingency plans to respond to potential further shocks; and (vi) coordination arrangements among key stakeholders. In recognition of the importance of well-designed bank diagnostics to the success of the financial sector strategy, the NBU will prepare a Terms of Reference in consultation with IMF staff describing the methodology and processes of bank diagnostics necessary to assess bank capital adequacy and identify NPL resolution priorities **(*Structural Benchmark, end-January 2023*).** The current prohibition on bank capital distributions will remain in place until these diagnostics have been completed. In line with our commitment to financial stability, the Financial Stability Council (FSC) will endorse by end-January 2023 a contingency plan in preparation for potential adverse rulings from the constitutional challenges against the DGF Law and the Bank Resolution Law (Law #590), and update the existing contingency plan, which was prepared at the onset of the last Stand-By Arrangement, in connection with litigation risks over failed banks.

37. We remain committed to strengthening the governance of state-owned banks (SOBs) and recovering value from former shareholders of failed banks. Under previous Fund-supported programs, we have undertaken substantial reforms to improve the governance and oversight of SOBs, including adoption in 2018 of a dedicated SOB framework within the banking law. For each SOB, we have: (i) appointed a majority-independent supervisory board, and (ii) signed a Memorandum of Understanding that defines its relationship with the Cabinet of Ministers of Ukraine as shareholder and to ensure that the SOBs are run on a commercial basis and protected from political interference on operational matters. We also reconfirm our commitment to continue efforts to recover value from assets of failed banks.

38. We remain fully committed to the independence of SOB supervisory boards. We recognize that upholding the spirit of governance reforms in SOBs is key to preserve financial stability, protect public finances, and maintain the confidence of our international partners. We are committed to ensuring that selected supervisory board members are genuinely independent and that the supervisory boards operate free from political pressure. We recently initiated a new recruitment process for independent supervisory board members and have appointed recruitment firms for each SOB. Our aim is to select members by end-February 2023. We will continue to adhere to the established processes for filling vacancies and will offer market-based remuneration to attract and motivate highly qualified Ukrainian and international professionals. We will ensure that

operational continuity and institutional memory are preserved at each SOB. To that end and in line with the rules, preference will be given to existing independent board members under equal conditions. The NBU will rigorously apply its fit and proper assessment framework.

F. Governance, Anti-Corruption, and Transparency

39. We reiterate our strong belief in the importance of sound corporate governance in SOEs. We will ensure that SOEs operate at arm's length from the government, including by maintaining majority-independent supervisory boards. We will continue our efforts to strengthen corporate governance in SOEs. A new Law on Joint-Stock Companies improving Ukraine's corporate governance framework was recently approved, and a law on corporatization of Energoatom has passed the first reading in the Rada. We commit to appoint and make fully operational the supervisory board of Naftogaz by end-January 2023, based on transparent and competitive selection procedures **(*Structural Benchmark*).** Finally, we will refrain from any decision that would undermine the corporate governance framework as well as governance in key SOEs, including in the energy sector.

40. We remain firmly committed to preserving independent, competent and trustworthy institutions to combat high-level corruption. Despite the war, efforts by the National Anti-Corruption Bureau of Ukraine (NABU), Specialized Anti-Corruption Prosecutor's Office (SAPO) and the High Anti-Corruption Court to investigate, prosecute and adjudicate corruption have continued unabated. New investigations and cases against senior public officials have been filed and pursued. In July 2022, a new SAPO head was appointed. To support the future work of the new SAPO head, we will reinforce the office with the onboarding of eight new and budgeted SAPO prosecutors by end-December 2022. The work of the selection commission for the new NABU head, which includes independent experts with international experience, is advancing. Consistent with the November 2021 legal amendments, the Cabinet of Ministers is expected to appoint the new head by end-March 2023, following an open, transparent and competitive selection process. The Ethics Council is also continuing with the vetting of candidates to fill all the vacancies in the High Council of Justice (Ukraine's highest judicial self-governance body responsible for judicial appointments and discipline).

41. We will ensure that our strategy for post-war reconstruction meets the highest standards of transparency and accountability. To achieve this goal in terms of usage of funds, we plan to take full advantage of digital technologies, and will coordinate with international partners and civil society organizations to design a platform that will provide timely information so we can transparently track and analyze reconstruction-related procurement processes and expenditures. Our reconstruction strategy will also involve establishing mechanisms to prevent and identify corruption risks, and escalate cases, as appropriate, for investigation by the anti-corruption institutions. Comprehensive audits of the use of reconstruction funds, performance audits of selected individual projects (including project costs, deliverables and outputs), and timely publication of audit reports will also be key features of our strategy.

G. Program Implementation and Monitoring

42. The PMB will have one review based on end-December 2022 test dates. Implementation of the policies under the program will be monitored through five structural benchmarks (SBs) as set out in Table 1, as well as two quantitative targets (QTs) and two indicative targets (ITs) as set out in Table 2. Indicative targets for end-March 2023 will help guide our program implementation at the start of next year.

43. To facilitate monitoring of program targets and commitments under the MEFP, we will adhere to data provision requirements as described in the attached Technical Memorandum of Understanding (TMU). The TMU defines the quantitative and indicative targets under the program, and specifies the data to be shared with IMF staff. On the fiscal front this includes information on critical expenditure categories and overdue financial obligations (including wage bill, social spending categories, deferred payments, arrears in both revenues and expenditures, guarantees, quantified main fiscal risks, including PPPs and social funds). Also, in line with the move toward normalizing economic policies, we will resume the provision of data critical to macroeconomic and financial surveillance as agreed with IMF staff.

Table 1. Ukraine: Structural Benchmarks

	Structural Benchmark	Sector	Timing
1	Develop an action plan to prevent and clear arrears over the course of the 2023 Budget and beyond.	Fiscal	End-January 2023
2	To support efforts to enhance tax revenues, submit to Parliament three draft laws: (i) on cancelling the moratoria on tax audits (effective July 1, 2023); (ii) on removing idiosyncrasies of the application of the simplified tax regime by taxpayers under the single tax of 2 percent, and restoring the pre-war regime for these taxpayers (effective 1 July, 2023); and, (iii) on ensuring full-scale enforcement of the usage of cash registers in retail outlets (and associated settlement and payment infrastructure), including restoring liability for violations (effective July 1, 2023).	Fiscal	End-January 2023
3	Prepare a concept note on how to approach reforms to the social safety net to achieve targeted, adequate, and efficiently delivered social assistance to the population, including newly emerging categories of vulnerable groups, while safeguarding fiscal sustainability.	Fiscal	End-January 2023
4	Prepare a Terms of Reference in consultation with IMF staff describing the methodology and processes of bank diagnostics necessary to assess bank capital adequacy and identify NPL resolution priorities.	Financial sector	End-January 2023
5	Appoint and make fully operational the supervisory board of Naftogaz based on transparent and competitive selection procedures.	Governance	End-January 2023

Table 2. Ukraine: Quantitative Targets and Indicative Targets[1/]

(In millions of Ukrainian hryvnia, unless otherwise stated)

	2022 December QT	2023 March IT
I. Quantitative target		
Floor on the non-defense cash primary balance of the general government, excluding grants (- implies a deficit) 2/	86,950	-8,240
Floor on net international reserves (in millions of U.S. dollars) 3/	15,000	11,500
II. Indicative Targets		
Floor on the overall cash balance of the general government, excluding grants (- implies a deficit) 2/	-1,425,762	-506,476
Ceiling on general government borrowing from the NBU 1/ 2/ 4/	388,500	-7,600
III. Memorandum Items		
External project financing 2/	51,733	13,713
Budget support grants 2/	461,940	182,843
Budget support loans 2/	577,814	164,559
NBU profit transfers to the government 2/	19,700	71,000
Net financing of general government deficit by commercial banks 2/	-101,223	-5,434
Government bonds for the purposes of bank recapitalization and DGF financing	0	0
Called guaranteed debt service 2/	15,000	10,500

Sources: Ukrainian authorities; and IMF staff estimates and projections.
1/ Definitions and adjustors are specified in the Technical Memorandum of Understanding (TMU).
2/ Targets and projections for 2022 are cumulative flows from January 1, 2022. Targets and projections for 2023 are cumulative flows from January 1, 2023.
3/ Calculated using program accounting exchange rates as specified in the TMU.
4/ Calculated using the projected redemption of government bonds for 2022Q4 and 2023Q1 respectively as of November 22, 2022.