WHITE PAPER ON IMMEDIATE ECONOMIC POLICY PRIORITIES FOR GROWTH

STRONGER FOUNDATIONS, HIGHER POTENTIAL, AND FASTER RECOVERY

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Key messages:

As the war becomes protracted, more rapid economic growth is essential to mobilize sufficient resources for continued high defense spending and other critical needs, and, over time, to achieve strategic integration with the EU and ultimately reach the EU's standard of living and achieve income convergence in less than a generation. To realize this vision, we require stronger economic foundations, higher growth potential, and a faster economic recovery. Strengthening these three areas necessitates support from our partners, policy coordination and consistency, and making difficult trade-offs.

First and foremost, establishing <u>strong foundations</u> for economic growth is crucial. Ensuring macroeconomic stability during wartime will require mobilizing additional domestic revenue, continued support from donors, and gaining access to frozen russian assets to meet urgent fiscal financing needs.

Second, while the reforms outlined in the Reforms Matrix are necessary, they alone are not sufficient for a <u>faster economic recovery</u>. Ukraine will need help from partners to champion additional measures in both reform and non-reform areas to realize the vision. In the short run, to remove constraints to external demand-led economic recovery, Ukraine must alleviate immediate growth constraints on both the demand and supply sides, this includes <u>Securing air defense</u>, addressing <u>Energy needs</u>, enabling stable and predictable <u>Access to external markets</u>, <u>managing</u> <u>Labor shortages</u>, and <u>restoring critical Logistics</u> (SEAL+).

Third, Ukraine is prepared to engage in the reforms to achieve <u>high economic growth potential</u>—namely its productive capacity, capital stock, skills, and technologies—to secure its own future. This includes reforms identified in the Reforms Matrix to address long-standing, legacy structural supply side-growth constraints as well as adjusting our economic institutions to function in a market economy capable of coping with competition and market forces. Over the long run, we will need resources to rebuild critical public infrastructure, as well as policy

measures that facilitate the transfer and diffusion of new technologies and skills across various sectors of the economy.

The IMF's EFF arrangement will continue to provide a strong anchor for our stabilization policies. The Ukraine Plan is one of the key instruments for Ukraine's recovery, reconstruction, and modernization, aimed at achieving high economic growth potential. European integration – as reflected in the Ukraine Plan and the Enlargement Report - serves as a guideline for internal transformations, the further integration of Ukraine into the EU internal market even before the acquisition of official membership through the adaptation of Ukrainian legislation to EU law. The following note outlines the most immediate economic priorities to enable a faster economic recovery, further strengthen macro foundations, and higher growth potential in an environment where the war related uncertainties are likely to become protracted.

Context:

1. **Russia's unprovoked, illegal, and unjustified invasion of Ukraine continues to bring enormous human, social and economic costs.** Approximately a quarter of the population has been displaced, and about 20 percent of the physical capital has been destroyed, including US$151.2 billion in documented infrastructure destruction as of December 31, 2023. Disruptions to economic organization and transport networks—including the main export channels in the Black Sea—have resulted in a significant decline in exports.

2. **Despite the devastation, the people of Ukraine continue to demonstrate remarkable resilience. Supported by external financing, authorities have preserved macroeconomic, financial, and external stability and continued to advance important structural reforms that, over time, would create conditions to put economic growth on a more stable footing.** A 48-month IMF's EFF arrangement, approved on March 31, 2023, became the first systemic and long-term instrument of support of the Ukrainian economy, which unlocked US$122 billion support package for Ukraine from the international partners for the duration of the program. As of early June 2024, Ukraine successfully completed three reviews and started preparation to the fourth one. In December 2023, the European Union (EU) agreed to open membership talks with Ukraine.

3. **Economic recovery has been stronger than expected—in 2023, the economy returned to growth as economic agents continued to adjust to wartime conditions. However, risks and headwinds remain.** Exceptionally high uncertainty, particularly concerning the sources of financing needed to maintain our social support initiatives and bolster our defense capabilities, remains. Many industries continue operating under capacity, and wartime destruction continues to take a toll. More rapid economic growth is needed if Ukraine is to meet its aspirations to become a member of the EU within the next years.

4. **Given these challenging conditions, we must implement a set of policy measures to mobilize adequate resources for defense needs, maintain overall macro-stability, remove immediate constraints to economic activity, and boost Ukraine's economic growth potential.** The economic policy priorities of Ukrainian government's economic program are anchored in three key pillars:

a. **Maintaining macroeconomic, external, and financial stability.** This requires mobilizing sufficient resources to support the war effort, sustain essential government functions, and keep the economy, ravaged by war, functioning. The IMF EFF program provides a strong anchor for these stabilization policies.

b. **Removing immediate constraints to an external demand-led economic recovery** that will help achieve high and sustained growth rates in the short term. With constrained access to external markets, economic recovery in 2023 was partly driven by a rebound in domestic consumption, a strategy that cannot be sustained over the medium term.

c. **Undertaking comprehensive reforms that lay the foundations for and promote Ukraine's long-term growth towards integration and, ultimately, convergence with the EU.** Implementing these wide-ranging policies will require our steadfast commitment for an extended period. The approval of the Ukraine Facility for 2024-27, along with the start of Ukraine`s EU accession process, anchors key reforms for long-term growth and stability.

5. **Achieving these priorities under current conditions will require continued navigation of difficult policy trade-offs.** At the beginning of the war, our efforts were primarily focused on maintaining macroeconomic stability and mobilizing sufficient resources to cover core budget needs. However, as the invasion continues for a third year, a sequential approach focusing only one priority area at a time is insufficient—all three priorities will need to be addressed simultaneously since each affect the others. Economic recovery in the short term is needed to help provide more resources for taxation and decrease dependency of donor flows to cover internal and external imbalances. On the supply side, delayed economic recovery and prolonged underutilization of productive capacity can be detrimental to long-term growth due to possible hysteresis effects, whereby temporary layoffs, outmigration, and de-skilling risk becoming permanent. Moreover, if investment levels—a fundamental pillar to enhance the stock of physical capital and new technologies—remain low for an extended period, Ukraine's potential output will continue to decline further. Similarly, foreign aid has been instrumental in maintaining macroeconomic stability by providing the necessary resources to cover essential expenditures in social sectors. However, substantial increases in interest payments on official debt necessitate a reevaluation of how these aid flows can also facilitate the real transfer of resources, including productive equipment, technologies, manpower, and skills, to aid Ukraine's economic recovery today. To further support more efficient use of foreign aid flows, we need to introduce policies that discourage unproductive imports and encourage exports, preparing for a future where donor flows to cover current fiscal expenditures are expected to moderate. Therefore, these elements of our priorities—long-term anchors of higher productivity and investment, economic recovery, and macro-stability—mutually reinforce each other.

6. **Coordinating budget support and their associated policy conditions is of paramount importance.** When benchmarking Ukraine's economic institutions against those of EU member states, it becomes evident that our gap in most metrics is substantial. A strategy that focuses on making improvements whenever opportunities arise will not be effective given our limited administrative resources, capacity, and time. Similarly, concentrating policy actions only on areas

where Ukraine significantly lags EU comparators may not address the most pressing demand or supply-side constraints to economic growth in the short term.

7. **While we remain committed to implement structural reforms and strengthen our institutions, critical elements also include providing air defense security guarantees to Ukraine and facilitating Ukraine's access to markets.** Without secure skies and stable integration agreements it will be hard to replicate the kind of economic transformation experienced elsewhere in Eastern Europe that benefited from integration into global value chains underpinned by long-term contracts, technology transfer, and predicable long-term access to external markets.

Impact of measures in the Reforms Matrix:

8. **To facilitate the coordination of economic reforms aimed at achieving higher incomes, we have prepared the Ukraine Reforms Matrix.** This document consolidates Ukraine's ongoing conditions and recommendations from partners, addressing structural impediments, stabilizing the macroeconomic environment, and improving economic institutions to highlight priority areas for economic growth. Ukraine remains committed to implementing more than two hundred reform measures in 2024, as outlined in the Reforms Matrix. Such a results framework is helping in underpinning a strategic planning process to serve as a living management tool for authorities—guiding corrective actions, facilitating the coordination of development efforts, and ultimately serving as a key accountability tool for achieving strategic objectives, and sequencing of reform implementation. The Matrix is also used to gear up necessary administrative, legislative, and financial resources—domestic and external—to achieve desired economic development goals.

9. An expert evaluation was undertaken by the Kyiv School of Economics and the Center of Economic Strategy to measure the impact of policy measures included in the Reforms Matrix on the supply-side drivers (potential output), key demand-side constraints, social stability, and fiscal stability. The policy measures outlined in the Matrix were also evaluated with respect to their impact on addressing significant market distortions caused by security issues and other factors that undermine short-term economic growth.

10. Among all the reforms included in the Reforms Matrix, specific reforms contribute to each pillar, and some areas have the highest impact:

a. Stronger macroeconomic foundations: tax and customs reforms to broaden domestic revenue base; strengthening public finance management; the removal of quasi-fiscal distortions; and maintaining adequate monetary policy stance.

b. A faster economic recovery: sectoral reforms in energy, critical materials, agriculture, and transport sectors; trade facilitation reforms to improve trade competitiveness and the effectiveness of border agencies; labor market programs focusing on increasing the labor market participation rate; and policies to preserve human capital.

c. A higher growth potential: strengthening law enforcement, judiciary and anticorruption efforts; enhancing public investment management; improving business climate for domestic and foreign investment; improving SOE corporate governance; and strengthening regional policy coordination.

11. However, the measures included in the Reforms Matrix include important elements that help to stabilize macroeconomic policies, strengthen government institutions, and increase Ukraine's future growth potential they alone are not sufficient to maintain economic activity during the war, nor do they include the most urgent measures needed to support economic activity. More policy actions are needed with the prime focus on advancing those reforms that (i) can be done now, (ii) have the least immediate fiscal costs, and (iii) ensure macro stability and economic recovery.

Immediate priorities of economic policy:

12. While the reforms outlined in the Reforms Matrix are necessary, they alone are not sufficient for a faster economic recovery. Ukraine will need assistance from partners to champion additional measures in both reform and non-reform areas to realize the vision:

a. First, to address macroeconomic risks it is critical for the Multi Donor Coordination Platform (MDCP) partners and Ukraine to establish a long-term plan for external financing (until 2027) and in-kind support to underpin our macroeconomic stability.

b. Second, to promote faster recovery by removing essential constraints—Securing air defense, addressing Energy needs, enabling stable and predictable Access to external markets, managing Labor shortages, and restoring critical Logistics (SEAL+). Furthermore, the implementation of the Enlargement Report measures should trigger time-specific and scope-specific market liberalization measures, as well as access to EU funds. Overall, the logic behind the accession negotiations should ensure that Ukrainian economy and society could experience tangible on-the-go benefits even before officially joining the European Union. Ukraine must pursue a rapid and accelerated integration process.

c. Third, to expand potential growth by supplementing necessary structural reforms with time-specific and scope-specific investment and technology transfer commitments from partners that boost productivity and capital accumulation. Ukraine Plan of the Ukraine Facility presents a good example of this approach, whereas implementation of the reform` and investment milestones of the Plan triggers both, the external budget support, as well as inflow of the financing and the investment for the private sector. Complementing such measures with the actual external financing and transfer of technologies through partnerships and joint ventures between the Ukraine and EU and G7 countries would significantly improve the productivity of the economy. Priority sectors for development, as stipulated in the Ukraine Plan and at the MDCP meetings, include energy, transport, agri-food, critical materials, digital transformation.

13. In specific terms most immediate priority areas are summarized below.

14. **PRIORITY AREA 1: MACROECONOMIC STABILITY:** upholding macroeconomic stability is crucial, and it is imperative that we receive sufficient, prompt and predictable financing in 2025. Effective functioning of our economy hinges on meeting these macroeconomic and financial needs. Sufficient budget support is also essential for Ukraine's economic resilience and recovery. This would require three things:

i. **Predictable financing from external donors.** Ukraine will continue to rely on foreign aid to meet its most immediate internal and external economic imbalances. Timely external financing on appropriately concessional terms is an essential pillar of our financing strategy, including meeting large official debt servicing needs in 2025. At the same time, we are strengthening public investment frameworks to enable planning and programming of official resources for priority needs that have the highest economic and social returns.

ii. **Bilateral and multilateral efforts to use frozen and immobilized Russian assets**. According to data from before February 24, 2022, the Central Bank of Russia's reserves totaled US$320 billion. It is estimated that an equivalent of US$224 billion is held across EU member states. Notably, *Euroclear*, based in Belgium, holds an equivalent of US$180 billion of these funds.

iii. **Measures to increase domestic revenues.** While external donors will continue to remain an important source of financing, there will be a need for greater self-reliance in generating tax and non-tax revenues to ensure the budget is financeable given continued high defense related needs. In this regard:

- We have launched the preparation of the Budget Declaration for 2025-27, which will be a basis for the preparation of the 2025 Budget. We are committed to raising adequate additional revenues to meet continued defense related needs, and to implementing reforms that improve the efficiency of non-defense expenditures, including those that enhance the targeting of the social safety net, increase the efficiency of the education system, and mitigate fiscal risks in the pension system.
- We will continue to take steps to reduce non-taxed activities in the sizeable shadow economy.
- At the same time, we will continue focusing on actions at increasing revenue and reducing corruptions risks within customs administration. This includes taking legislative steps to criminalize large-scale customs fraud and smuggling.

15. **PRIORITY AREA 2: REMOVING IMMEDIATE CONSTRAINTS TO EXTERNAL DEMAND-LED ECONOMIC RECOVERY:** the highest growth impact in the short-run would result from additional policy actions that are directly focused on supporting external demand driven growth by alleviating immediate constraints on the demand and supply sides focusing on enhancing **S**ecurity, addressing **E**nergy needs, enabling stable and predictable **A**ccess to external markets, managing **L**abor shortages, and restoring critical **L**ogistics (SEAL+):

i. **Security:** Market mechanisms (competition and price signals) fail to efficiently allocate productive resources if market distortions and failures associated with the security challenges of a wartime economy continue to persist. While fully addressing security challenges immediately might not be possible, securing air defense is the most critical priority to protect economic activity and securing trade routes. High security risks have led to a serious increase in the cost of product transportation, reducing export earnings and thus economic returns. For example, in October 2023, freight rates for Ukrainian steelmakers through the sea corridor were four times higher than pre-war levels, and in

January 2024 twice as high. On our part, we have deployed policy instruments to address externalities related to deteriorating credit conditions, insufficient trade finance, and incomplete de-risking and insurance markets. However, these steps are not enough. We urgently need more air defense systems from our partners to protect our cities, critical infrastructure, industries, and trade routes.

ii. **Energy:** we need to balance short-term energy needs with long-term goals in a context of considerable uncertainty. To maintain and enable necessary conditions for economic recovery, basic energy and utility services must be restored as soon as possible. About 40 percent of the electricity transmission infrastructure, 20 percent of the infrastructure of the electricity distribution system and up to 50 percent of the electricity generation capacity is occupied, destroyed, or severely damaged. Addressing the energy deficit would require undertaking investments to increase the capacity of the energy system. This includes help from our partners to construct interconnectors to enhance the capacity of cross-border power grids with EU countries, and building new combined cycle thermal power plants—featuring high maneuverability, decentralization of energy sources, and a capacity of 2 to 3 GW.

iii. **Access:** the permanent and predictable removal of remaining tariff and non-tariff barriers to access external markets, primarily the EU one is essential. All post-war economic miracles, such as those in Germany, Japan, and the Republic of Korea, were enabled by access to markets. The comprehensive predictable, and durable integration and access to the EU internal market, that provide Ukrainian exporters with long-term supply contracts, investment, and technology transfer is core element of economic recovery. The temporary nature of unprecedently full EU's autonomous trade measures overshadowed their positive impact as well as general free trade regime, established by the Association Agreement. Thus it does not allow local or foreign firms to make the longer-term investments needed for economic growth, since the liberalization can be easily reversed or diluted. For example, the European Commission can take swift action and impose any measures it deems necessary should there be significant disruption to the EU market or the markets of one or more EU member states due to Ukrainian exports. Moreover, the Commission can reimpose tariffs for many agricultural products—namely poultry, eggs, sugar, oats, groats, maize, and honey—if Ukraine's exports of these products surpass the average of export volumes recorded in the second half of 2021, and all of 2022 and 2023. In addition to these tariff barriers, non-tariff barriers associated related to blockades and disruptions of land crossings with Poland—our largest trading partner—resulted in a US$160 million loss in exports per month, according to estimates of the National Bank of Ukraine. The EU and Ukraine urgently need to transform the trade regime into truly open and predictable trade regime that advances further with progress in accession talks. The trade regime should utilize the advancements in approximation of legislation. The ACAA agreement, roam like at home, SEPA and other areas of internal market regime for Ukrainian goods, services and businesses should be introduced as fast as possible and in all available areas of the EU internal market.

iv. **Labor:** According to the UN, the total number of refugees in Europe is approximately 5.8 million people, including 4.5 million in the EU and other European countries, and 1.3 million in russia/Belarus. Due to military operations and population reduction, Ukraine's labor force decreased by 2.1 million people (a decline of about 12 percent), to 15.2 million. Moreover, about half of Ukraine's labor force is inactive—neither employed nor looking for employment—while almost three-quarters of employers in the country indicate they are experiencing a staff shortage. This is compounded by Ukraine's pre-war challenge of a rapidly aging and shrinking population. Returning refugees are projected to increase the labor force to between 16.0 and 16.4 million people in 2026, which is still 0.9 to 1.3 million less than the pre-war record of 17.3 million in 2021. This confirms the need to attract more labor, incentivize the return of refugees, and increase labor force participation—particularly among women—to support economic recovery. Ukraine is committed to take the necessary reforms to address some of these issues, but would also need help in providing the social services and job opportunities needed to attract more workers.

16. **Logistics:** Transport and logistics—the backbone of the economy and exports—plays a key role in maintaining Ukraine's economic resilience. Reconstruction and increased capacity of key transport and logistics links is needed to ensure stable supply and competitiveness of Ukrainian products on external markets. Maintaining access to the Black Sea ports will have the most significant impact on minerals extraction and metallurgy industries, and will decrease the cost of logistics for the agriculture thus increasing income from the exports. At the same time, we strive to improve the Solidarity Lanes with Poland, Hungary, Slovakia, Romania, and Moldova by increasing the capacity of existing customs checkpoints, including from the partner countries side (by developing transport infrastructure, increasing the number of workers, and improving organizational measures) and advancing reforms to amend the Customs Code and align it with EU customs legislation, strengthening selection process for the leadership of the State Customs Service and other trade facilitation policies.

17. **POLICY AREA 3: STRENGTHENING ECONOMIC GROWTH POTENITAL:** sustained increase in real GDP per capita over time requires structural reforms that help to rebuilding human capital, attracting investment, and fostering an enabling business environment that propel productivity growth. Ukraine is committed to advance structural reforms. However, reforms alone will not be sufficient. Ukraine's growth potential—namely its productive capacity, capital stock, skills, and technologies—will require additional policy interventions that facilitate reallocation of productive resources, including new resources to rebuild critical public infrastructure, and intentional measures that facilitate diffusion of new technologies across sectors of economy, to incentivize the private sector to adopt modern technologies and successful business processes from abroad, for example, supporting businesses that are ready and able to enhance their production by adopting global technologies. With the Ukraine Plan, the Government has set out its short to medium-term priorities for investments over the course of the next four years laying out areas of investments that will enable economic and social growth and resilience, most immediate priorities include the following areas:

i. **We will continue to undertake reforms aimed at strengthening the business environment.** Private sector will be the most important driver of growth. To support this, efforts are being made to create a favorable investment environment and to advance the deregulation of the business environment. By early 2023, there were 84 areas of state supervision and control and over 30 inspection bodies, with many having overlapping functions. Currently, there are over 1000 instruments of state regulation, including 528 permits, 224 licenses, 157 approvals, 145 conclusions, 121 certificates, 55 declarations, 42 notifications, and 23 authorizations. This is in addition to hundreds of building regulations and sanitary rules. Deregulation, simplification, and digitalization of procedures can significantly reduce the costs of doing business in Ukraine. We will continue to deregulate the licensing and permit system, enhance the e-construction portal, simplify procedures for temporary business constructions, abolish outdated provisions, and digitalize the issuance of licenses. The adoption of the EU acquis that sometimes envisage complex and sophisticated regulations of business activities shall be adjusted to the needs of economic recovery and shall allow application of simpler and more digitalized solution if available.

ii. **We will continue to strengthen the government's capacity to support growth through public investments and the efficient management of state-owned enterprises.** This will require institutional reforms to clearly identify policy strategies for key sectors of economy, strengthening public investment management, and instruments of state support for private businesses. Moreover, improved management of state-owned enterprises is also expected to contribute to the economic growth potential. These sectors are both of immediate strategic importance for the country as well as potential catalysts of accelerated post-war economic growth.

iii. **We will deploy non-market-distortive, time-bound, targeted instruments to support sectors where Ukraine has a comparative advantage.** The Ukraine Reform Plan has outlined sectors assessed to have the largest potential for unleashing economic growth, namely defense industry, energy, agriculture, transport, critical raw materials (as well as developing process industries capacities), and IT. Support for small and medium enterprises (SMEs) is also critical. Finally, technology transfer commitments from partners that boost productivity and capital accumulation are essential, including focusing on imitating and diffusing modern technologies from advanced economies and applying this knowledge at scale in Ukraine. Ukraine shall be, as it is applicable and possible, entitled to participate in the EU programs for industrial development and aid.

iv. **We will need the help of our partners to use the market access for integration into value chains of our partners, and efforts to reduce excessive reliance on imports are necessary to improve the overall trade balance using open, sustainable and assertive trade policy .** We need to integrate into global value chains. Our partners can facilitate adaption of concepts such as nearshoring, friendshoring, and diversifying supply chains. These strategies are crucial for reducing dependence on dominant suppliers enhancing economic resilience of EU countries. At the same time, wartime trade disruptions have underscored the need to build a robust domestic processing industry. This will enable Ukraine to meet domestic demands during hostilities and reconstruction, thereby decreasing dependence on imports and enhancing the overall trade balance. Consequently, to strengthen the trade balance, our focus must shift from importing critical goods to domestically producing and competitively exporting items such as food, building materials, and more.

v. **We will need the help of our partners to develop critical raw materials, a vital sector for Ukraine's trade specialization.** Ukraine boasts deposits of 22 out of the EU's 34 critical minerals, positioning our country among the top 10 producers of titanium, zirconium, graphite, and manganese. We also have significant reserves of lithium, beryllium, rare earth elements, and nickel, which are essential for meeting Europe's increasing demand for green energy and innovative technologies. Consequently, this presents a wide range of mining investment opportunities.

18. We recognize that the road ahead will be long and challenging. It will take many years for GDP levels to return to pre-war levels, and even longer to significantly narrow the income per capita gap with EU countries. Today, we have already started to create growth points for the post-war economy—export-oriented and integrated into European and global production chains. Our integration with the EU is the only path to achieve this goal. We are laying the foundations for the next European growth miracle. A growth miracle that extends the single market from Lisbon to Kharkiv, offering businesses from other countries opportunities to expand markets, diversify supply chains, and exploit the economies of scale provided by Ukraine. However, Ukraine cannot achieve this alone; support from our partners will be essential along this path. **Without a prosperous Ukraine, European prosperity will not be fully realized.**

Slava Ukraini !