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## NEGOTIATING CHAPTER “ECONOMIC AND MONETARY POLICY”: HOW TO FAST-TRACK UKRAINE'S ACCESSION TO THE EU?

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The European debt crisis of 2009-2010 revealed that within the internal market, a macroeconomic imbalance in one country becomes a problem for all EU members

- The 17th negotiating chapter of the Acquis, Economic and Monetary Policy, sets out the framework for the smooth functioning of the economic and monetary union
- The key principles for developing and implementing fiscal and monetary policy are set out in the Treaty on the Functioning of the European Union. **Furthermore, the Acquis in this area significantly expanded after the European debt crisis in 2009 and 2010.**
- In general, according to EU principles:
  - **Fiscal policy** should be based on long-term goals.
  - **Budget expenditures and revenues** should be transparent and projectable.
  - **Corrective measures** should be based on monitoring and analysis of the macroeconomic environment.
  - Independent from the government, the central bank should conduct **monetary policy** using market-based instruments and avoid significant interventions in the money markets.

# IMPLEMENTATION OF THE URGENT RECOMMENDATIONS OF THE EUROPEAN COMMISSION

# URGENT RECOMMENDATIONS OF THE EUROPEAN COMMISSION

According to the latest European Commission report, dated 08.11.2023, Ukraine is moderately ready for accession in terms of the 17th negotiating chapter, “Economic and Monetary Policy.”

## **Recommendations for 2024 include:**

- preparation for a return to inflation targeting and a flexible exchange rate regime;
- limitation of monetary financing of the state budget;
- preparation for a return to medium-term budget planning starting in 2024.



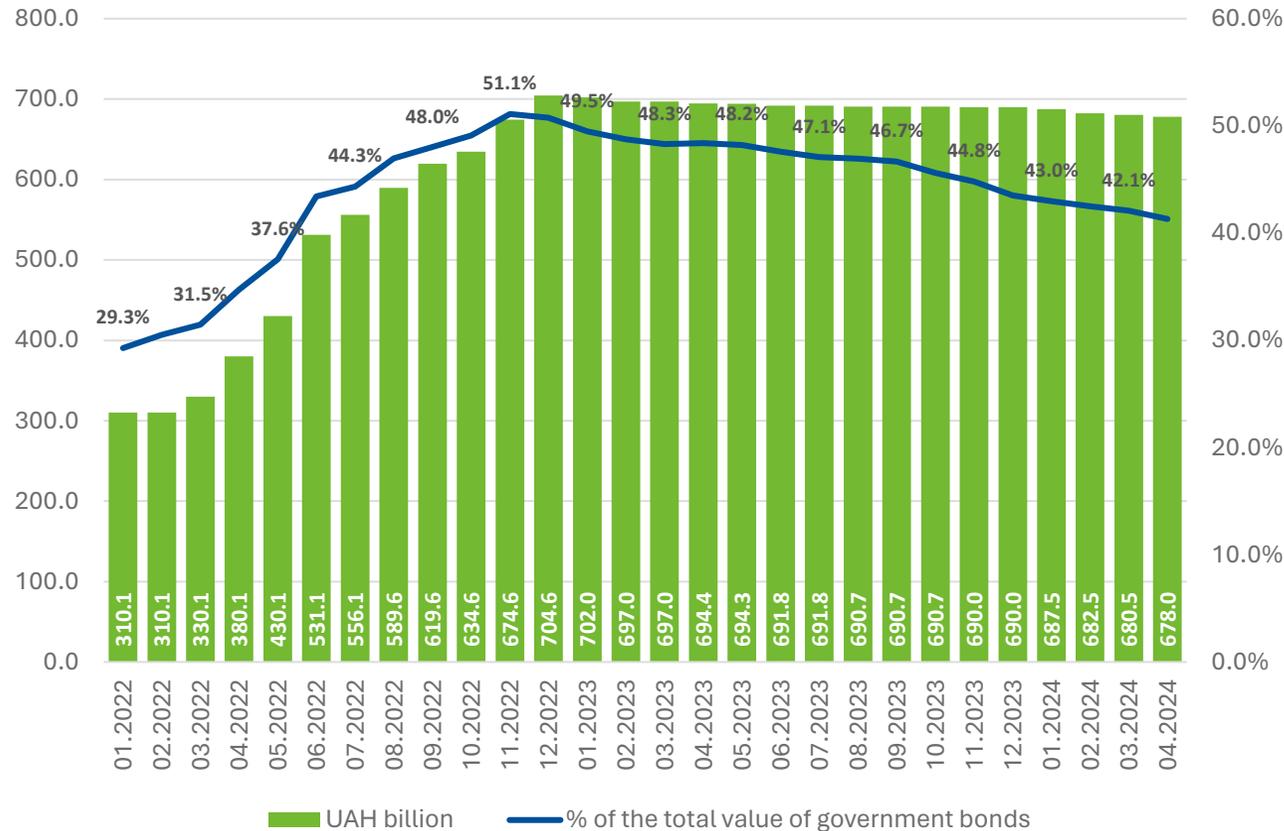
# INFLATION TARGETING AND FLEXIBLE EXCHANGE RATE REGIME

Introducing a fixed exchange rate (especially when accompanied by restrictions on the freedom of capital movement) is not in line with EU principles but is a necessary measure in wartime.

- As of 2021, the NBU maintained a floating exchange rate and both de jure and de facto inflation targeting. After 24 February 2022, the NBU fixed the exchange rate (followed by a further devaluation in July).
- In October 2023, the NBU introduced a managed floating exchange rate regime as part of a **long-term strategy to return to a flexible exchange rate and inflation targeting**, which includes three main stages:
  - Stage I - minimising the multiplicity of exchange rates, liberalising trade operations and facilitating new loans and investments;
  - Stage II - liberalisation of trade finance, bank exchange rate risk management, and the possibility of repatriating interest on ‘old’ debt and investments;
  - Stage III - the possibility of repayment of loans and investments, liberalisation of household transactions and derivatives transactions, the possibility of lending to non-residents and investing abroad.
- In May and July 2024, the NBU introduced new currency easing measures.
- **The fixed exchange rate was a necessary measure at the beginning of the full-scale war. The NBU is now implementing a strategy of smoothly returning to a free exchange rate through a managed floating exchange rate regime.**

# RESTRICTIONS ON MONETARY FINANCING

The Treaty on the Functioning of the European Union explicitly prohibits the emission financing of state and local budgets



Domestic government bonds in the NBU's assets (in billion hryvnias and % of the total value of domestic government bonds) in 2022-2024 Source: CES calculations and visualisation based on NBU data T-bills\_nom.xlsx (live.com)

- Article 54 of the **Law on the National Bank of Ukraine** prohibits the NBU from lending to the state and purchasing domestic government bonds on the primary market.
- The NBU resorted to monetary financing at the beginning of the full-scale invasion in 2022, as the total of domestic and foreign budget revenues was not enough to cover military expenditures - **the resolution On the Purchase of Domestic Government Bonds ‘Military Bonds’ during the period of martial law** served as the legal framework for financing the NBU's military needs during martial law.
- Between February and December 2022, the volume of domestic government bonds in the NBU's portfolio increased by UAH 394.5 billion. However, starting in January 2023, this figure has been decreasing.
- **The NBU does not resort to emission financing of debt.**

# MEDIUM-TERM BUDGET PLANNING AND OTHER FISCAL POLICY MATTERS

## A full-scale war causes too much uncertainty for proper medium-term budget planning

- The European Commission acknowledges that the war has challenged macroeconomic forecasting and budget planning.
- Ukraine does not have an independent fiscal council to assess the quality of forecasts and budget assumptions and to monitor the quality of previous years' forecasts.
- The public finance audit system, including the State Audit Service and the Accounting Chamber, must be reformed.
- At the end of June 2024, the Cabinet of Ministers approved **the Budget Declaration for 2025-2027**. This means a return to medium-term budget planning and creating a guideline for macroeconomic and budgetary indicators. However, the forecasting process is significantly complicated due to the high level of uncertainty due to the war, which is unlikely to allow the document to become a reliable roadmap.
- **While a full-scale war complicates medium-term budget planning, it is not the only obstacle. Ukraine must also establish an independent fiscal authority to monitor planning quality and ensure a credible public finance audit system.**



# EUROPEAN LEGISLATION IN THE DEVELOPMENT AND IMPLEMENTATION OF ECONOMIC AND MONETARY POLICY

## The Treaty on the Functioning of the European Union is a key EU policy document

- The Treaty outlines the EU's operational framework and defines the powers and functions of its agencies.
- Chapter VIII sets out the key economic and monetary policy principles within the EU.
  - The European Council is empowered to define key areas of economic policy and monitoring in Member States; in case of non-compliance, the European Commission and the Council jointly develop individual recommendations.
  - Emission financing of state and local budgets is prohibited.
  - Member States must ensure the sustainability of public finances, measured by the budget deficit ratio and public debt to GDP.
  - The European Central Bank implements monetary policy in the Euro area. Member States have an obligation to ensure that national legislation (including national bank charters) complies with the charter of the European System of Central Banks and the European Central Bank.



# TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union is a 2012 intergovernmental treaty between EU Member States aimed at strengthening fiscal discipline and coordination in the EU.

- **Requirements for a balanced budget:** the budget deficit should not exceed 3% of GDP, while the structural budget deficit should not exceed 0.5%. However, if the public debt-to-GDP ratio falls well below the critical 60% threshold, the structural budget deficit may be as high as 1% of GDP.
- **Automatic correction mechanism:** Member States should apply an automatic budget correction mechanism if the budget deficit deviates significantly from the critical value.
- **Strengthening supervision:** expanding the European Commission's powers to monitor the budgetary policies of Member States, including the right to review draft budget plans and provide recommendations if the plans do not comply with the rules.
- **Economic Partnership Programmes:** In case of excessive deficits, Member States should introduce a programme that outlines structural reforms to correct budget deficits and prevent further deficits effectively.
- **Coordination of national policies:** Member states should coordinate their short- and medium-term economic policies and take measures to promote economic cohesion.
- **Governance and accountability:** The Euro summit is officially recognised as the key forum for discussing governance issues within the Euro area.

## STABILITY AND GROWTH PACT (1)

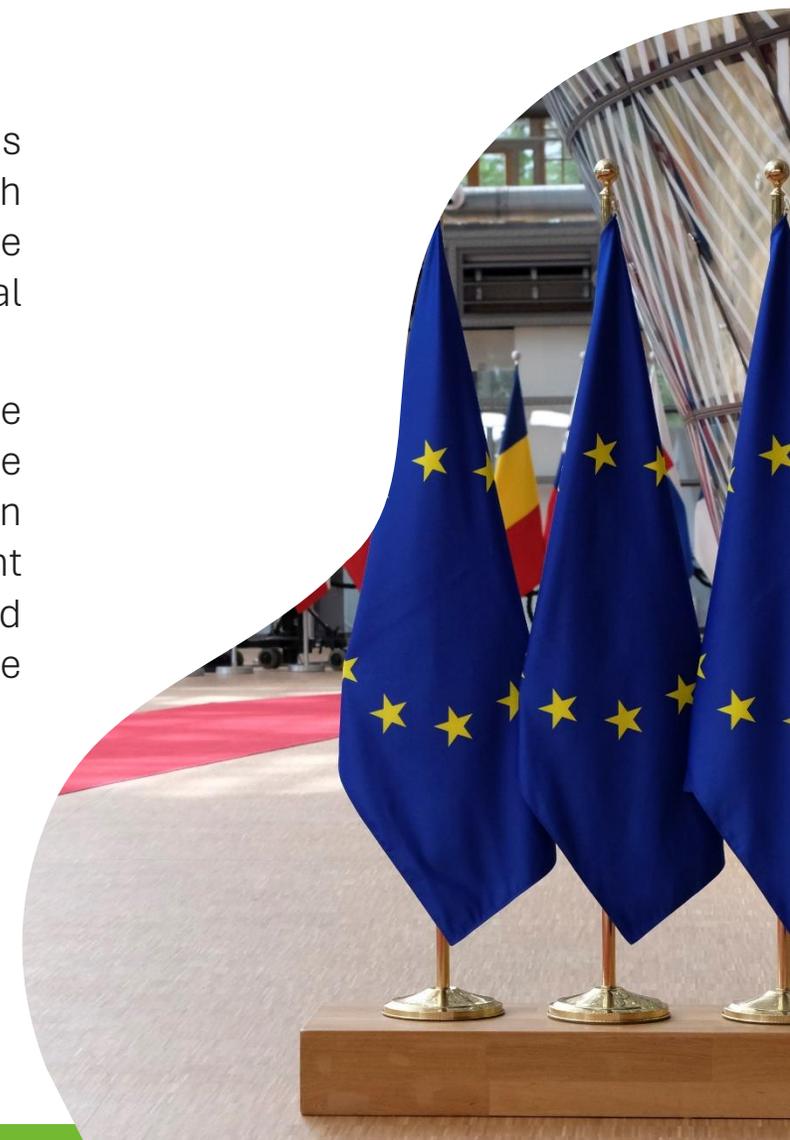
The Stability and Growth Pact was adopted in 1997 to provide a framework for monitoring and coordinating the fiscal policies of EU Member States (especially those in the Eurozone). However, the regulatory framework in this area has been significantly expanded after the European debt crisis

- **Directive 2011/85** strengthens fiscal control by establishing a unified budgeting framework for all EU Member States.
- **Regulation 1177/2011** sets out detailed procedures for the excessive deficit procedure, triggered when a Member State exceeds the deficit (3% of GDP) or debt (60% of GDP) thresholds set by the Maastricht criteria.
- **Regulation 1173/2011** ensures compliance with budgetary discipline through fines and sanctions. Exceeding the thresholds for the budget deficit (3% of GDP) and public debt (60% of GDP) provides grounds for triggering the budget resolution mechanism (EDP, Excessive Deficit Procedure). It also prescribes enforcement mechanisms for Eurozone countries subject to the EDP, including an interest-free deposit of up to 0.2% of GDP or a fine of 0.2% of GDP. Non-Euro area Member States must comply with the fiscal thresholds; however, they are not subject to fines and sanctions.
- **Regulation 1176/2011** introduces mechanisms for the supervision and correction of macroeconomic imbalances in the EU (with a particular focus on the Eurozone). The MIP (Macroeconomic Imbalances Procedure) is a structured approach to identifying, preventing and correcting macroeconomic imbalances.
- **Regulation 1175/2011** extends the scope of the EU's budgetary supervision and economic policy coordination framework by requiring Member States to submit annual Stability Programmes (for Euro area countries) or Convergence Programmes (for non-Euro area countries) approved by the Commission and the EU Council.

## STABILITY AND GROWTH PACT (2)

### The 2013 reform somewhat expanded the responsibilities of Member States in maintaining financial and budgetary stability

- **Regulation 472/2013** provides enhanced supervisory procedures for Eurozone countries experiencing severe financial distress or receiving financial assistance from EU funds, such as the European Stability Mechanism (ESM). Countries receiving financial aid must prepare macroeconomic adjustment programmes detailing structural reforms and fiscal consolidation measures.
- **Regulation 473/2013** was introduced to strengthen fiscal discipline and enhance economic policy coordination among Eurozone Member States. In particular, the Regulation obliges Eurozone countries to submit annual draft budgets to the European Commission for approval. Member States are also required to have independent institutions responsible for monitoring the implementation of national fiscal rules and providing economic forecasts (although the regulation applies exclusively to Eurozone countries, other EU members are also encouraged to follow this practice).



# ASSESSMENT OF UKRAINE'S ACCESSION READINESS

# MONETARY POLICY QUALITY

## The NBU operates in accordance with the basic principles of the European System of Central Banks, except for certain institutional differences

- **Primary functions.** Like the European Central Bank, the NBU defines ‘ensuring the stability of the Ukrainian currency’ as its primary function; maintaining sustainable economic growth is also within the NBU's mandate, as long as it does not contradict its primary function.
- **Prohibition of monetary debt financing.** In both the EU and Ukraine, the legislation explicitly prohibits the central bank from lending to the government or purchasing government bonds on the primary market. The NBU deviated from this rule at the beginning of the war, but this required the adoption of a separate bylaw.
- **Independence of the central bank.** In both the EU and Ukraine, the central bank develops and implements monetary policy independently of the government; the central bank and the government are not liable for each other's obligations. **However, the European Commission interprets the ability to dismiss members of the NBU Council appointed by the President and the Verkhovna Rada as a threat to the NBU's independence.**
- **Terms of service of the NBU Governor.** EU legislation requires that the NBU governor's term of office be at least 5 years. The Law on the National Bank of Ukraine stipulates that the NBU Governor is appointed by the Verkhovna Rada upon the president's proposal for a 7-year term.
- **Mechanisms of monetary intervention.** The NBU conducts its monetary policy using interest rate instruments, foreign exchange interventions, and reserve requirements in line with EU principles. The currency restrictions introduced in 2022 are gradually being eased with a view to a complete transition to a flexible exchange rate regime.

# BUDGETARY FRAMEWORK

- **Directive 2011/85** defines several components that should be included in the budgetary frameworks of Member States.
- Ukraine already has almost all of them in its Budget Code:
  - Budgetary accounting and statistical reporting systems: **available**
  - Rules and procedures governing the preparation of forecasts for budget planning: **available**
  - Quantitative fiscal rules specific to the country, which promote the coherence of fiscal policies of Member States with their respective obligations under the Treaty of the European Union, in the form of a generalised budgetary performance indicator, such as the budget deficit, borrowing, debt or its main component: **available, but postponed due to the war in the final provisions of the relevant budget law**
  - Budget procedures that support the budget process at all its stages: **available**
  - Medium-term budgetary planning as a specific set of national budgetary procedures that extend the horizon of fiscal policy making beyond the annual budget calendar, including the setting of policy priorities and medium-term budgetary targets: : **available, but not fully in line with European practices**
  - Mechanisms for independent monitoring and analysis to enhance the transparency of elements of the budget process: **not available**
  - Mechanisms and rules governing fiscal relations between public authorities in different sub-sectors of general government: **available**

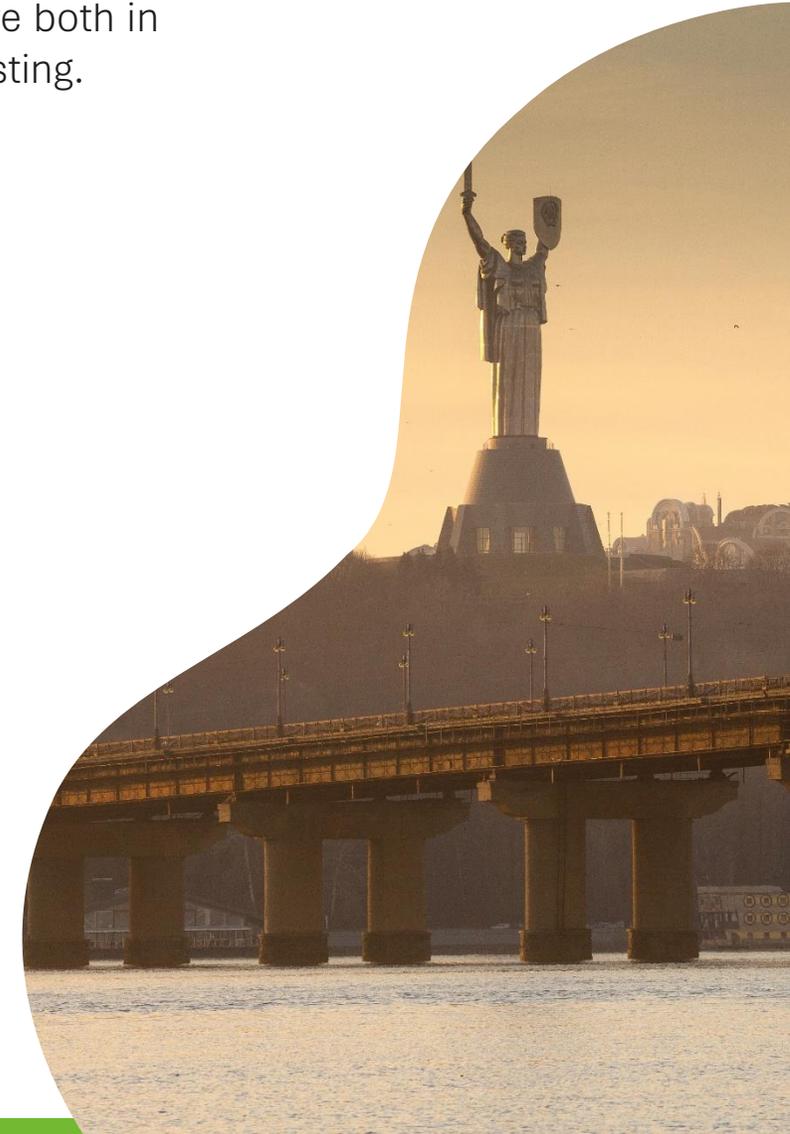
# CHAPTER II ACCOUNTING AND STATISTICS

- Economic and monetary policy must be evidence-based - this is one of the EU's key public administration principles. Accordingly, the quality of statistical data plays an important role.
- Chapter II of Directive 2011/85 sets out the principles of statistics and forecasting in the field of economic policy, in particular:
  - requires all EU Member States to use the unified standard of the European System of Accounts (ESA, European System of Accounts 2010);
  - stipulates that national accounting systems are subject to regular and independent audits;
  - requires all EU Member States to publish on a timely and regular basis fiscal data for all subsectors of the public administration sector, including cash-based fiscal data (monthly for central government, state government and social security subsectors, quarterly for the local government subsector) and a detailed reconciliation table demonstrating the methodology for the transition between cash-based data.
- In the context of macroeconomic and public finance statistics, Ukraine has some level of preparation for accession but has not demonstrated significant progress in recent years.
- **Macroeconomic statistics is aligned with European standards, but the frequency of reporting and data transfer to Eurostat remains a challenge.**
- **Public finance statistics are published according to the IMF methodology, not the ESA 2010.**
- **Additionally, statistical indicators directly related to the excessive debt procedure are not published or provided to Eurostat.**
- **Data on indicators subject to regular monitoring as part of the procedure for correcting macroeconomic imbalances (by Regulation 1176/2011) are not published.**

## CHAPTER III FORECASTS (1)

In macroeconomic forecasting, Ukraine meets the requirements for the availability and quality of macroeconomic forecasts, but fiscal forecasting procedures do not comply with the directive both in terms of taking into account different macro scenarios and in terms of transparency of forecasting.

- EU Member States must use the most realistic or conservative forecast. **Planning in Ukraine is based on the most realistic macroeconomic forecast selected from several scenarios presented by the Ministry of Economy.**
- As part of the sensitivity analysis, the macroeconomic and budget forecasts include the dynamics of the main fiscal variables under different assumptions regarding growth and interest rates. The range of alternative assumptions used in the macroeconomic and budget forecasts should be determined based on the results of previous forecasts, and the relevant risk scenarios should be considered. **Ukraine has alternative macroeconomic scenarios, but alternative budget revenues and expenditures scenarios have not been published but are considered in the Budget Declaration. However, the latest document (State Budget Indicators for 2025-2026) does not provide a quantitative assessment of the impact of changes in interest rates or growth. The impact of war scenarios on the budget is also not presented.**



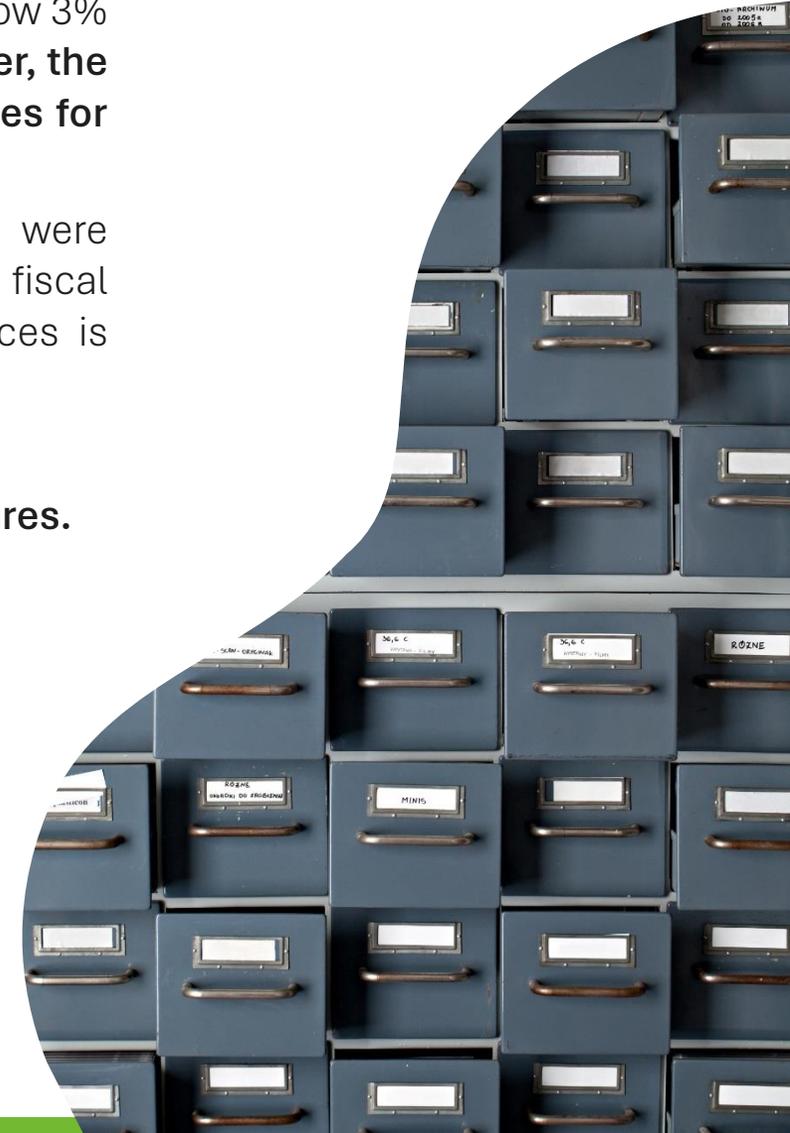
## CHAPTER III FORECASTS (2)

- Member States should identify which institution is responsible for preparing macroeconomic and budgetary forecasts and make public the official macroeconomic and budgetary forecasts prepared for fiscal planning, including the methodologies, assumptions and relevant parameters underlying these forecasts. **Macroeconomic forecasts are presented to the public in full, including assumptions. The Ministry of Economy regularly meets with research centres and experts to discuss forecasts and assumptions. However, the forecasting of state budget revenues and expenditures is not transparent.**
- Macroeconomic and budgetary forecasts for budget planning should be subject to regular, impartial and comprehensive evaluation based on objective criteria, including ex-post evaluation. The results of such an assessment should be made public and properly considered in future macroeconomic and budgetary forecasts. **No assessment of macroeconomic development forecasts and budget revenues and expenditures is performed.**



## CHAPTER IV NUMERICAL FISCAL RULES

- In Ukraine, the **Budget Code** sets out both major fiscal rules - keeping the budget deficit below 3% of forecast GDP and keeping public and guaranteed debt at a ceiling of 60% of GDP. **However, the legislation does not provide for consequences for breaching these rules and procedures for returning to the limits.**
- During the war, the fiscal rules in Ukraine (the relevant articles of the Budget Code) were suspended in the final provisions of the annual budget laws. Ukraine adhered to the fiscal regulations until 2020 inclusively, and deviating from them in extraordinary circumstances is entirely justified.
- A full return to fiscal rules will be possible only after the war.
- **Ukraine should introduce procedures similar to the European Excessive Deficit Procedures.**



## PUBLIC FINANCE CONTROL

- The Treaty on the Functioning of the European Union sets out the following guidelines for controlling public finances within the framework of fiscal policy:
  - The budget deficit should not exceed 3% of GDP;
  - Public debt should not exceed 60% of GDP.
- The restrained fiscal policy and reforms introduced after 2015 allowed Ukraine to meet these criteria before the full-scale war: the budget deficit in 2021 was 3.4% of GDP, and public and publicly guaranteed debt was 49% of GDP.
- As of 2023, the officially published budget deficit exceeded 20% of GDP, and the adjusted implied deficit (which excludes grants and direct aid from budget revenues) reached 38% of GDP. With this grant support, debt accumulation did not increase as rapidly as it could have, and public debt was kept at 84% of GDP by the end of 2023.
- **During the war, the country cannot and should not set itself the goal of reaching peacetime targets. Still, in the years after the war, when the economy recovers, it may need to reduce its debt burden and return to a policy of restrained budget deficits.**

## CHAPTER V MEDIUM TERM BUDGETARY FRAMEWORKS

- After signing the Association Agreement, Ukraine moved to medium-term budget planning, developing, and approving the first-ever medium-term budget declaration for 2022-2024.
- However, medium-term budgetary planning in Ukraine was suspended after the outbreak of the war and resumed in June 2024 with the approval of the Budget Declaration for 2025-2027.
- The Ukrainian medium-term planning framework (described in Chapter 33 of the Budget Code of Ukraine) only partially complies with Directive 2011/85 requirements.
- The main difference and focus area for the Ukrainian government is the inclusion of all public finance **entities in the medium-term budgetary framework in the EU sense.**
- Medium-term budgetary planning is also closely linked to defining policy objectives, the resources needed to achieve them, and the respective planning of budget expenditures. **In Ukraine, there is no budget expenditure forecast in the functional classification.**
- **The formal approach to describing the main areas of expenditures does not allow for assessing the effectiveness or quality of budget planning and its impact on achieving policy goals.**
- **In addition, Directive 2011/85 assesses the long-term impact of fiscal policies on public finance indicators, which is currently not contained in the Ukrainian Budget Declaration.**

# CHAPTER VI TRANSPARENCY OF GENERAL GOVERNMENT FINANCES AND COMPREHENSIVE SCOPE OF BUDGETARY FRAMEWORKS

- The sub-sectors of the general government sector as defined in the EU include the budget of the central government (ministries, departments, etc.), the budgets of state agencies, the budgets of local governments, and the budgets of social funds.
- Ukrainian medium-term budgetary planning framework covers only the sub-sectors that are part of the state budget - the central government budget and the budgets of state agencies. The adopted declaration for 2025-2027 also contains indicators for local budgets for 2025-2027. Still, the information is presented separately from the state budget indicators and is not aggregated into data on the general government sector. **This time, the declaration also does not contain information on social fund budgets.**
- The medium-term budgetary planning framework should contain consistent and complete information on the state and forecasts of finances of all subsectors of the general government sector, including local budgets and social fund budgets.
- This information should be collected in a unified manner, using the same accounting and reporting procedures, to ensure that the data collected is correct and comparable.
- Mechanisms for coordination between sub-sectors are needed to ensure that all areas of medium-term planning, fiscal rules, and forecasting are fully covered.

# CONCLUSIONS AND RECOMMENDATIONS

## KEY RECOMMENDATIONS (1)

- **Monetary policy:**
  - To continue implementing the strategy of transition to inflation targeting and flexible exchange rate regime.
  - To introduce a judicial procedure for dismissal of the NBU Council members to prevent unlawful dismissals and thus strengthen the NBU's independence.
- **Macroeconomic forecasting:**
  - To add a section to the Budget Declaration that considers different macroeconomic scenarios and their impact on the budget. The Ministry of Economy is already preparing such scenarios, but an estimate of their fiscal impact is needed.
  - Introduce a practice of regular, unbiased assessment and post-assessment of macroeconomic and fiscal forecasts.
- **Quantitative fiscal rules:**
  - To describe in the Budget Code the consequences of violating fiscal rules and the mechanism for reintroducing them in case of their violation.
  - To entrust the Fiscal Council (or another institution) with monitoring compliance with the rules and independent assessment of the processes related to budget planning and execution, including the implementation of fiscal rules.

## KEY RECOMMENDATIONS (2)

- **Medium-term budget planning:**
  - To include in the medium-term budgetary framework all entities of the general government sector in the EU sense, namely local budgets and budgets of social funds, in the form of separate data and consolidated indicators for the general government sector.
  - To revise the strategic planning system to define the objectives of budget expenditures better and reflect them in the medium-term budget framework, including policy descriptions.
  - To supplement the Budget Declaration with a forecast of expenditures by functional classification, separately by sub-sectors and for the general government sector.
  - To supplement the Budget Declaration with an assessment of the long-term impact of policies on public finances.
- **Transparency of public finances and comprehensiveness of the "budget framework":**
  - To ensure that the medium-term budgetary framework provides consistent and complete information on the financial situation and forecasts of all sub-sectors of the general government, including local budgets and budgets of social funds, collected uniformly, using the same accounting and reporting procedures to ensure the correctness and comparability of the data collected in a form that meets the requirements for submission to EU statistics.
  - To supplement the Budget Declaration with an analysis of the impact on the general government budget of the finances of state bodies and funds that are not part of the general government budgets.
- **Intersectional topics - statistics :**
  - The quality of public finance statistics can be improved by implementing ESA 2010 standards.
  - In addition, Eurostat data must be regularly provided, and key indicators for the macroeconomic imbalance procedure (MIP) must be published.